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

Then	Now
Mostly High Fares	Lots of Low Fares
Lots of Airlines	Not Many Airlines
Opulent Service	Bare-bones Service
Pianos onboard	Wi-fi onboard
Delays	Delays

How Did We Get Here?

1903 - 1978

From the Wright Brothers until 1978, airline travel in the US was regulated. The Civial 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

PSA AIRLINES

MOHAWK AIRLINES

HUGHES AIRWEST

PIEDMONT

PEOPLExpress

REPUBLIC AIRLINES

MuseAir

Empire AIRLINES

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 …JetBlue Breaks New Ground

- Changed the World
- Changed Airline Security
- Changed Travel Patterns
- Shrunk Air Travel Demand

2002 - 2012

The Terror Attacks on 9/11 Had A Transformational Impact on the Airline Industry

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

ATSB 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%

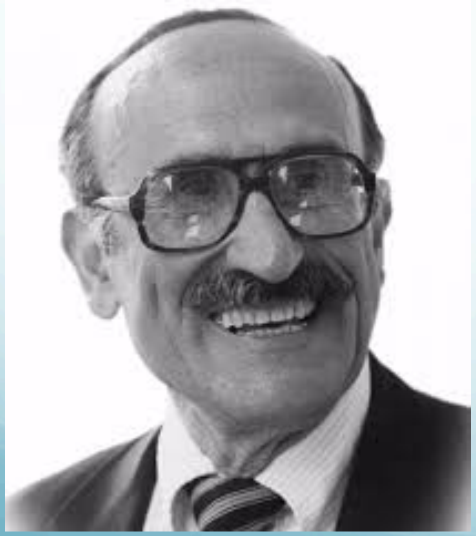
Airline Industry's "Mount Rushmore"

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

Average Cost and Marginal Cost

$4.50

$5.00

Avg. Cost:	$2.48		Avg. Cost:	$4.36
Marg. Cost:	$0.42		Marg. Cost:	$0.44

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 more unit of a product. In this case, one more hamburger.

