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Airline Pricing Primer:
Fare Rules and Segmentation

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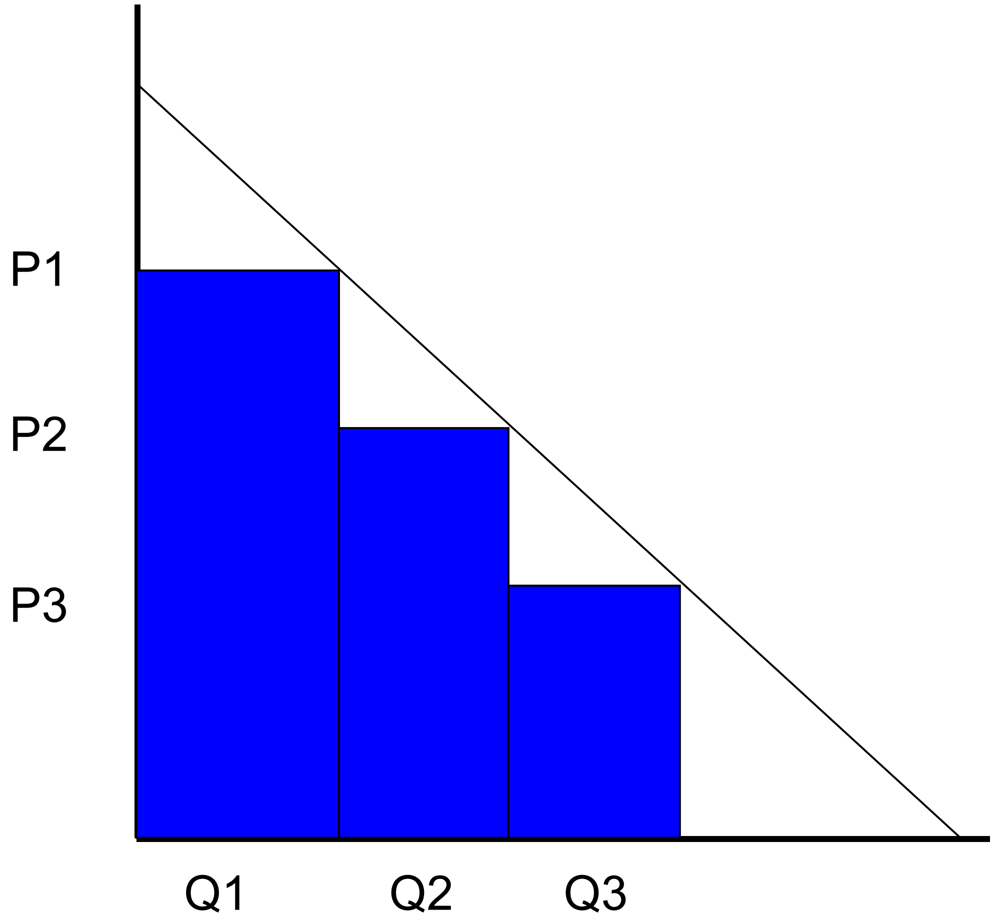
Differential Pricing of Airline Tickets



- Demand segments with different “willingness to pay” for air travel
- Different “fare products” offered to business versus leisure travelers
- Airlines prevent diversion by setting restrictions on lower fare products and limiting seats available
- Increased revenues and higher load factors than any single fare strategy

Differential Pricing Benefits Airlines and Consumers

- Allows the airline to increase total flight revenues with little impact on total operating costs:
  - Incremental revenue generated by discount fare passengers who otherwise would not be able to fly
  - Incremental revenue from high fare passengers willing to pay more
  - Most airlines could not cover total operating costs by offering a single fare level to all passengers
- Consumers also benefit from differential pricing:
  - Most notably, discount passengers who otherwise would not fly at higher fares
  - At the same time, high fare passengers pay less and/or enjoy more frequency and availability given the presence of low fare passengers

Market Demand Segmentation and Fare Rules

- Successful differential pricing depends on effective ways to identify different demand segments:
  - Business vs. leisure travelers are two traditional segments, still the most important distinction for pricing purposes
  - Possible to increase revenues with more segments, prices and products, but it is difficult to keep additional segments separate
- Airlines apply stricter rules on low fare products to keep business travelers from purchasing them ("diversion"):
  - Lowest fares have advance purchase and minimum stay requirements , as well as cancellation, change fees, and non-refundability
  - These rules increase the inconvenience or "disutility cost" of low fares to travelers with high WTP, so they choose fares with fewer restrictions

Example: Fare Rules Help to Segment Demand

Fare Class	One-way Fare	Advance Purchase	Round-trip Required	Minimum Stay	Refundable
Y	$500	--	--	--	Yes
B	$375	7 days	--	--	No
M	$240	14 days	Yes	3 days	No
Q	$169	21 days	Yes	Sat. Night	No

- Business passengers unwilling to stay 3 days or more will not buy M or Q. Those needing full flexibility will choose Y.
- M, Q fares are still attractive to leisure passengers even with more restrictions.

Low-Cost Carriers “Simplified” Fares by Eliminating Minimum Stay and Round-trip Rules

Fare Class	One-way Fare	Advance Purchase	Round-trip Required	Minimum Stay	Refundable
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- Such simplification has made airline pricing more reliant on advance purchase and (non-) refundability to segment demand
- Even LCCs all make extensive use of AP rules and refundability to differentiate their fare products

Summary: Differential Pricing of Airline Tickets

- Differential pricing benefits both airlines and consumers
  - Airlines increase revenues and load factors
  - More leisure travelers can afford to fly by purchasing lowest fares with acceptable restrictions
  - Business travelers get more choice of flight and fare options, and lower fares given presence of leisure passengers
- Fare rules are critical to effective differential pricing
  - Various restrictions on lower fare classes are needed to ensure only leisure passengers purchase them
  - Low-Cost competitors eliminated several powerful segmentation tools, putting greater importance on advance purchase and refundability differences between fare classes