

Legacy Carriers Fight Back: pricing and product differentiation in modern airline marketing

by

Tim Hazledine

Department of Economics

The University of Auckland

t.hazledine@auckland.ac.nz

for

GARS Workshop: New issues in airline and
airport economics

Hamburg

February 11, 2009

Why haven't LCCs conquered?

- Market penetration stuck @ 20-40%?
- LCCs account for only 10% of $\Delta\pi$ of legacy carriers, 1999-2006 (Berry & Jia, 2009)

This paper:

- Looks at two legacy carriers that are coping successfully with LCCs (actual or threat)
- Goes beyond usual focus in US (and European?) studies of simple price impacts
- See how Air NZ and Air Canada have cleverly exploited their natural advantages as national legacy carriers, plus internet B2C marketing

LCCs' biggest impact

Cheap one-way fares (MT)

- *It's SOS for SNS!*
- *Air New Zealand the first to respond
(actually had cheap OW fares for a decade,
but...)*
- *Air NZ in desperate straits after failure of
Ansett, 2002.....*

November 2002, AirNZ rolls out *Express Fare System.....*

- Pared back product
- Just three fare types
- Four price points in each type
- Everything OW
- Everything (incl FFP rewards) easily accessible from airline's website
- Accompanied by "Being There" marketing

Can change price without changing prices

TABLE 1: Prices observed on Air New Zealand, November-December 2004, NZ\$

| route | distance (kms) | daily number of flights | SuperSaver fare class | | | | FlexiSaver fare class | | | | Fully Flexi fare class | | | |
|-------------------------|----------------|-------------------------|-----------------------|-----|-----|-----|-----------------------|-----|-----|-----|------------------------|-----|-----|-----|
| | | | 109 | 129 | 139 | 169 | 199 | 219 | 239 | 279 | 299 | 399 | 479 | 559 |
| Auckland-Dunedin | 1062 | 12 | | | | | | | | | | | | |
| Auckland-Napier | 328 | 11 | | | 86 | 96 | 106 | 126 | 146 | 176 | 206 | 226 | 246 | 306 |
| Auckland-Queenstown | 1023 | 6 | 128 | 148 | 168 | 188 | 218 | 248 | 278 | 308 | 338 | 488 | 608 | 708 |
| Auckland-Wanaka | 1000 | 1 | | | 155 | 185 | 215 | 245 | 275 | 315 | | 375 | 485 | |
| Auckland-Wellington | 480 | 19 | 90 | 100 | 110 | 120 | 150 | 170 | 190 | 200 | 230 | 280 | 330 | 360 |
| Christchurch-Queenstown | 347 | 6 | 84 | 94 | 104 | 114 | 144 | 164 | 184 | | 229 | 254 | 276 | 314 |
| Christchurch-Wanaka | 294 | 1 | 86 | | | | 136 | 156 | 186 | | | 242 | 276 | |
| Wellington-Christchurch | 303 | 13 | 70 | 80 | 90 | 100 | 120 | 140 | 150 | 160 | 180 | 220 | 260 | 290 |

Radical idea: increase profits by moving down the demand curve!

“Simplicity is the essence of affordable travel. Fare structures were extensively simplified and prices reduced by an average of 20% and up to 50%.... Savings of around 21% for our business travellers... everyday low fares stimulated traffic by 22%... capacity increased by 10%. (Air NZ Annual Report 2003)

Sounds like LCC strategy, but..

Express went to places that LCCs can't go

- Air NZ a truly national carrier with a complete regional network
- Exploited non-linearities in advertising and websites
- Express copied by Qantas, extended to Tasman routes
- Air NZ highly profitable domestically (LCC didn't enter until 2007...)

AirNZ earns fare premium over its rivals!

On domestic and trans-Tasman routes, after controlling for other factors (distance, HHI, demand shifters)

- Air NZ earned 10% price premium over Qantas; 20% over Pacific Blue, Emirates
- Even larger premia at the business end of the market
- No problem price discriminating!

Enter Air Canada...

- Express Fares eliminated one of the spoiled-product attributes of SNS
- But it still bundled features into its higher price fares which not all travellers want

In 2006 [?] Air Canada introduced its own new fare system

- Superficially looks like Air NZ, but....

Air Canada's three economy "fare products"

- Tango, Tango+, Latitude
- Actual "products" each with 'at least five options'
- Encourage "buy-up" from Tango to Tango Plus
- But large price differential between Tango Plus and Latitude

so does Air NZ have large differences in price of fare classes, but:

- Unlike Air NZ, Air Canada keeps its Tango+ product on the market right up to flight date (tho may cost more than Advanced purchase Latitude fare)
- So the last-minute customers who purchase Latitude fares almost always could pay \$200 less for a Tango+ fare!
- *Big agency problem for employers...*

Creating a product out of nothing...

