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Airfare Growth Softens After A Year Of Pricing Hegemony

By Jay Boehmer

FEBRUARY 05, 2007 -- With 10 published airfare hikes, high fare growth and planes that were exceedingly full, domestic airlines in 2006 wielded a level of pricing power not seen in recent years. However, according to airfare data, pricing power appeared to soften as the year progressed, and overall fares are expected to grow modestly this year.

Domestic carriers are maintaining an aggressive posture so far this year to maximize passenger revenue. The major domestic carriers are batting .500 for published fare increases, with two hikes in January—one successful, the other a strikeout. At press time on Friday, Delta raised fares systemwide by $5 per way.

Last year, average domestic fares grew by nearly 10 percent, according to carrier figures and Calyon Securities forecasts, which show that fares have grown steadily since 2004. In 2005, the average fare increased by nearly 3 percent, but last year fares saw their biggest boost—growing by nearly 10 percent among the Big Six carriers and 8.3 percent by such other domestic carriers as AirTran, Frontier, JetBlue and Southwest.

Growth is expected to moderate this year, with Calyon forecasts suggesting only a 0.8 percent jump in average fare per mile for 2007. As in January, however, carriers should be aggressive for at least the short term. "We believe that with demand remaining strong, we will see additional price increases as we move toward the strong spring travel seasonal," Neidl wrote in a research note.

Prior to Delta's move last week, legacy carriers in January rescinded a briefly successful $5 one-way fare increase, but analysts expect more lasting ones to come soon. This year's first effort among legacy carriers came earlier in January with a $5 one-way increase led by United.

"We would expect another, largely similar industry effort within coming weeks," said JP Morgan airline analyst Jamie Baker in a research note. United initiated the move by raising domestic fares by $5 "in nonstop and connecting markets exceeding 1,000 miles, excluding Southwest-competitive markets," Baker said. The hike, however, unraveled as American and Delta moved to "broaden the scope of the effort," Baker noted.

"I would be really surprised if the airline industry is as successful as it was last year in regards to fare increases," said TRX Travel Analytics vice president Scott Gillespie.

Bob Brindley, vice president of the Americas for Advito, BCD Travel's consulting division, said domestic carriers likely will continue to attempt fare increases this year, the degree to which the market will determine.

"They'll still keep trying, because they are at record load factors and demand still seems to be there," he said. "The question is: When will people start to slow their buying because of price levels?"

Brindley said news of airlines attempting to raise published fares is not particularly bad for corporate travel buyers. "Because the rates have gone up so much, in the short term you're seeing the corporate discounts are catching up to the rate increases, so that may temper the net price growth for the next period," he said. "I definitely see that in the past few months, in reacting to big price increases, discounts are trending upwards again."

The Big Six and Alaska Airlines' fares grew every month in 2006 over the same month in 2005, according to the Air Transport Association. However, the growth rate beginning in June last year slowed, and in December only grew 1.5 percent over the same period in 2005.

Even so, average per-mile fares—which represent a combination of business and leisure fares—don't paint a complete picture.

Bob Harrell, principal of airfare consultancy Harrell Associates, said that for the latter part of 2006, high growth in business fares offset a decline in leisure fares, resulting in modestly growing overall fares.

For the last period of 2006, "business fares were about 9 percent higher than they were the previous year," while leisure fares fell 8 percent below the same period in 2005, Harrell said.

"The leisure fares really are more a reflection of market demand forces because that's the price-sensitive end of the market. Business fares are treated to be inelastic. The only thing that changes them generally is expansion of a low-cost carrier into a previously unpenetrated market," Harrell said, noting that for the second half of the year—particularly following the August 2006 London terror scare—leisure fare pricing power had softened.

The trend continued in the first month of 2007, Harrell said. One-way business fares across 100 major domestic routes averaged around $485—roughly 9 percent above January 2006 levels. Meanwhile, January 2007 leisure fares across those same markets averaged about $97—decreasing about 5 percent from the same month in 2006.

Yet, even as fare growth on a monthly basis slowed during the second half of 2006 as compared with 2005, overall increases have surpassed those in recent years.

The Department of Transportation's Bureau of Travel Statistics' latest Air Travel Price Index, released last month, rose 7.5 percent for the third quarter of 2006 over the same period in 2005. "The biggest year-to-year rise since third-quarter 2000," the report said. "The average domestic itinerary fare in the third quarter of 2006 was $389.08, up 8.1 percent from the average fare in the third quarter of 2005, but down 4.7 percent from the historic third-quarter high of $408.35 in 2000," it said. Among the 85 largest airline markets studied in the index, Cincinnati had the highest percentage growth at nearly 25 percent, followed by Charleston, S.C.; Manchester, N.H.; Providence, R.I.; and Greensboro/High Point, N.C.

Annual domestic carrier earnings noted similar trends helped to improve 2006 finances: Planes were fuller and fares were higher. While cost-cutting helped carriers, earnings point to a level of pricing power carriers have not had in years and resulted in the first profitable year for the U.S. airline industry since 2000.

American, Continental, JetBlue, US Airways and Southwest reported profits last year. Meanwhile, United earned $25 million in its first 11 months after its emergence from bankruptcy protection, as Delta and Northwest still remain under Chapter 11 protection, but witnessed a healthy revenue environment, the carriers said. The earning picture is living up to the expectations of analysts and economists who predicted 2006 would bring a turnaround for the long-suffering airline industry. "If demand stays high, if prices stay as high as they have gotten and if costs start coming down—especially fuel costs—that paints a rosy picture for profits," Brindley said.

The Air Transport Association said industry profits should be between $2 billion and $3 billion for 2006. ATA, meanwhile, said the economic outlook for the airline industry in 2007 is even more promising, with a projected net profit of approximately $4 billion.

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