

6 Pricing and Revenue Management

Of all the different facets of airline marketing, none has changed further or faster in recent years than the question of appropriate pricing policies. Today's airline managers are having to learn and apply skills which were either unknown or not needed by their predecessors, and where some of the fundamentals which have served the industry well in the past are being brought into question. It is also a high profile area, where mistakes can result in large losses in a very short time.

6:1 Building Blocks in Airline Pricing Policy

6:1:1 Pricing - A Part of the Marketing Mix

In studying the question of appropriate policies for airlines it is first of all necessary to emphasise that pricing decisions cannot be made in isolation – they can only be seen in the context of the Marketing Mix model presented in Section 1:1:2. In particular, product and pricing decisions must clearly be made together. In recent years, many airlines have invested large sums in improving the specification of their First and Business Class products, with costly investments having been made in such things as better (usually flat-bedded) seats, higher quality catering and greatly improved in-flight entertainment. At the same time they have generally – and correctly – raised the prices of First and Business Class tickets in real terms, to provide a return on the investment that has been made. As we have discussed, whether or not they will be able to maintain these higher prices and the same return when recessionary conditions re-assert themselves is another question.

6:1:2 Deregulation

Until recently, the question of government regulatory policy was a major constraint on airlines' pricing freedom in international aviation. Almost all

intergovernmental Air Services Agreements were written in terms which were designed to stop airlines competing on price. The airlines designated under these agreements were required to meet together, agree on what the fares should be, and file these fares with their respective governments for approval. Assuming that this approval was forthcoming – and it normally was – the airlines in question would implement a fare structure based on the principle that all those on a route would charge exactly the same fares. Even in domestic markets – notably so in the USA – government regulation was imposed to prevent price competition, presumably in the hope of maintaining a stable industry.

The situation today is totally different. Many domestic markets have been completely deregulated with regard to price, with airlines free to price as they choose. In some international markets, too, a virtual deregulation of pricing has taken place. This is notably so with respect to the so-called Single Aviation Market of the European Union.

Even in markets where the old facade of price regulation nominally remains, the situation today has still changed a great deal from that which prevailed only a few years ago. In these markets, it had been one of the functions of the International Air Transport Association (IATA) to run the Tariff Conferences at which fares have been agreed. The machinery of so-called Tariff Co-ordination has become more flexible. Airlines have gained the freedom to innovate with their own promotional fares, with Tariff Co-ordination activity confined to the highest, interlinable fares. Even where fares still fall within the responsibility of the Traffic Conferences, it is an open secret that airlines have engaged in a great deal of under-the-counter tariff discounting, with IATA having discontinued what were described as its Compliance efforts. There were designed to ensure that carriers implemented the fares policies to which they had agreed.

It is impossible to exaggerate the significance of the moves towards less regulated pricing. They have allowed many airlines to develop a low cost/low fares philosophy, something which they could never have done under the old regulated pricing regimes. This in turn has challenged incumbents to become more efficient and innovative. At the same time, managers responsible for pricing policy have had to develop a completely new set of skills. Under the former regime, the skills required were those of attending often-interminable IATA Tariff Co-ordination meetings and engineering a compromise between supposed competitors. Today, the skills are those of forming an appropriate rapid response to the pricing initiatives of these competitors, and deciding when the airline should lead the market in a change of pricing policy.

6:1:3 Dissemination of Fares Information

Until relatively recently, the pace of change in airline fares was slow. Regulated competition meant that all prices were a compromise, and reaching such a compromise was usually a drawn-out affair. At the same time, the system for disseminating fares information precluded rapid changes. The method for such dissemination was a printed tariff manual. Preparing these manuals ready for a fares change would in itself take many weeks, as would distributing them to the travel agents who needed them. (The delivery of the tariff manuals to agents was a task generally undertaken by the airline's field sales executives). The effect of all these factors was that the fares were only changed once a year or once every two years.

Again, the situation today could not be more different. The development of Global Distribution Systems (see Section 7:3) has meant that almost all travel agents have instant access to a fares database which is up-dated (by the GDS firms) several times a day if necessary. At the same time, an increasing proportion of airline tickets are being sold through carriers' own websites, where the process of tariff updating can be even more rapid if necessary. The result of both these trends is that the fare structure is now highly unstable at times of active price competition. Such competition will be especially prevalent during recessionary periods, when supply exceeds demand and airlines are fighting to fill otherwise empty seats. It will also break out in the autumn of each year on many routes as the summer peak period comes to an end and airlines compete for their share of the declining market.

At times such as these, millions of fares in the industry's main fares databases may change every day, challenging airline pricing managers not only to get their pricing decisions right, but to make these decisions quickly and under great pressure.

6:1:4 Revenue Management Systems

Clearly, the pricing environment today is a far more challenging one. There is, however, one major change which has made it much easier for airline managers to develop sound pricing policies – the advent of sophisticated systems for managing the sale of seats (and, increasingly, of cargo space).