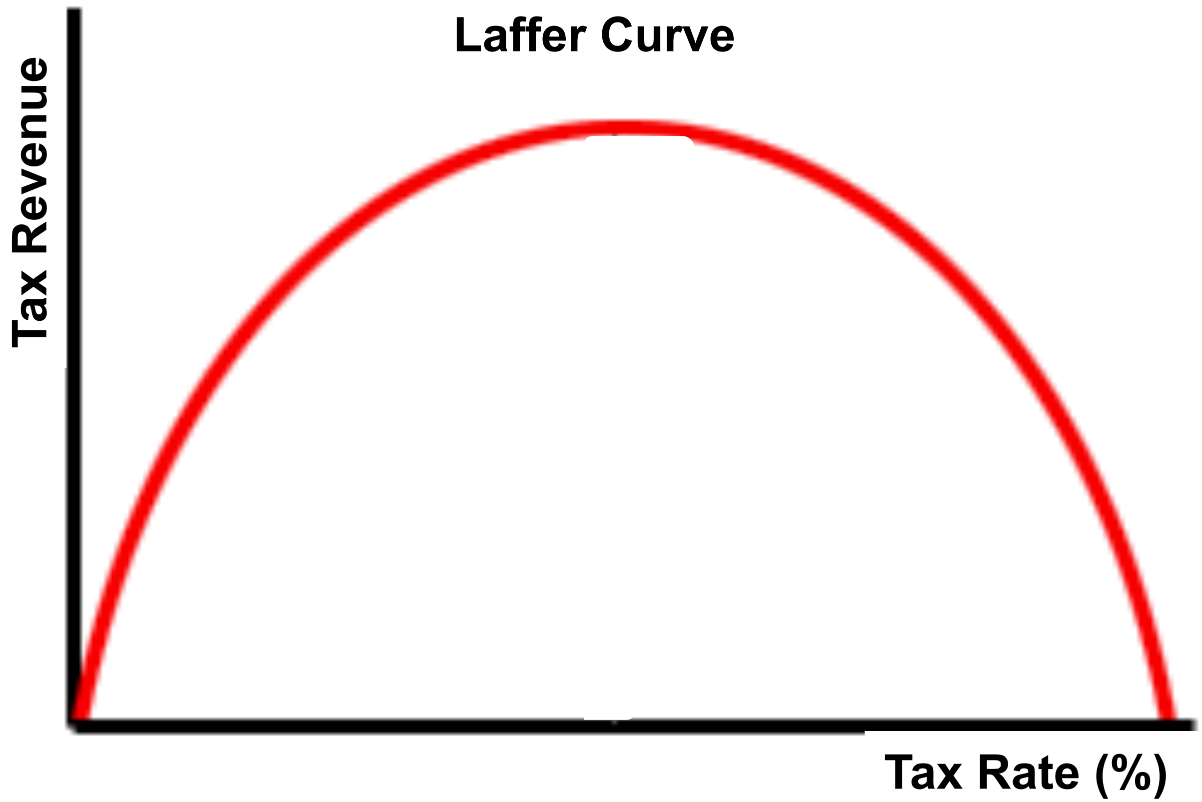
Big Idea #2

Airlines have **High Average Costs** but

very **Low Marginal Costs**

What drives Airline Prices?

