Office of Aviation and International Affairs, Aviation Analysis

Fare Restructuring in Cincinnati – Second Quarter 2005

Domestic Aviation Competition Issue Brief Number 28

The entry of low-cost carrier competition into a legacy carrier dominated market creates intense pressure on incumbent carriers to alter their traditional pricing and yield management tactics in the affected markets to remain competitive. As low-cost airlines have continued to expand their presence into an increasing number of markets, other carriers are evaluating whether wider-scale changes to their pricing and yield management strategies are needed. For example, in early 2002, America West unveiled systemwide changes to its pricing structure.[1] More recently, Air Canada implemented a revamped pricing strategy in Canadian domestic markets and certain international markets, hallmarks of which include greater transparency to the consumer and the unbundling of various features of its product (e.g. a traveler pays a premium over the lowest fares for an advanced seat assignment).

In January 2005, Delta became the first U.S. legacy carrier to introduce a domestic-wide fare restructuring in response to the growing threat of low-cost carrier competition. Delta's program, marketed under the name "Simplifares," featured reductions in the level of Delta's highest fares, fare caps, fewer fares, elimination of the Saturday night stay requirement, and a lower change fee.[2] Delta's nationwide rollout of Simplifares was preceded by a localized test in the Cincinnati market that was officially announced in mid-August of 2004. This quarter's special feature examines the impact of the fare restructuring Delta implemented in Cincinnati by comparing traffic and fare data for the second quarter of 2004 (prior to Delta's rollout of Simplifares in Cincinnati during the third quarter of 2004) to the second quarter of 2005 with Simplifares in place.

Cincinnati Market Background

Cincinnati is home to Delta's second largest hub (after Atlanta) as measured by total seats and total departures. Delta and its regional affiliates dominate air service there; during the second quarter of 2005, Delta and its affiliates operated 94% of total domestic[3] available seat miles at Cincinnati and they had an 80% share of local traffic in domestic markets. While Delta has reduced capacity at Cincinnati as part of its restructuring plan under Chapter 11, it remains Cincinnati's dominant carrier.

In large part because of Delta's dominance and its relatively small local market, Cincinnati is one of the largest markets that lacks service from low-fare carriers.[4] Consequently, Cincinnati has historically been at or near the top of our measures of domestic airports with the highest fares. During the second quarter of 2004 (pre-Simplifares) Cincinnati's fare premium of 61% ranked it as the airport with the highest fare premium in the continental U.S. [5]

Cincinnati's high fares have motivated certain travelers to seek out lower fares at other airports in the region. One of the purposes of Delta's rollout of Simplifares in Cincinnati was to stem the diversion of

[1] See "Fare Structure Experimentation," U.S. Department of Transportation, Domestic Aviation Competition Issue Brief 21, released with Domestic Airline Fares Consumer Report for First Quarter of 2003, January 2004.
[2] Later in 2005, Delta raised the level of its fare caps because of increases in the cost of jet fuel. The future of the Simplifares strategy as it exists today is uncertain in light of Delta's mid-September 2005 bankruptcy filing.
[3] In this report, "domestic" refers to the continental U.S. only.
[4] USA 3000 operates a handful of flights per week to/from Cincinnati in several warm-weather leisure markets during the winter season.
[5] Our fare premium calculation includes airports that appear within the 1,000 largest continental U.S. city-pair markets and is based on all continental U.S. markets with at least one passenger per day. Information on fare premiums is located at Table 7 in every Fare Report.