In deciding on pricing policies which will optimise financial returns, carriers must decide on the number of seats they will sell, at what prices and in what currencies. They must also make often difficult decisions

about traffic which will be accepted, and which refused on the grounds that the yield obtained from it is too low.

Twenty years ago, there were no tools that would allow this process to be controlled effectively. Today, there most certainly are. Modern airline reservations computers allow the capacity on board each aircraft to be divided up into a large number of booking classes – currently 26 in the more sophisticated systems with larger numbers than this likely to be possible in the future. Decisions can then be made about the number of seats to be allocated to each class, and the time at which these seats will be made available for sale. These decisions will reflect different patterns of demand. For example, for a flight leaving to a business destination on a Monday morning, few if any seats will be allocated to those classes allowing for early sale at low prices. Almost all of them will be in classes where sale will only be permitted at high fares, with many bookings only being made a relatively short time before flight departure. In contrast, a flight leaving to such a destination early on a Sunday morning will be given a completely different profile. Here, almost all the seats will be allocated to booking classes allowing for sale at low prices (or for their use by people redeeming Frequent Flyer Programme credits) as the airline attempts to obtain at least some revenue from seats which might otherwise remain empty.

A particular problem in airline revenue management at the moment concerns the question of connecting versus point-to-point traffic. Generally, airlines earn a better yield on short-haul routes from passengers who are only flying out and back on the route, rather than from those who are using the short sector to fly to a hub, from where they will connect onto a long-haul service. Unless a Revenue Management system is monitored carefully, there will be a tendency for long-haul connecting traffic to be turned away, and point-to-point passengers to be accepted. This will improve the apparent financial performance of the airline's short-haul routes whilst worsening the carrier's overall financial results because of the loss of so-called network revenue. In terms of the development of Revenue Management technology, many airlines are now attempting to produce the systems which will allow them to optimise revenue through taking account of the true origin and destination of passengers. This is, though, a challenging problem of software development.

6:2 “Uniform” and “Differential” Pricing

6:2:1 *The Principles*¹⁴

Table 6:1 presents data which describes the present pricing structure of one of the airlines on the Heathrow – Toronto route. This route has not been selected on account of it having any special features. The situation there is a typical one, replicated on thousands of different routes around the world.

Table 6:1 Fare Structure, Heathrow – Toronto, October 2005

Fare Type	Fare Level	Conditions
J	£4,163 RTN	-
S2	£1,171 RTN	Point-to-point only
“World Offer”	£543 RTN	Saturday night stay required Mid-week travel only £50 fee to change reservation

The situation presented is one of considerable complexity. Prices vary enormously from the seemingly outrageous levels of Business Class fares down to the very low so-called “World Offer” fare. They also vary in terms of the conditions attached to each fare, with some fares – the more expensive ones – being fully flexible, and others having tightly restrictive limitations attached to their use.

To some degree, such wide differences in price levels are easy to explain and understand. In particular, the very high prices charged for seats in the First Class and Business Class cabins reflect substantial, tangible differences in the product supplied. As already discussed, a modern state-of-the-art First Class cabin will have seats which fold down into full-length beds. These will require a Seat Pitch of 70 inches or more. First Class passengers benefit from extravagant standards of in-flight service and entertainment. It is also generally the case that airlines operate their First Class cabins at low average load factors. Figures of only 40-50% are

¹⁴ For a theoretical review of these principles, see N Hanna, H R Dodge “Pricing Policies and Procedures”. Macmillan 1995

typical. Amongst the reasons for this is that First Class cabins are generally not overbooked as airlines regard the risk of having to off-load such commercially important people as unacceptable. It is clearly correct, though, that First Class passengers should pay both for the seat they occupy, and also for the empty seats in a low load-factor operation.

Though the specification of a typical Business Class is still somewhat lower than for First Class, it is still a very expensive one for airlines to provide. A typical Business Class seat pitch is now over 70", to permit the seat to be folded down into the flat bed that the state-of-the art requires should be made available. The passenger also benefits from better food, a higher ratio of cabin staff to passengers, and more choice in terms of in-flight entertainment.

Overall, whilst First Class and Business Class fare levels appear very high, it is at least possible for airlines to justify them in terms of differences in the product offered. It is much harder for them to do this for Economy Class fares. Here people paying very different prices will sit in the same part of the aircraft, in the same type of seat, and will experience exactly the same in-flight service and entertainment. Not surprisingly, there have been complaints that the existing fare structure is discriminatory. Those people who pay the higher fares argue that they are overcharged in order to subsidize the losses made on "below-cost" cheap fares.

It is possible to refute such arguments to a degree, but they should not be dismissed lightly. Both those who pay high fares and those who pay lower fares may benefit from a properly-applied Differential fare structure. This is obvious in the case of low-fare passengers who are able to travel at a price they can afford. It is less obvious, but can still be the case, that the high-fare payers also gain from Differential pricing.

The critic of differential fares might argue that airlines should instead adopt a uniform approach to pricing in the Economy cabin. For example, the data given in Table 6:1, stated that people in the Economy cabin could be paying a fare somewhere between £1,171 and £543 for a return ticket. A uniform approach to pricing would require that everyone should pay the same. The high fare would be lowered – perhaps to £700, and the lower fares would be raised to the same level.