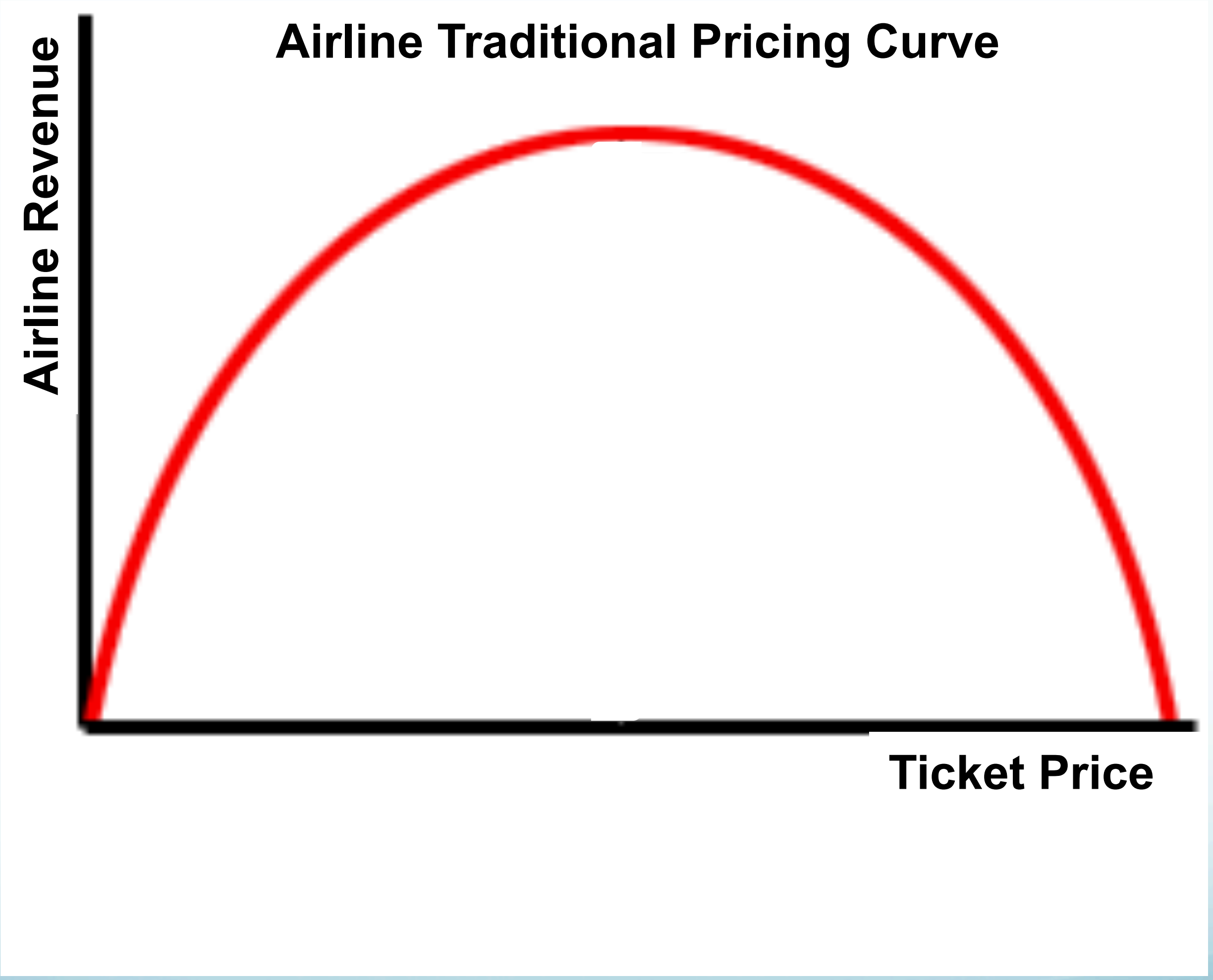
Setting the Right Price



This Drove “Reaganonomics” in the 1980s

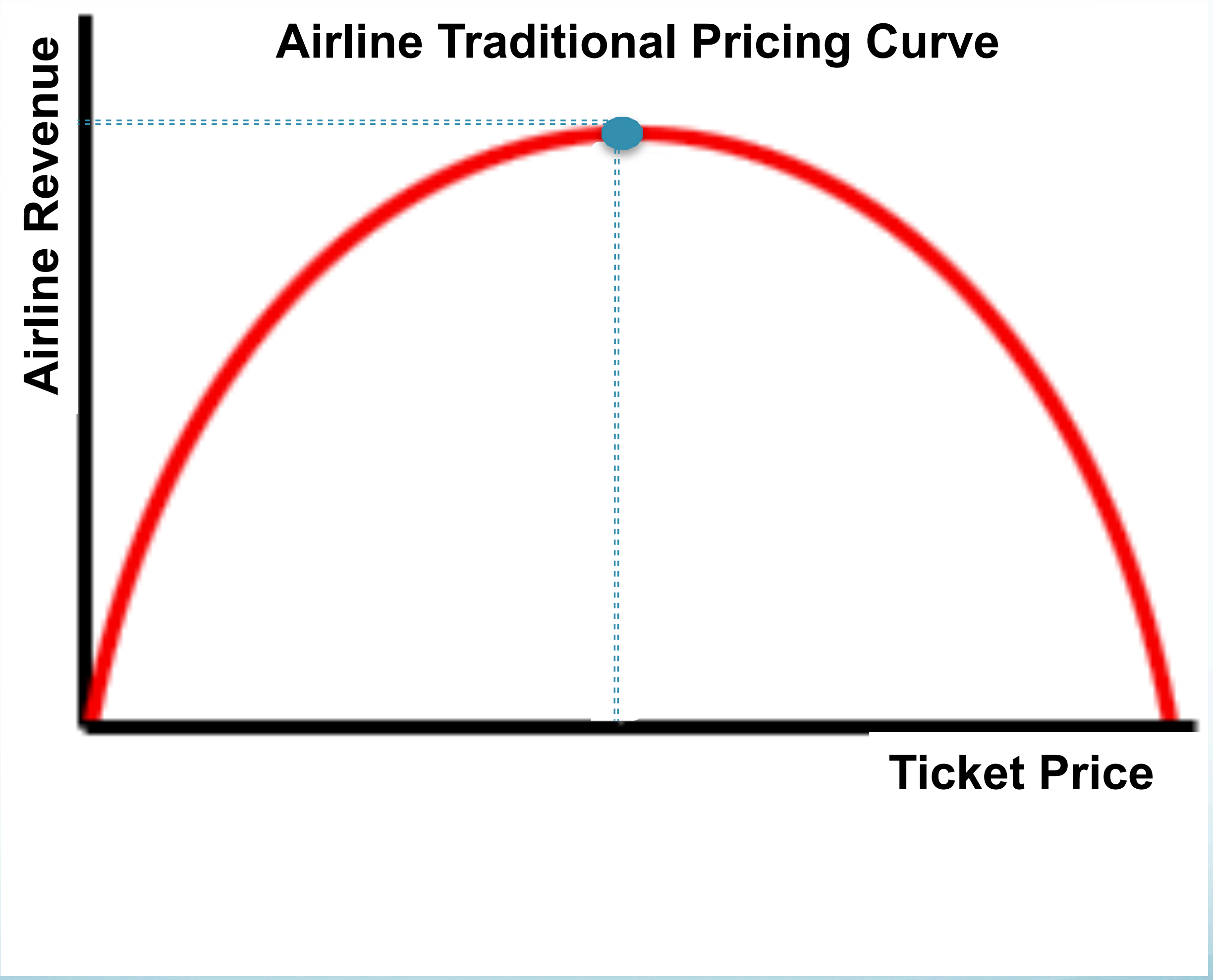
This idea was used to show that tax rates could be lowered while keeping government tax revenue the same.