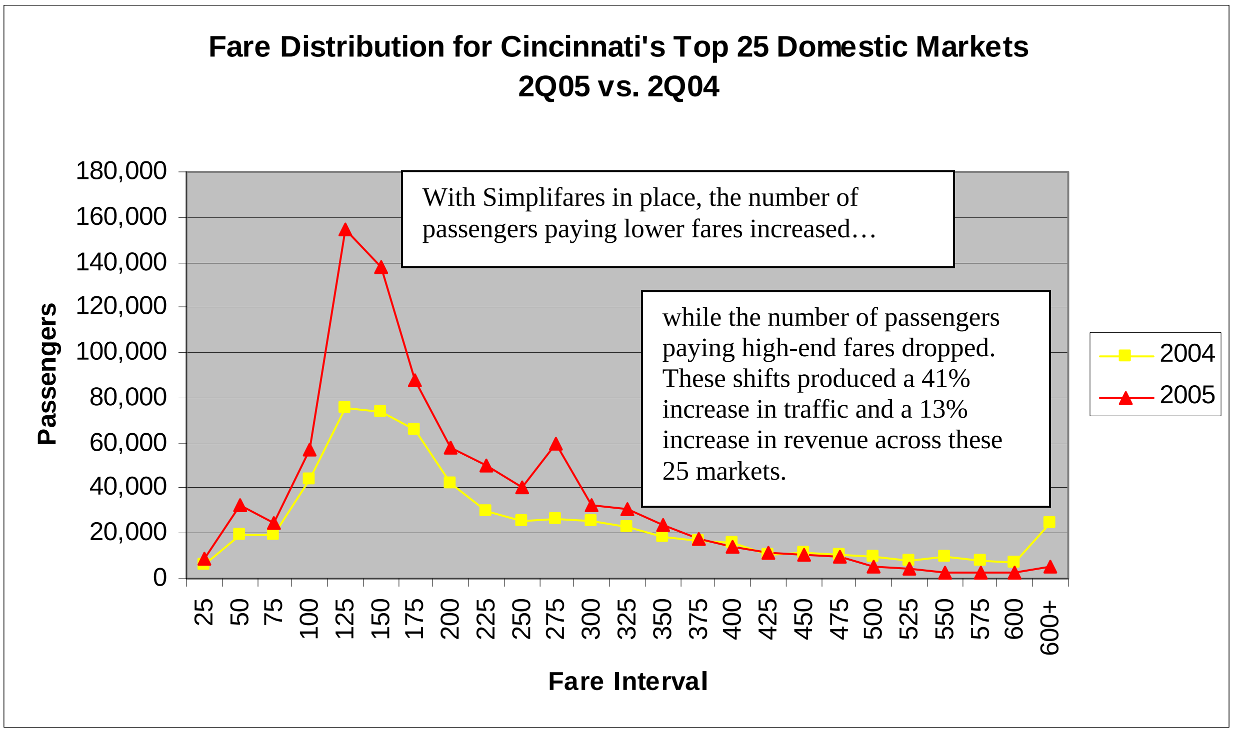
revenue and traffic to other cities, such as Louisville and Dayton, where fares were generally lower than those available from Cincinnati.

Changes in Cincinnati's Top 25 Domestic Markets

Our analysis examined the 25 largest Cincinnati domestic origin and destination markets during the second quarter of 2004.[6] These markets collectively account for about two-thirds of Cincinnati's total domestic origin and destination traffic.

Graph 1 shows the distribution of traffic across the top 25 markets by fare interval in both years. Table 1 provides details on the year-over-year percentage changes in average fares, traffic, revenue, and nonstop capacity in each of the top 25 markets.

Graph 1



[6] Regional carriers that were not required to report origin and destination traffic and fare data to DOT operated at least some nonstop service during 2Q04 and/or 2Q05 in the following markets among the Top 25: Boston Metro, Chicago, Detroit, Miami Metro, Minneapolis/St. Paul, Philadelphia, Raleigh/Durham, and St. Louis. In most cases, non-reporting carriers comprised less than 10% of total nonstop capacity and/or the percentage of capacity operated by non-reporting carriers stayed relatively constant year-over-year, thereby minimizing their effect on the analysis. A change in the proportion of nonstop capacity operated by non-reporting carriers contributed to an anomalous result in the Cincinnati-Chicago market. See footnote 7.