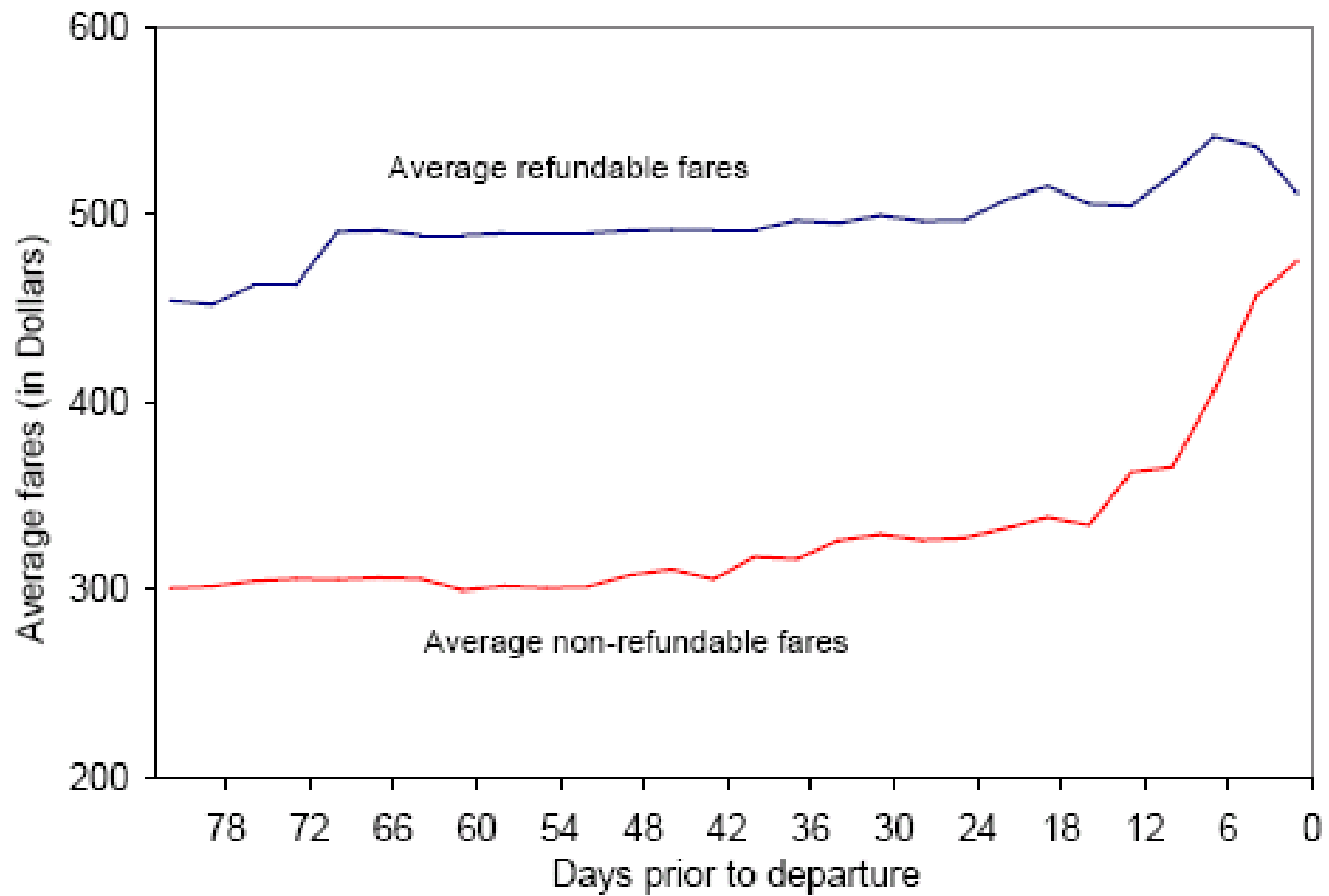
The \$200 domestic Latitude fare premium must be close to pure profit at the margin

- Non-linearities in supplying Business Class, FFP, Lounges
- So opportunity cost of supplying upgrades and reward seats etc rather low at the margin
- Note differences in trans-border routes!

