The Crazy Airline Industry
My Background

- Eleven years as CEO of Spirit Airlines
- Six Years at US Airways
- Three Years at TACA
- Three Years at Continental
- Early Years at American, Northwest, and UPS
- Syracuse University ’84 and Princeton ’86
- Grew up in Rome, NY
## Airlines Then and Now

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How Did We Get Here?
From the Wright Brothers until 1978, airline travel in the US was regulated. The Civil Aeronautics Board had to approve routes flown and prices charged.

Southwest and PSA airlines were not subject to this regulation because they operated only within the states of Texas and California respectively.
1978 Airline Deregulation Act

- Cornell Economist Alfred Kahn Made the Academic Case
- Southwest and PSA used as “models”
- Democrats Crafted the Legislation
- President Jimmy Carter Signed into Law
- Transformed the Industry in Many Ways
1979 - 1991

Innovation...

Yield Management

Hub & Spoke Scheduling

Frequent Flier Programs

Computerized Reservation Systems
1979 - 1991

... And Early Consolidation
1979 - 1991

Bob Crandall, CEO of American Airlines, was the industry leader in this period.
1992 - 2000

Early Losses...

...Late Period Success

...First Alliances Form

...JetBlue Breaks New Ground
• Changed the World
• Changed Airline Security
• Changed Travel Patterns
• Shrank Air Travel Demand
The Terror Attacks on 9/11 Had A Transformational Impact on the Airline Industry

2002 - 2012

- Huge Demand Drop
- New Security Rules
- Froze Access to Capital
- Tens of Thousands Laid Off

ATSBI Created to Give Airlines Access to Capital
2002 - 2012

Oil Reaches $147/Barrel in 2008

Between Demand Drop and Oil Price, Airlines Lose $Billions

Most Major Airlines Used Chapter 11 Bankruptcy Protection!
2002 – 2012
Consolidation

These Four Airlines Now Carry >80% of All US Travel!
2012 - Today

Profitable and Stable, For the Most Part

Four Big Airlines: AA, UA, DL, Southwest 80%

Four Small but Growing ULCCs: Spirit, Frontier, Allegiant, Sun Country 5%

Three Hybrids: JetBlue, Alaska, Hawaiian 15%
Airline Industry’s “Mount Rushmore”

Robert Crandall
American Airlines

Herb Kelleher
Southwest Airlines

Alfred Kahn
“Father of Deregulation”

Frank Lorenzo
Continental and Eastern
When “Crazy” Makes Sense:
Airline Economics
Big Idea #1

Airlines are like a Factory

The Product they Produce is an ASM - Available Seat Mile

An ASM is One Seat flying One Mile
Airlines Use “ASMs” To Measure

Unit Revenue – RASM

Unit Cost – CASM

Load Factor – % of ASMs Filled
In standard Micro-economics theory, price approaches marginal costs in a fully competitive market for similar goods. Marginal cost is the cost to produce more unit of a product. In this case, one more burger.
Big Idea #2

Airlines have **High Average Costs** but

very **Low Marginal Costs**

What drives Airline Prices?
This idea was used to show that tax rates could be lowered while keeping government tax revenue the same.
Setting the Right Price

If airlines charge zero, they get zero. If they charge $1M per ticket, they also get zero. So in between is a theoretical optimal price.
Setting the Right Price

Airlines Would Set the Price that Drives the Highest Revenue, of course
In the 80s and 90s, Southwest would set the price where they could make money but their higher-cost competitor could not, driving them out of the market.
We All Have an Idea of What Most Things Should Cost. Decades of Airlines Pricing Towards Marginal Cost Has Distorted Airline Reference Prices.
Big Idea #3

**Price Elasticity** means that as **Price** changes, **Demand** changes. This amount can be measured!

Airline Customers are Elastic!
Elasticity Example

Dallas to Chicago

1000 Passengers Every Day @ $200

1450 Passengers Every Day @ $150

A **25%** Reduction in the Price Produced almost **50%** more Demand!
Big Idea #4

**Consumer Surplus** is the gain, or “welfare” created when you pay **LESS** for something than you would.

Airlines try to keep all of this!
The lower the price, the more demand for a product, according to basic economic theory.
Consumer Surplus Theory

If a company sets one price, everyone pays the same. Some people pay less than they otherwise would and some demand is not serviced because the price is too expensive.

People in this part of the demand curve “get a deal” because they would pay more but don’t have to.

Demand here is not serviced because the price is too high.
Consumer Surplus Theory

Some People Pay Less Than They Would, and Consumers Benefit By This Amount
More Prices Means Less Consumer Surplus

![Graph showing the relationship between price and quantity demanded. The graph illustrates that as price increases, the quantity demanded decreases, leading to a reduction in consumer surplus.](image-url)
More Prices Means Less Consumer Surplus

Price

Quantity Demanded

With this new higher price, the supplier takes back this much of the consumer surplus
More Prices Means Less Consumer Surplus
And Increased Demand Potential

With this new lower price, the supplier can now service new demand
This Process is Called “Yield Management”

Airlines use **Segmented Fares** and try to measure every customer’s **Price Elasticity** so that every customer pays as much as they will.

Customers reveal their **Elasticity** in their purchase choices!
Other Important Airline Ideas

**Oversales** result when there are more passengers than seats.

Prices are **Transparent** and Airlines use a company called **ATPCO** to Distribute their fares.

**Ancillary Revenue** has become very important!
Fees, Fees, Fees!

Why do Airlines Use So Many Extra Fees?

- Different Price Elasticity
- Lowers Base Fares
- Harder to Compete
- Lets Customers Only Pay for What They Use
- Saves Taxes, too!
Big Idea #5

Bigger is Better when it comes to attracting passengers.

Airlines use Alliances and Codesharing to get bigger using partners.
Major Alliances

- Started by **Northwest** and **KLM** back in the early 1990s...

- Now Three Big Alliances:
  - Delta + Air France and many more
  - American + British Airways and many more
  - United + Lufthansa and many more
Our Government Protects US!
Our Government Protects US?
The **US Department of Transportation (DOT)** tracks and reports on many airline operations:

- On-Time Performance
- Lost Baggage
- Oversales
- Complaints
Why “On-Time” is not “Reliable”

Option 1: Every flight is exactly 15 minutes late

DOT says this airline is 0% On-Time!

Option 2: 10% of flights are late, but are late by four (4) hours each

DOT says this airline is 90% On-Time!

Which Airline Would You Likely Choose to Fly?
Most Airline Craziness Makes Some Economic Sense!

- Bag Fees
- Small Seats
- Delayed Flights
- Crazy Pricing
- No Food
Questions?