Setting the Right Price



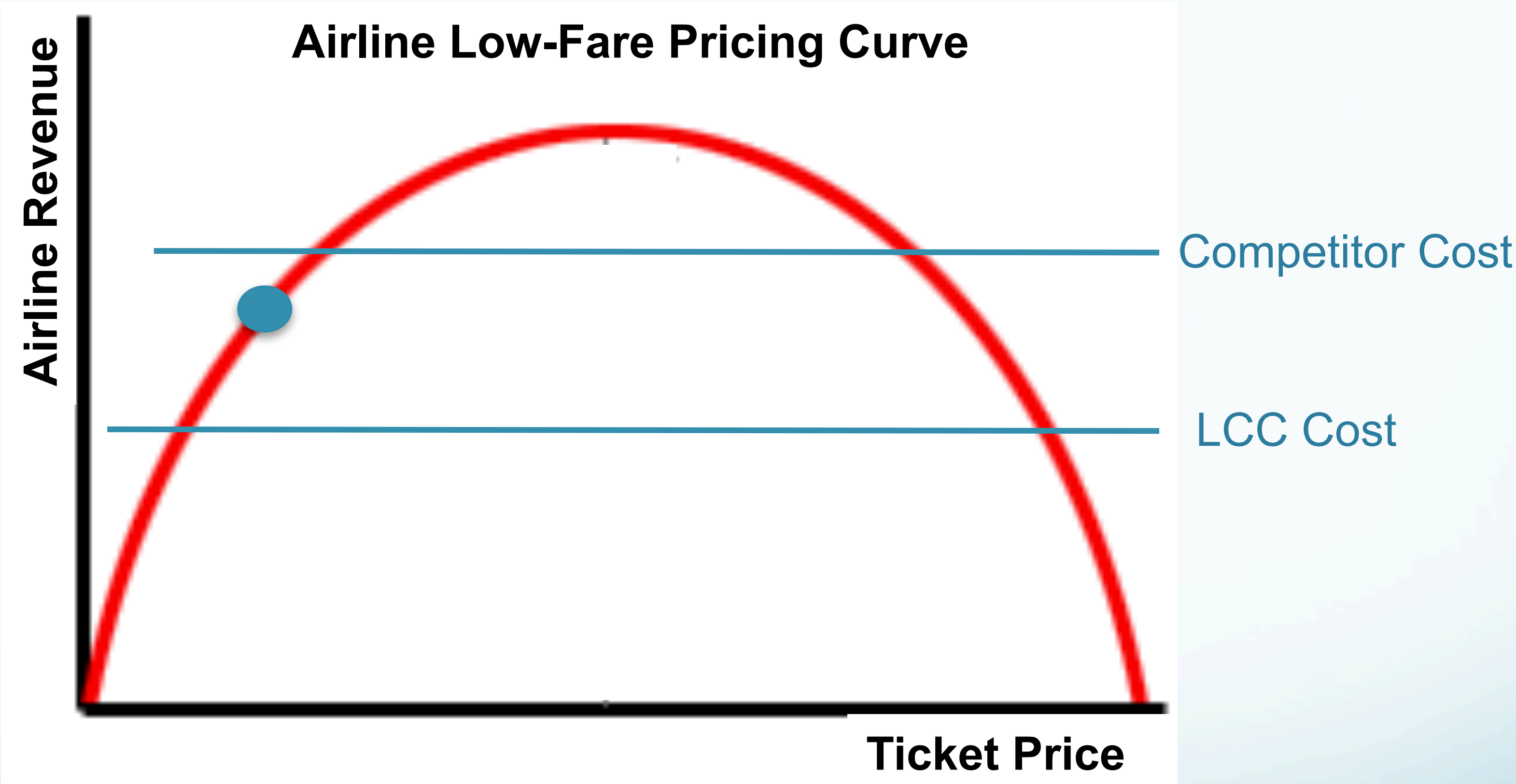
If airlines charge zero, they get zero. If they charge $1M per ticket, they also get zero. So in between is a theoretical optimal price.