Table 1

Rank	Cincinnati Market	2Q04 Avg Fare	2Q05 Avg Fare	% Cng Avg Fare	% Cng Pax	% Cng Rev	% Cng Nonstop Capacity
1	New York	$267	$200	-25%	29%	-3%	-4%
2	Chicago	$181	$187	3%	-1%	2%	-5%
3	Washington Metro Area	$225	$188	-17%	20%	0%	-11%
4	Boston Metro Area	$261	$197	-24%	44%	9%	-4%
5	Miami Metro Area	$189	$153	-19%	33%	7%	-11%
6	Los Angeles Metro Area	$307	$256	-17%	51%	26%	-4%
7	Tampa Metro Area	$169	$152	-10%	29%	16%	-3%
8	Orlando/Kissimmee	$204	$160	-21%	60%	26%	-1%
9	Atlanta	$270	$198	-27%	79%	31%	22%
10	Philadelphia	$264	$198	-25%	48%	11%	1%
11	Dallas/Ft. Worth	$312	$224	-28%	55%	11%	0%
12	San Francisco Metro Area	$344	$239	-31%	78%	23%	-1%
13	Las Vegas	$229	$207	-10%	62%	46%	31%
14	Minneapolis/St.Paul	$269	$171	-36%	27%	-19%	-16%
15	Ft. Myers	$175	$124	-29%	106%	46%	12%
16	Denver	$260	$209	-20%	56%	26%	9%
17	Houston	$276	$212	-23%	51%	16%	-15%
18	Sarasota/Bradenton	$148	$139	-6%	8%	2%	-14%
19	Phoenix	$264	$210	-21%	85%	47%	16%
20	Salt Lake City	$253	$215	-15%	53%	31%	30%
21	St. Louis	$259	$206	-20%	44%	15%	-25%
22	Kansas City	$238	$178	-25%	47%	10%	2%
23	Raleigh/Durham	$211	$174	-17%	33%	10%	-1%
24	Detroit	$257	$209	-19%	9%	-11%	-6%
25	San Diego	$273	$233	-15%	45%	24%	-6%
	Top 25 Composite	$242	$194	-20%	41%	13%	0%

On average, the Cincinnati market became less expensive with Simplifares in place. The average fare across the top 25 markets fell 20%, from $242 to $194. Average fares fell in 24 of the top 25 markets, Chicago being the exception with a 3% increase.

As a consequence of the greater availability of lower priced tickets, including lower fares targeted at the business traveler purchasing close to departure and not staying over a Saturday night, traffic increased. Across these 25 markets, traffic was 41% higher in 2005 compared to 2004, with all individual markets in the group posting increases except for a slight decline in the Chicago market.[7] While some of this increase undoubtedly includes traffic that was recaptured by Cincinnati from other airports in the region, the magnitude of the increase suggests the new pricing strategy stimulated local traffic. In most cases, local traffic increased despite reductions in nonstop capacity.

Cincinnati's fare premium fell from 61% during the second quarter of 2004 to 23% during the second quarter of 2005. Cincinnati went from the highest ranked airport in terms of fair premium in the second quarter of 2004 to the fifth highest in second quarter 2005.

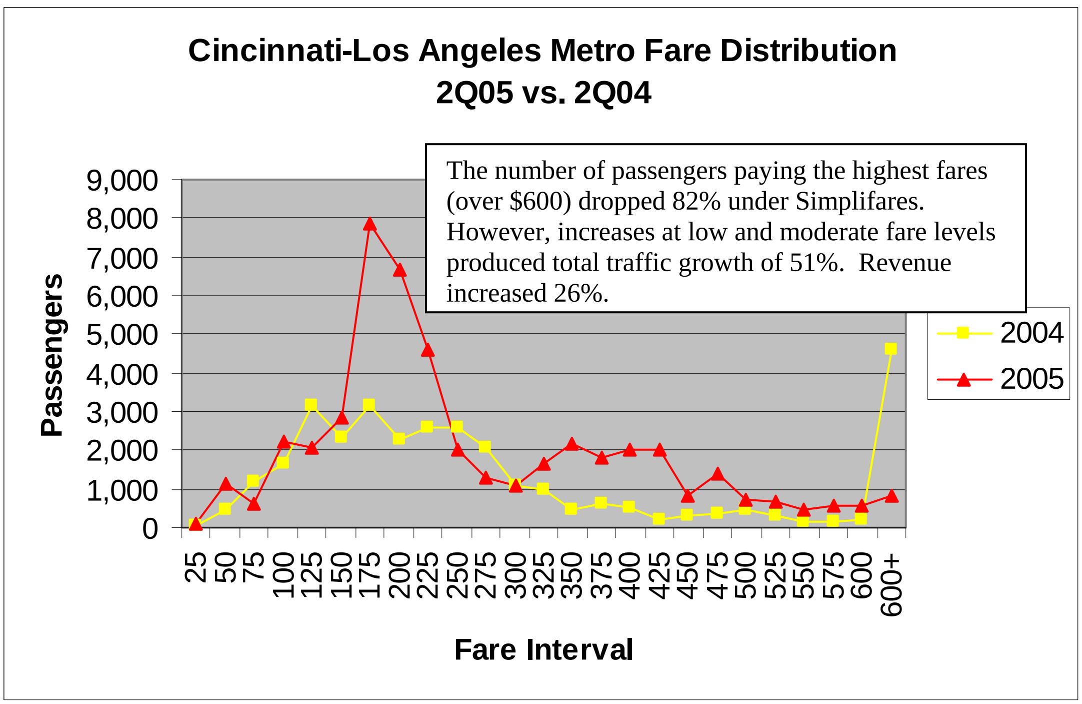
[7] Although O&D survey data indicates that traffic in the Chicago-Cincinnati market declined year-over-year, this is almost certainly not the case. During 2Q05, 14% of nonstop capacity was operated by non-reporting regional carriers, up from only 2% during 2Q04. This increase in the proportion of capacity operated by non-reporting carriers distorts year-over-year comparisons.

