



Airfare Reform – The Wrong Answer To The Right Question

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The Association of Corporate Travel Executives (ACTE) released a white paper last week calling for reforms to the way airlines price their fares. The paper's goal is to lay a path for helping the airline industry return to profitability. Taking the paper's path would be a major mistake for the airline industry and its customers.

Let's start with the basic formula of Revenue - Cost = Profit. The right question is how can the airline industry improve its profits. For now, the wrong answer is to focus on the revenue side of the equation. The solution to the industry's problems must first come from a radical restructuring of the cost side. Only then can the industry afford to look at changing its pricing structure.

Calls for reforming airfares, when boiled down to their essence, are pleas for lower and simpler prices. Both features sound good on the surface, but in fact are counter-productive.

There is no reason to believe that simplifying airfares will increase the amount spent by travelers; nor will simplifying airfares lead to any significant cost reductions. In fact, simplifying airfares will do more harm than good. To simplify you have to reduce variety. Reducing variety means reducing choice. Reducing choice creates economic waste because supply cannot be matched with demand.

In an industry that has to set prices against the need for over 100 million trips each year, it should be obvious that the industry's pricing mechanism must be complex. How else can an airline hope to meet the diverse demand for its product? Trying to force the airlines to offer only a few fares is like trying to tell the auto industry to sell its wide variety of car models using only four or five price points. It doesn't make sense for cars, or for airlines, or for most other industries.

Surprisingly, lowering business fares is not the answer either. Business people may take more trips if fares are lower, of course. But this does not mean companies will spend more money overall on air travel. Most

companies either manage travel budgets explicitly, or manage them implicitly as part of a larger budget category. Everything else being equal, for a company to spend more on travel it must spend less somewhere else.

When food prices drop, most families do not spend more on groceries. Instead, they are happy to take the savings on groceries and use them in some other part of their household budget. Business travel, like groceries, must be viewed as being inelastic. The airlines clearly believe this, or else they would have reduced fares in an attempt to drive revenue into the industry.

Instead of spending more on travel, companies are far more likely to squeeze more trips out of their existing travel budgets. They do this by having travelers plan farther in advance, accept more restrictive tickets, and spend more time looking for low fares – exactly the behavior that the industry is seeing today.

The implication for the airline industry should be clear. Lowering fares will reduce the industry's revenues while increasing the number of passengers carried. This combination of lower revenues and higher costs is exactly the opposite of what we need for a profitable airline industry.

So if neither simplifying nor lowering airfares are the right answer, what is? The right answer is to use the tight relationship between airline labor and airline capital to drive down the amount spent on both.

Start by convincing the unions at one major airline that bankruptcy looms, and that their jobs are all in jeopardy unless the labor unions make significant concessions on the key issues of wages, job security and scope clauses. At the same time, the airline's management must be allowed, even required, to reduce its capital and operating costs by significantly reducing its fleet size.

Once the first carrier gains the concessions - perhaps by going into bankruptcy, perhaps not - the other major carriers will likely follow quickly in order to get the same competitive labor cost advantages that the first carrier gets. Just the prospect of this scenario may be enough to crack open the concessions needed from airline labor unions. But then airline management absolutely must go against its nature and in fact reduce fleet sizes significantly.

The forces of capitalism will eventually sort out the industry's assets into a smaller but more profitable and sustainable collection of airlines. This will not be a pleasant path forward. But unless the economy booms, it appears the airline industry has run out of other options.