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United Air Lines, Inc.

I have been asked to discuss differential pricing policy in the airline industry. I plan to confine my remarks to the passenger pricing although there is no question but what cargo is also an important part of this industry. Further, I think the principles that apply to passenger pricing also apply to cargo pricing and most of you are more familiar and more experienced with passenger pricing practices.

Differential pricing policy really has its beginnings I suppose in monopolistic theory which says that if the monopolist can successfully discriminate among markets and not permit revenue dilution to occur in his major market as a result of discriminatory pricing in secondary markets, he can increase his total profits as long as he does not increase his investment base or in more pragmatic terms expand his plant size or capacity. That same theory holds true with respect to airlines' differential pricing policy and the rather tenuous relationship between the theoretical application of differential pricing and its actual practice is what I plan to discuss today.

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price with peak demand. Although I've chosen to treat these two practices separately they are conceptually the same. In practice one usually precedes the other, however.

Before I begin a discussion of the application of differential pricing policy, I would like to make mention of one other factor which is a major consideration in the airline industry and makes us act differently than private industry. That is the presence of our regulatory agency - the Civil Aeronautics Board. The CAB, as you all know, plays a large role in the pricing policy of airlines. It is one of the few regulatory agencies which has the responsibility to promote its industry but coupled with that responsibility is an additional responsibility for passing judgement on the pricing practices of certificated air carriers. The CAB is required to guard against what we might call overly zealous price differentiation. Carriers are not able to maintain pricing practices which the Board judges to be unjustly discriminatory or unduly preferential or that give an unfair advantage to certain customers. Our prices are also totally public knowledge as a result of the requirement that we publish and maintain tariffs. So, within these constraints, we are reasonably free to differentiate our prices and in so doing attempt to increase our overall profitability.

Let's move now to the practice of discrimination among markets. First

of all we must identify those markets. There are probably hundreds of ways to define markets, but as most of you know, in the airline industry we tend to break them down into two basic categories. The business market and the pleasure market.

The business market is the simplest of these two to deal with. It is the market to which we gear our prime product, convenient, reasonably frequent schedules between most major cities in the United States. It is this market that is considered to be basic, and it is to this market that we direct our prime price. It is this market that demands our prime product. The business market then really only splits into two pieces - the first class market and the coach market; and each of these markets has a basic, full, non-discounted price. In the case of first class a premium is applied because the first class passenger receives a premium service in terms of both inflight amenities and the amount of space he is permitted to consume during the time he is on board. The coach market sets the standard for all airline pricing and indeed it is the coach fare which is the basic fare in the industry.

The pleasure market is far more complex than the business market. It is a market which has led to the practice of differential pricing and which

we like to think at least is the most responsive to differential pricing. The pleasure market is as some are fond of saying - - where the action is, and it is the market that we generally consider to hold the most opportunity for the future growth of this industry. It is a discretionary market. People who are spending their dollars on air transportation are spending dollars that they are not required to spend for the basic essentials of life...food, shelter, clothing, education and some form of transportation to and from their place of work. In order to compete for these dollars, we must compete effectively with many other products and services. Automobiles, for example, particularly the second car; color television perhaps; vacations which do not require a great deal of travel; vacation homes, another growing competitor for discretionary dollars. In one respect we have a product disadvantage. Our product is an intangible, once it is consumed it is gone, and the pleasures of a vacation trip can only be preserved on film and in memories, and on cold winter nights a memory may not be nearly as satisfying as sitting in front of a tangible, visible and sometimes entertaining color television set. These are some of the factors we must contend with and compete with as we seek to reach this market. Nevertheless, as I mentioned, this is where most of us believe the action is and are trying to use price as a means to compete.

It is quite easy to characterize our major markets as business and pleasure. As I mentioned the business market quickly subdivides into the coach and first class markets. But when we consider the pleasure market we find that we are dealing with a large, very heterogeneous and very complex category. We must deal with each of these submarkets and must thoroughly understand them. For example, the bulk of people traveling for what we would consider to be basically pleasure purposes are traveling to visit their friends and relatives. However, another large sector of this market plans to use commercial facilities during the entire trip; that is, they will not only use air transportation as a means of getting there, but they will be staying at a resort area, eating in restaurants, etc. There is a warm weather market; places like Florida, California and Hawaii have a great attraction for pleasure travelers. And a cold weather market, the ski areas for example. There is a young market - we are all familiar with the youth fares, controversial although they may be. And there is an old market which has been demanding equal treatment with youth. There is a market for group fares, and this market too can be subdivided into at least two categories - some who travel with groups are with the group because they enjoy the security of the group, they appreciate the fixed price nature of most group travel, they want someone to make the arrangements for them, to handle the administrative

details and to ensure that everything goes right. The other part of this market, typically a younger part of the market, is very budget conscious. They are there because the price is right - they don't care at all about the security factors. There is a market for package tours, people who want everything planned in advance. Again, this can be either on a group or individual basis, but they like the fixed price aspects of a package tour. They like knowing in advance what they are going to see and where they are going to be, and they may save by buying a package, save both in terms of ground arrangements and air transportation. And finally there is foreign pleasure travel and domestic pleasure travel. And in many cases domestic carriers have an opportunity to participate in the pleasure travel with those going to international destinations.