Setting the Right Price



Airlines Would Set the Price that Drives the Highest Revenue, of course

Setting the Right Price



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

Reference Prices

What's Wrong Here?

On Sale today for just $99.95!

Come have lunch for just $99.95 per taco!

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!

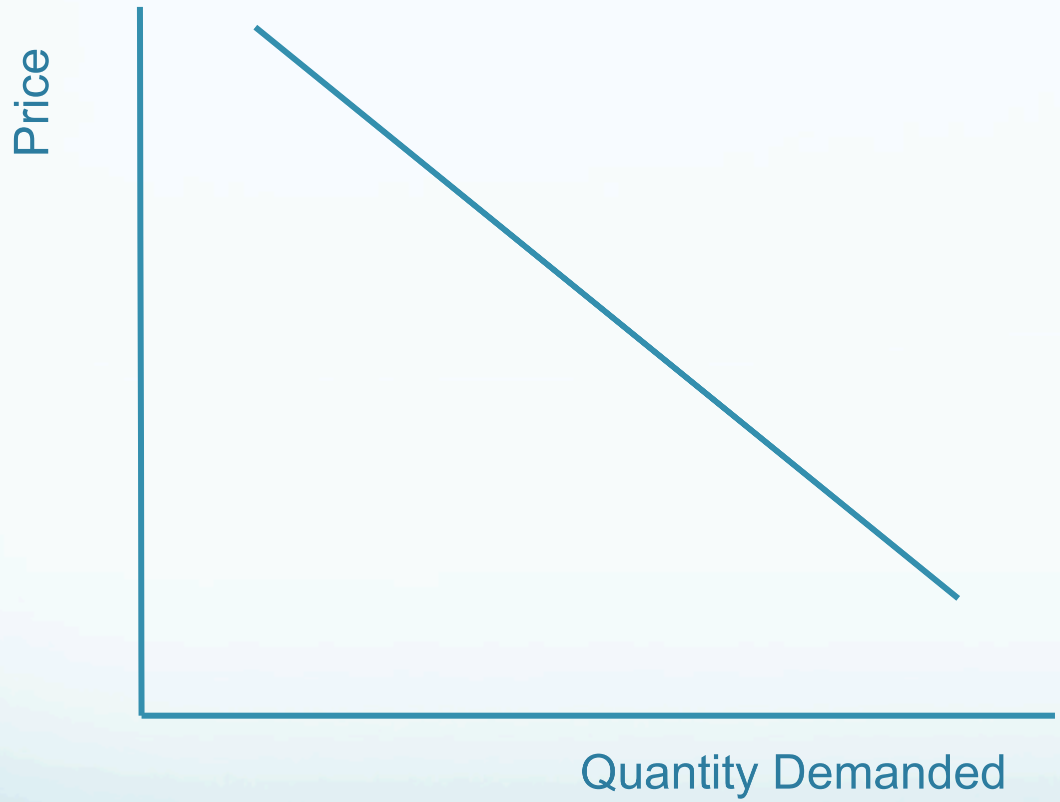
Big Idea #4

Consumer Surplus is the gain, or "welfare"

