Airline Marketing - The Economics of Unbundling and Ancillary Fees

- **Unbundling enables discriminant pricing on service attributes**
- **Airlines just break even without ancillary fees**

Discriminant pricing or product-price differentiation is the underpinning of revenue management. Unbundling takes this to a new level and dimension.

As background, the maximum amount that a person is willing to spend on a product or service, for example, travel from A to B on terms quoted on date C purchased D days in advance of departure, is called that person's reservation price. That person's reservation price can also be represented as a probability distribution (the probability of a customer purchasing travel at a price and set of terms).

If travel is sold at a single price P, all potential customers with a reservation price less than P will not buy the travel (resulting in demand destruction) and the airline fails to fully realize the revenue opportunity from all customers with a reservation price higher than P, who would have willingly paid more.

Thinking out loud about the demand curve for travel A-B on terms C and D, the total area under the curve is the maximum amount of revenue that can be realized if each potential customer is fully exploited at respective reservation prices.

Achieving this would require a nearly infinite number of prices, and is impractical. By contrast, if a single price, P was chosen, with the associated number of units sold being N, the area within a rectangular area (P, N) represents the revenue that would be realized. For any given single price, the area within the single rectangle is significantly less than the total area under the demand curve.

In revenue management, numerous price points are offered to sell the same service, differentiated on terms. These different prices are rationalized by differences in associated terms and services that the customer receives and purchases under. This is called multiple discriminant pricing or product-price differentiation.

By summing up proceeds from demand (N1, N2, N3, ...) at multiple prices (P1, P2, P3, ...) on different terms and with different features, filling in more boxes, so to speak, more of the area underneath the demand curve is captured, resulting in greater revenue realization. Customers are differentiated by the price they will pay for the service.

The same idea applies to unbundling. Unbundling (theoretically) lowers costs, can (economically) shift the demand curve to a lower price point yielding higher demand, and also creates via an added services dimension the potential to realize yet further revenue from follow-on sales of ancillary services desired by travelers.

Unbundling creates an additional dimension of sales opportunities, checks more boxes under the demand curve and realizes more of the total potential revenue.