My reason for discussing these various markets or submarkets is to acquaint you with the fact that almost everyone can be categorized into one or more of these different pleasure market classifications. In fact, most people at any given time, may fit into more than one of these categories. And this is where the difficulty begins when we attempt to practice differential pricing.

I suppose the first attempt made to differentiate prices in the airline industry was made in the late 1930's with the introduction of the family

plan, which I might add is still part of the basic price structure in this industry. But the theory was then, and it is now, that offering a price difference would fill seats that would be flown and would not otherwise have been filled. The execution of this theory is simplicity itself, and the theory itself is certainly simple. You don't need a PHD in economics to understand that if you can get more revenue than your variable cost, without diluting current revenue or increasing fixed costs, you will improve your overall profitability. And to put this into practice in this industry, or for that matter, I guess, almost any industry, is quite easy.

First, you identify the market both demographically and geographically.

Next, you determine precisely what price that market will pay for your product. Too much and you lose the market, too little and you lose profits.

Then, you structure your product offering so that it just fits this market and cannot be purchased by anyone that is part of a market that would pay more. Because if it could be purchased by someone that is willing to pay more, once again you have eroded your profitability.

In our case, we will review our product to be sure that it will meet all

the regulatory tests, and on the assumption that it will we will file it with the CAB. 30 to 45 days later we can take it to market where we will sell our product, sit back and smile benignly and enjoy our profits.

Oh, and let's not forget that as time passes we will be ever vigilant and not increase the size of our plant (investment base) because if we do our product then must bear its full share of cost and it hasn't been priced at a level which will permit it to do that.

This then is the underlying theory and hypothetical practice of the most common application of differential pricing policy in the airline industry today. Now let's look at the "real world" as we are often fond of saying. The first example I would like to direct your attention to is the Discover America fare. This fare, introduced in 1966, was designed to encourage discretionary spending on air travel. It carried a discount from normal coach fares of 25%, required round trip, required that the individual not depart and return in the same calendar week, he could not be gone more than 30 days, could not travel on Fridays or Mondays, generally peak business travel days, and could not travel during the peak periods of the summer or at peak holidays. All of these restrictions were created to differentiate this product from the basic coach product and to discourage discount travel during prime demand periods as well as discourage those

who were able and willing to pay the full coach price from shifting to this discounted fare. The assumption was that no additional capacity would be added and the revenue from this fare would far more than exceed the variable cost of carrying the traffic. Yet, in only two short years after its introduction, changes were made. The discount was still 25%, a round trip was still required, you still had to be gone 7 days and had to return within 30 days, but Fridays and Mondays were no longer blacked out. Now the blackout was from Friday noon to Friday midnight, and from Sunday noon to Sunday midnight. In other words, 24 hours during the week were excluded as opposed to 48 hours at its inception. But perhaps the most important difference was that this fare was now valid on a year round basis; so, even in the summer when demand peaked the discounted price was still available.

The Discover America fare is still part of our fare structure, it has changed again in its characteristics from 1969 but it is still far more liberal in terms of periods of applicability than it was at the outset.

The second example I would like to touch on is a group fare filed originally to compete for traffic carried by supplemental carriers who were serving Hawaii from the East Coast, offering low cost transportation predicated on high load factors through group travel. At the outset in order to qualify for

this group fare you had to be part of a group of 88 to 154 people and as the group got larger the price got lower. You could only depart from Chicago, Detroit, Cleveland or New York. And from a practical standpoint most of the business was done from New York. The group had to travel together during the entire trip, both coming and going. They had to buy a tour package so that it was truly an all inclusive tour and they had to stay for a minimum of 14 days. Each of these restrictions was applied to prevent diversion from higher fares to this lower group fare on the part of those who were able and willing to pay a higher fare in order to achieve greater personal travel flexibility and more comfortable travel. Today, the same group fare is available for groups beginning at 40 persons. It is national in scope rather than applying to the major population centers of the east from where the participating airline was virtually guaranteed a long flight where it could achieve maximum efficiency of operation. First, passengers were permitted and encouraged to consolidate in Chicago by providing a lower price on air transportation from their home to Chicago. Next the West Coast was picked as a consolidation point, and today passengers can originate any place in the United States, travel on an individual basis to or from the West Coast, stopover and spend whatever time they wish on the West Coast, then continue on to Hawaii as a part of a group. In many instances no tour package is required and the

minimum stay is now a short 7 days, which is no problem for anyone going to Hawaii for virtually any purpose.

