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
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

<table>
<thead>
<tr>
<th>Fare Class</th>
<th>One-way Fare</th>
<th>Advance Purchase</th>
<th>Round-trip Required</th>
<th>Minimum Stay</th>
<th>Refundable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Y</td>
<td>$500</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>Yes</td>
</tr>
<tr>
<td>B</td>
<td>$375</td>
<td>7 days</td>
<td>--</td>
<td>--</td>
<td>No</td>
</tr>
<tr>
<td>M</td>
<td>$240</td>
<td>14 days</td>
<td>Yes</td>
<td>3 days</td>
<td>No</td>
</tr>
<tr>
<td>Q</td>
<td>$169</td>
<td>21 days</td>
<td>Yes</td>
<td>Sat. Night</td>
<td>No</td>
</tr>
</tbody>
</table>

- 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

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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
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