created when you pay **LESS** for something than you would

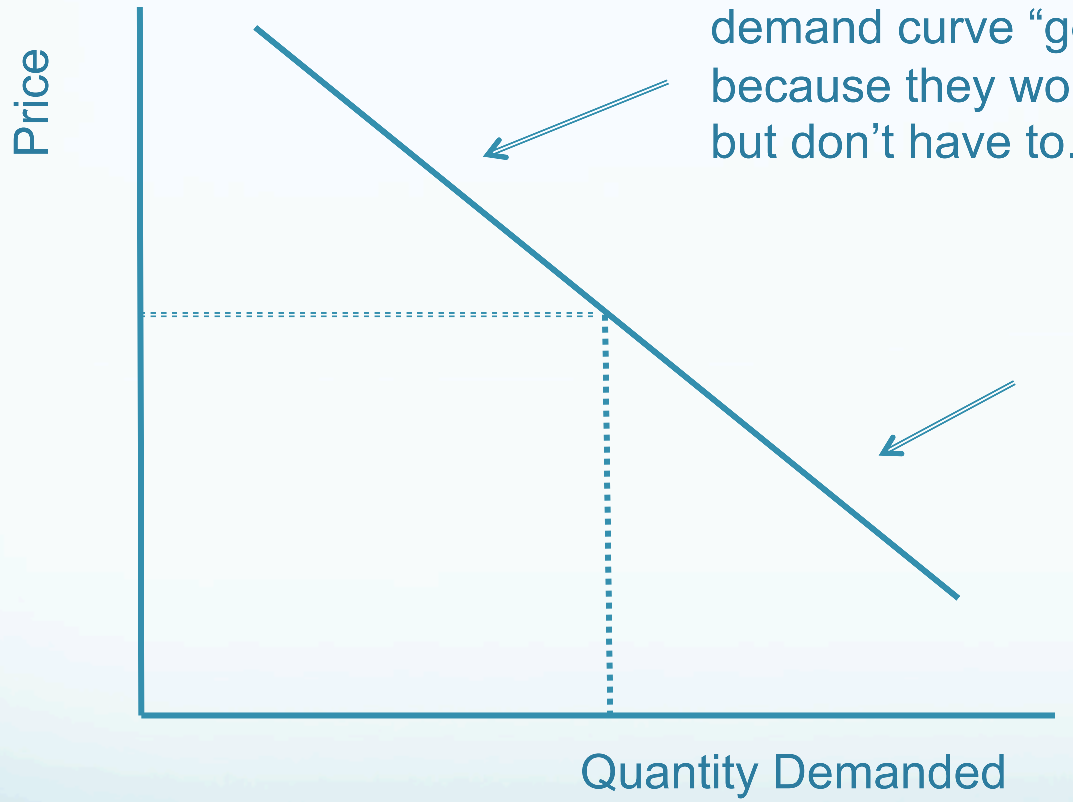
Airlines try to keep all of this!

Demand Curve



The lower the price, the more demand for a product, according to basic economic theory.