The point I am trying to make with these two illustrations is that all too frequently the best of intentions and the best applications of true differential pricing theory soon are completely lost in practice. What starts out to be a highly effective, valid attempt to add traffic to existing capacity becomes nothing more than a generally available discount price available to virtually anyo e.

Let's look back now to the execution of differential pricing policy which I have described as simplicity itself. I mentioned that all you needed to do was identify the market, arrive at a price, structure the product offering so that it would just fit the market, make sure you met your regulatory requirements, and be sure that you didn't at some time in the future add capacity for this product. It is easy to describe what should be done but it is extremely difficult in actual practice to measure the precise impact of various price levels and the real effect of the restrictions which are frequently applied to promotional or differential pricing.

I think I can say without reservation that everyone in the industry attempts to make these measurements and find these price levels but I doubt that

anyone would be sufficiently bold as to claim that they were able to do so with great precision and anything approaching 100% accuracy. Differential pricing is still far too much of an art and not enough of a science in the airline industry.

Of an even greater concern, there is ample evidence that the industry has not been successful in keeping short run variable costs from turning into long run fully allocated costs. And differential pricing will not support fully allocated costs. There is considerable evidence that capacity has been added for incrementally priced traffic, and it is this addition of capacity and the addition of staff and capital investments required that defeats the concept of differential pricing, particularly as it applies on a selective market basis.

A secondary method of differential pricing and one in which there may be more short term promise is that of matching peak price with peak demand. Again the theory here is so basic that it almost needs no explanation. That is, you charge the most when the demand for your product is highest. This can be done on a time of day basis and is, it can be done on a day of week basis and is, and it can be done on a seasonal basis and is. I think the best examples of this type pricing can be found in the international market place, but that doesn't make it any less valid for domestic application.

This type of pricing also has the virtue that one needn't worry about the present price structure, for matching peak price with peak demand is merely an attempt to improve the present structure - not to change it. It's workable and we have some good examples of its workability in the Hawaiian market, and more recently in the major midwestern and eastern markets to Las Vegas, which has some very unique demand characteristics as I am sure you can imagine. The only danger in application of this type of pricing is the temptation to cut the price in the off-peak as opposed to increasing it during the peak period. If one yields to the temptation to cut the price, then we become subject for the same need for precision and infallible judgement as we find when we differentiate on a selective market basis. It may work, but the risks are far higher.

Increasing the price during the peak period on the other hand carriers little risk except that if your action is too bold or too steep you may discourage the market entirely during those periods. Fortunately, this is something that you will learn very quickly and something which is very easy to correct. It is always easier to adjust price on the downside than it is on the upside. So, in my judgement at least, the application of differential pricing in a fashion which applies peak price to the peak demand period is sound in both theory and practice, provided that those of us who are practitioners do not yield to the temptation to put too much faith in our crystal ball.

I might add, too, that this is an area where the CAB has typically given us a fair degree of freedom so that we have been able to experiment with price differentials and adjust them to some degree of reasonableness, so long as we do not get beyond the basic coach level and so long as we do not make a change of a radical nature at a time when a substantial number of the traveling public are affected. So with a certain amount of guarded optimism I think there is an opportunity for some successful practice of differential pricing as it relates to matching peak demand and peak price.

Let's go back now and talk for a few more minutes about the more difficult problem of selective or differential pricing on an individual market basis. There is no question but what this too is a valid pricing technique - if it is properly applied. The difficulty is how to bring theory and practice together. And I think that that becomes the mutual responsibility of the carriers and their regulators. First of all, the carriers must use caution and restraint both in the development of promotional or differential price offerings and the application of those offerings in the marketplace.

Carriers must stop and realize that long term planning means more than a week from today and that some of the actions that are taken for short term expediency can have some serious long term effects. Experiments must be treated as experiments by both the carriers and the CAB, and when a filing

is described as an experiment, the results of that experiment must be evaluated and its success or failure judged so that only the successful experiments can be allowed to continue.

Differential pricing can be a valid means of improving profits, keeping the total cost of air transportation down, and making it possible for more people to use air transportation. However, until we can truly put theory into practice we must be very critical of differential pricing proposals.

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