Table 3: Air Canada's Strategic Product Enhancement

| | Tango+ fare, 22 days before take- off | Latitude fare, 22 days before take-off | Tango+ fare, 1 day before take- off | Latitude fare, 1 day before take-off | Price of frills 22 days before take- off | Price of frills 1 day before take-off |
|---------------------------|--|--|--|--|---|---|
| Canada monopoly routes | 473 | 686 | 648 | 846 | 213 | 197 |
| Canada duopoly routes | 302 | 480 | 430 | 619 | 178 | 189 |
| Trans-border routes | 309 | 517 | 767 | 858 | 209 | 91 |
| All routes | 336 | 529 | 564 | 722 | 193 | 158 |

Data from Gillen & Hazledine (in progress), prices observed on Air Canada website for 46 domestic Canadian and 27 trans-border routes; 380 flight numbers; each flight observed four time from 22 days to 1 day before take-off, on three Wednesdays in October, 2007

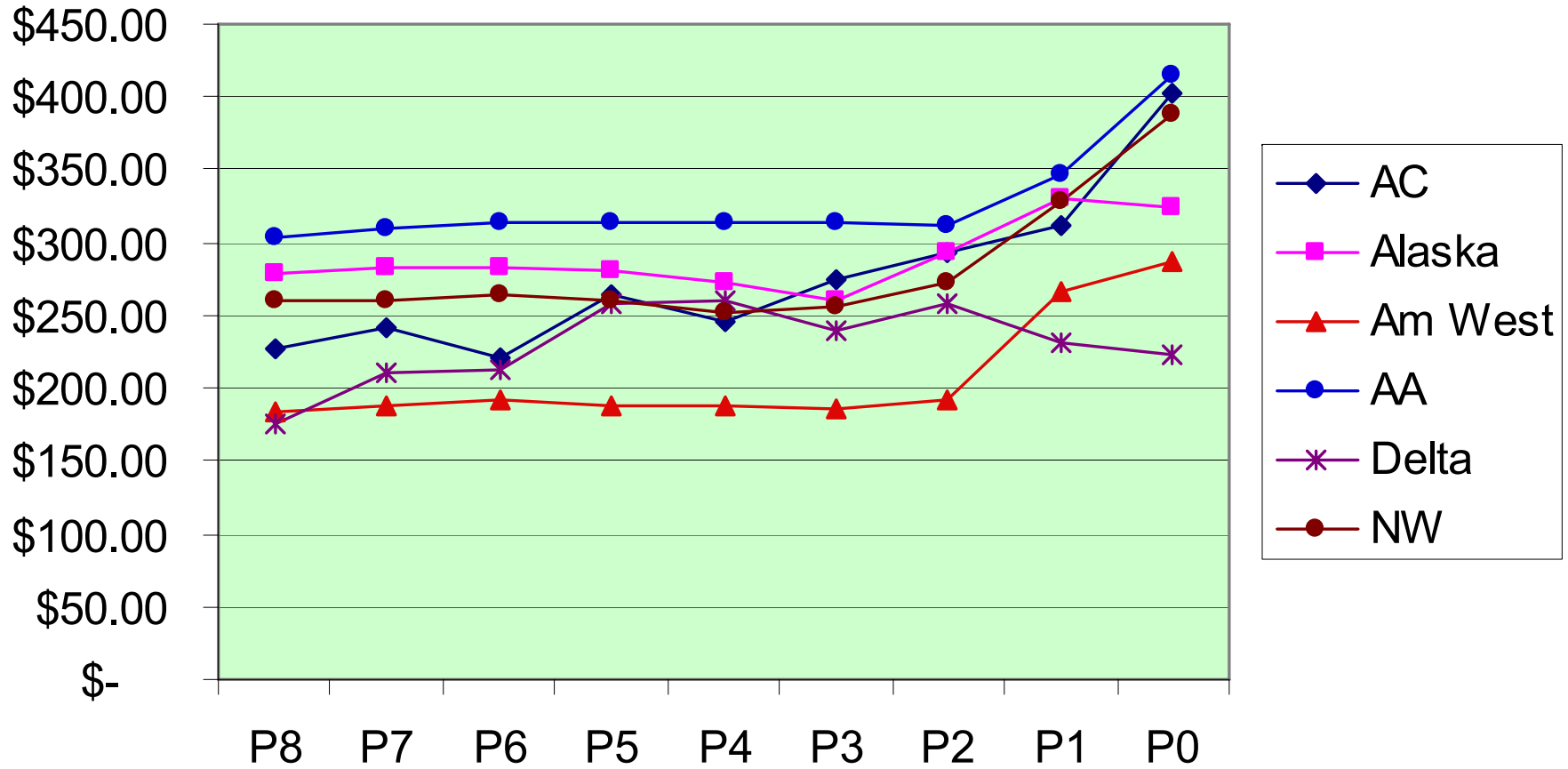


Conclusion

“reports of the death of the legacy carrier model are exaggerated”

Well-run legacy carriers can capitalise on their inherent advantages to create valuable products not accessible to LCCs, while still matching or close to matching LCCs on no-frills fares

Fare by Carrier LAX-YVR May 2006



Average Fare by Carrier YYZ-LGA May 2006