Below we examine three of the Cincinnati markets that are among the Top 25: the Los Angeles Metro Area (long-haul), New York (short-haul), and Miami Metro Area (medium-haul) markets.

Long-Haul: Cincinnati-Los Angeles Metro Area

The Cincinnati-Los Angeles Metro Area[8] market is Cincinnati's largest domestic long-haul city-pair market and it ranks sixth overall among Cincinnati domestic markets. Delta offered nonstop service between Cincinnati and both Los Angeles (LAX) and Orange County (SNA) during both quarters. As noted in Table 1 above, overall origin and destination traffic increased 51% on a decline in average fare of 17% percent. Revenue increased by 26%. Graph 2 below shows the Cincinnati-Los Angeles Metro Area fare distribution for both years. Graph 2 illustrates two phenomena: (1) a large increase in the number of passengers paying fares at the low end of the fare spectrum and (2) a dramatic decline in the number of passengers paying the highest fares (more than $600) compensated for by increases at more moderate fare levels (e.g. between $300 and $475). The magnitude of the overall passenger increase speaks to the tremendous demand for air travel in this market that was not being accommodated by the pricing and inventory management regime in place during the previous year. Additionally, the changes in the fare distribution in this market suggest that business travel was stimulated by the availability of lower fares, as the increases in traffic at more moderate but still high-end fares far outpaced the decline in the highest fares.[9] Specifically, 3,800 fewer passengers paid fares above $600 during 2Q05 than during 2Q04 but, at the same time, the number of passengers that paid fares between $300 and $600 increased by 10,000. These shifts contributed to the 26% increase in market revenue.