Consumer Surplus Theory

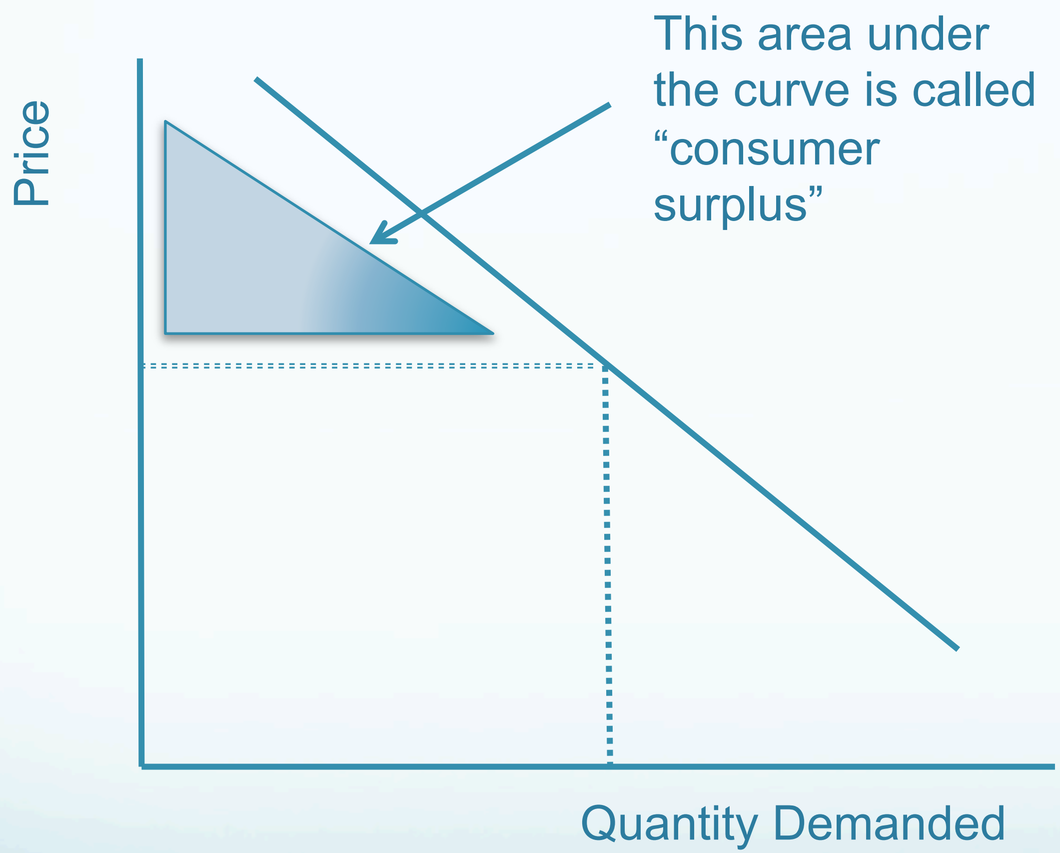


People in this part of the demand curve “get a deal” because they would pay more but don’t have to.

Demand here is not serviced because the price is too high.

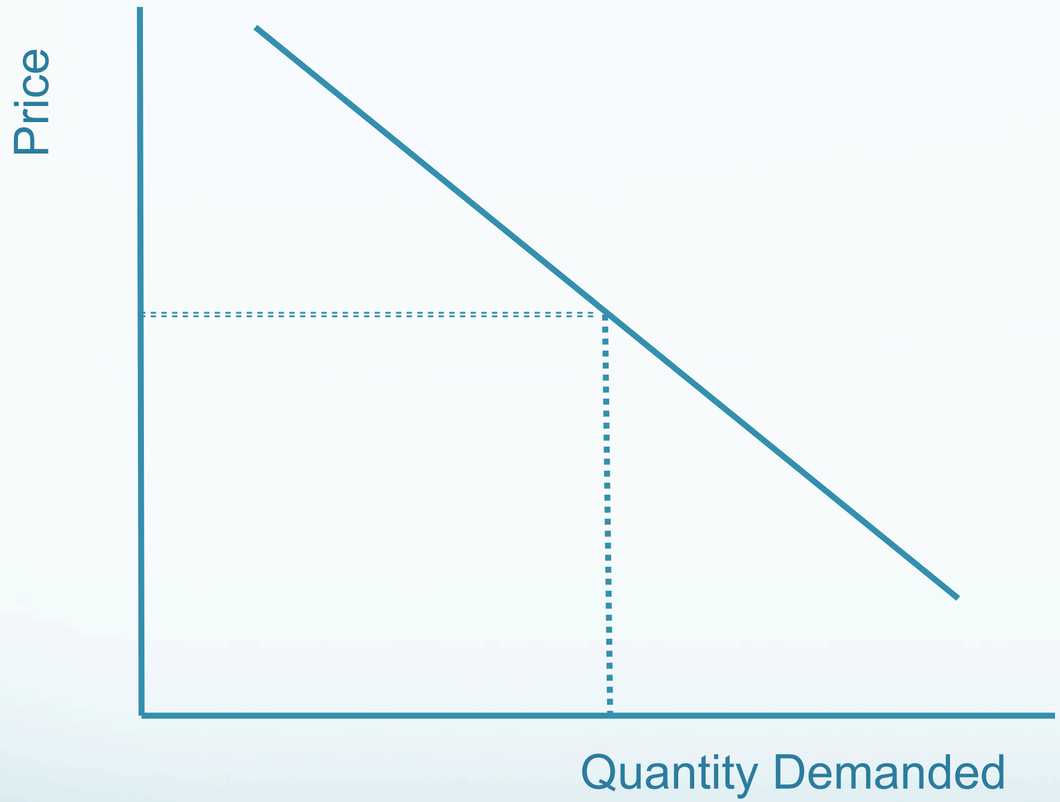
If a company sets one price, everyone pays the same. Some people pay less than they otherwise would and some demand is not serviced because the price is too expense.

Consumer Surplus Theory



Some People Pay Less Than They Would, and Consumers Benefit By This Amount

More Prices Means Less Consumer Surplus



More Prices Means Less Consumer Surplus

More Prices Means Less Consumer Surplus And Increased Demand Potential

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 in 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?

DOT Measurements

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?