

Marginal Rule pricing & Continental Airlines

(Source: Business Week: April 20th 1963).

General rule for flights: 65% capacity to fly. Reason:
Average total cost (ATC) pricing:

Total cost of flights/number of flights = average total
cost = \$4000

Plane had to be 65% full to earn \$4000.

Problems with ATC pricing:

1. ATC includes *sunk costs*. Sunk costs are sunk whether plane takes off or not. They should be irrelevant to the decision.
2. Average cost *changes* as output (flights) *change*. Wrong to think of AC as constant in the pricing decision.

Continental took $MR = MC$ approach.

What was the marginal cost of a flight? Done on variable costs: fuel, flight attendants, meals, ground crew. Marginal cost = \$2000.

Marginal revenue at 50% capacity = \$3000.

Because $MR = MC$ rule, Continental made profit and expanded.