Graph 2



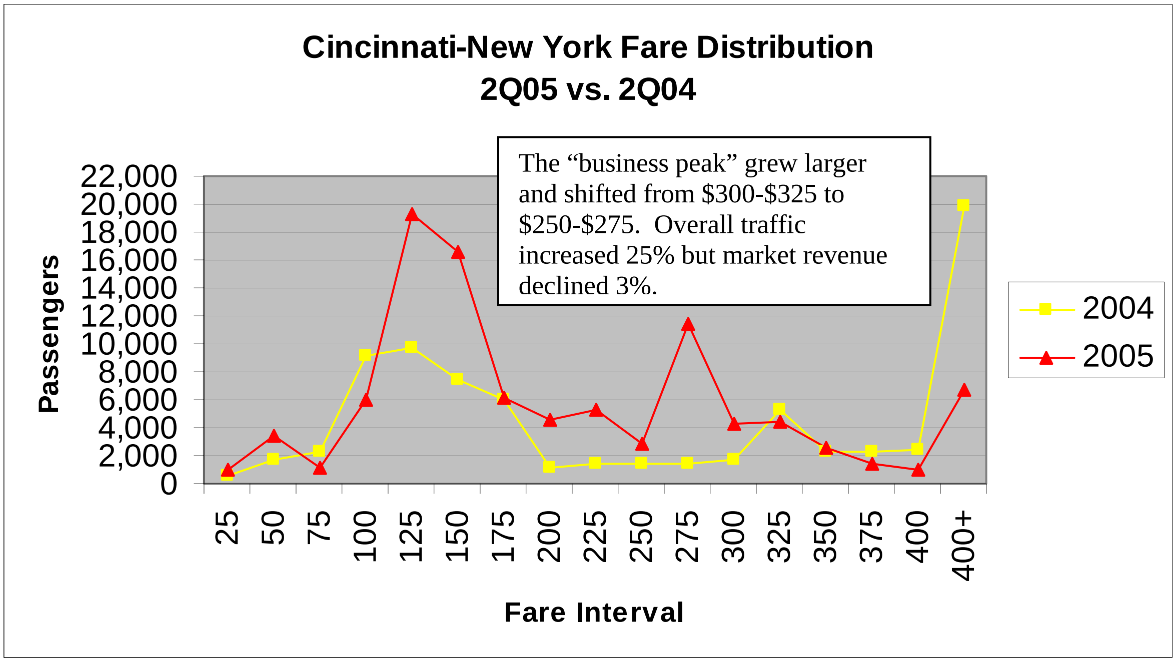
Short-Haul: Cincinnati-New York

The Cincinnati-New York market is Cincinnati's largest domestic city-pair market. Delta offers frequent nonstop service between Cincinnati and each of Newark, LaGuardia, and JFK airports. Continental competes with nonstop service between Cincinnati and its Newark hub. With Simplifares in place, the

[8] The Los Angeles Metro Area is composed of the following airports: LAX, SNA, LGB, BUR, ONT.
[9] In this market, we have defined business travelers as those that paid more than $300.

average fare fell 25% and traffic increased 29% despite a 4% decline in nonstop capacity. Market revenue declined 3%. Graph 3 illustrates that pre-Simplifares, this market had a bi-modal fare distribution with a leisure peak at $100 to $125 and a business peak at $300 to $325. In 2005, under Simplifares, a bi-modal distribution remained; however, the "business peak" declined from the $300-$325 interval to the $250-$275 interval. As in the Los Angeles Metro Area market, in this market it appears that business travel was stimulated by the increased availability of lower priced business fares, although not to the same degree.[10] While the number of travelers that paid more than $400 declined by 13,000, the aggregate number of passengers that paid between $200 and $400 increased by 15,000. However, unlike in the Los Angeles Metro Area market, the reduction in the number of people paying the highest fares was not offset by the increased number of passengers traveling, as overall revenue in this market declined.

Graph 3

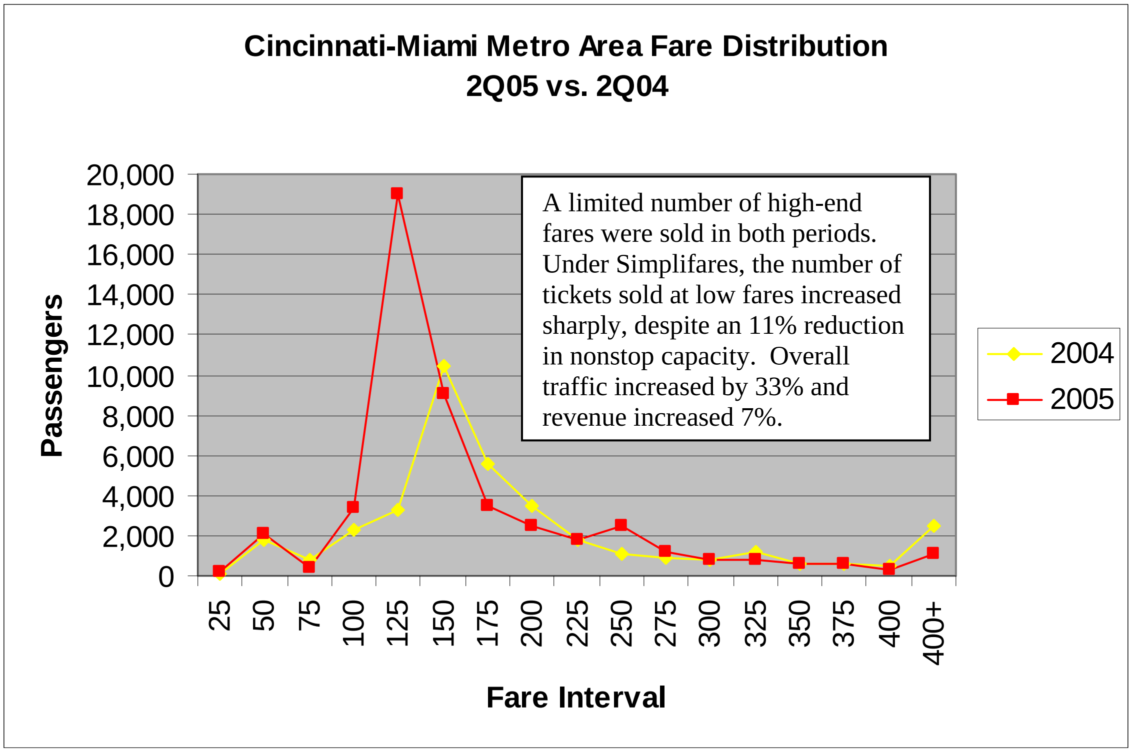


Medium-Haul: Cincinnati-Miami Metro Area

The Cincinnati-Miami Metro Area market[11] is Cincinnati's fifth largest domestic market. Delta flies nonstop between Cincinnati and both Miami and Ft. Lauderdale. American competes with nonstop service between Cincinnati and its Miami hub. In the Cincinnati-Miami Metro Area market, the nature of the change in the fare distribution was different than in the other two markets profiled in this section. Given that this is primarily a leisure market, relatively few passengers paid high-end fares in either period. However, with Simplifares in place, many more seats were sold at the lower end of the fare spectrum. Specifically, the number of passengers traveling at fares less than $200 increased by 45%. Overall traffic increased by 33% on a 19% reduction in average fare. The increase in local traffic occurred despite a 11% reduction in nonstop capacity. Revenue in this market increased 7%.

[10] In this market, we have defined business travelers as those that paid more than $200.
[11] The Miami Metro Area market includes Miami and Ft. Lauderdale airports.

Graph 4



Conclusion

A central message of many of our special features has been that there is tremendous demand for air travel that goes unsatisfied by the traditional legacy carrier pricing and revenue management model. This model is designed to maximize revenue by employing segmentation strategies that limit the ability of less price sensitive travelers to obtain low fares (through fare fencing mechanisms such as Saturday night stay and advanced purchase requirements) while at the same time limiting the number of seats made available at lower fare levels. Although the low-cost carriers also price discriminate, these carriers' marketing strategies are such that the differential between the highest and lowest fares is smaller and fewer and less onerous purchase restrictions generally apply, compared to the traditional legacy carrier model.

One of the challenges that the legacy carriers face is that their traditional pricing and yield management model does not work well when they are faced with low-cost carrier competition. When presented with a viable, less expensive alternative, comparatively few consumers are willing to pay the high fares that they are forced to pay absent the availability of an alternative. The legacy carriers are thus usually forced to adopt a pricing and yield management posture similar to that of their low-cost carrier competition. However, unlike the low-cost carriers, the legacy carriers do not have the cost structure to support the seismic shift in the revenue environment that occurs concomitant with low-cost carrier entry. The ongoing process of legacy carrier restructuring, on both the cost and revenue sides, is designed to make the legacy carriers better able to face the competitive threat posed by low-cost carrier competition.

Delta's implementation of Simplifares, first at Cincinnati and later across its domestic system, is just one example of how legacy carriers are adapting to the changes in the competitive environment. With Delta's revised pricing structure in place, the Cincinnati market, while still among the country's most expensive markets, has seen its fare premium decline. The changes in the pricing structure have contributed to increases in traffic in all of Cincinnati's largest markets. A closer examination of select individual markets suggests that the greater accessibility of lower fares not only stimulated leisure travel but also the business market. Although this analysis did not examine changes in overall network revenue, it is also noteworthy that local market revenue increased in almost every market among the Top 25. We will continue to monitor changes to the industry's pricing structures and provide updates on their impact as developments warrant.