Whilst such a situation might appear to be an ideal one, this might not be the case, for two reasons. Firstly, Economy passengers do not all have the same needs, despite the fact that they all sit in the same cabin. In particular, business travellers often have a requirement for flexibility which is absent in the typical product needs of the leisure traveller. Those flying on business may sometimes have a requirement to obtain a booking shortly before a flight departs, because of an unexpected business crisis arising. They may also need to cancel a booking once they have made it and re-

book on another flight due to their plans changing. Leisure travellers, on the other hand will generally book weeks or months before they fly and will only need to alter or cancel a booking on rare occasions due to factors such as illness.

If an airline is to meet these two sets of needs effectively it must adopt a quite different philosophy for capacity management in the part of the aircraft given over to business travellers, compared to that occupied by leisure flyers. If business travellers are to be given the flexibility they need, a relatively low year-round load factor will be inevitable. This is because the pattern of demand from such people has a random, unforecastable component to it. If seats are to be available at the last minute for a high proportion of the people who need them, substantial numbers of seats will have to be kept back in the airline's capacity management system - a number well in excess of the average demand for such seats. This will, of course, result in empty seats at take-off on days when the actual demand is low.

Overall, an airline successfully offering last minute seats and full ticketing flexibility to those of its customers who need them will do well to achieve a year-round load factor of 65-70% in the part of the aircraft allocated to this segment of the market. In contrast, an airline not seeking to give an on-demand product will be able to operate at much higher load factors, often in excess of 90%. Indeed, the charter airlines in Europe which are certainly not in the "on-demand" business do achieve these very high load factors consistently.

These differences in load factor give a first, important clue as to why fares may need to vary in the Economy cabin, despite all the passengers there experiencing the same tangible product features. The tangible features are indeed the same, but the intangible one of flexibility is not. Prices can reflect the costs of providing these different degrees of flexibility.

Some of the arguments in favour of Differential pricing can thus be based on questions of costs. Others, and ones of greater importance still, can be derived from the nature of airline market segmentation.

The advocate of a Uniform approach to pricing might argue that such an approach would be an optimal one because people currently paying high prices would pay substantially less. This, however, is a false view. They might actually in the long run end up paying more, for an inferior product.

If we return to the data given in Table 6:1, the suggestion is that Uniform pricing would see the fares charged to those paying the higher fare fall from the current level of nearly £1,200 down to, say, £700. They would no doubt be pleased by this, arguing that this represents the amount by which they are now being overcharged. The situation would be less

happy, though, for those passengers who are currently paying the lower fares. The proposition for these people is that their fares would have to rise to the Uniform level, reflecting the end of the cross-subsidy of their fares by those currently paying higher prices.

In such a situation, it is most unlikely that the people concerned will simply pay the extra in order to continue travelling with the airline concerned. As discussed in Section 2:3:5, most leisure air travellers have a high price-elasticity, reflecting the fact that they are paying fares out of their own pocket. Because of this, a sudden steep increase in ticket prices would result in some not travelling at all. A much greater number will continue to travel, but will choose an airline which is continuing to offer attractive low fares as part of a Differential fare structure. Overall, an airline changing over from such a fare structure to one of Uniform pricing might easily find that the number of passengers it carried fell by 40 per cent or more.

The first reaction of business travellers to such a development might be to welcome it. They might argue that their air trips will be more enjoyable without revelling holidaymakers. They might also see it as a vindication of their arguments about cross-subsidy. Once the over-charging of business travellers to provide such cross-subsidy ceased, large numbers of leisure travellers could no longer afford to fly.

Such an attitude could be short-sighted. There is a synergy available to airlines which carry significant numbers of both business and leisure travellers, and the business flyer is a major beneficiary of this. In particular airlines which participate in both the business and leisure markets are able to maintain a much broader network, with a better flight frequency than those which do not. As shown in section 2:3:3, network and frequency are two of the prime product requirements of the business traveller. Also, such airlines are able to maintain frequencies whilst using larger aircraft. Aircraft show Economies of Scale whereby lower seat-kilometre costs can be obtained from larger planes. These cost advantages can in turn be passed on to passengers in the form of lower fares. Finally, all airlines have a proportion of their costs which must be regarded as fixed overheads. Expenses such as those associated with the reservation and revenue accounting systems, and brand-building advertising, come into this category. Larger and larger numbers of passengers permit these costs to be spread more widely, again allowing fares to be lowered. On the other hand, a substantial fall in the numbers of passengers carried would almost certainly not be followed by a pro-rata fall in overheads. If passenger numbers fell by 40%, an airline might do very well to reduce overheads by, say, 20%. The result would be that the remaining passengers would each have to cover a higher proportion of overhead costs if the airline is to

achieve a profit. This will in turn lead to higher, rather than lower, fares.

Overall, the risk is that Uniform pricing might result in business travellers paying still higher prices for a worse product than they currently receive. It is not in their interests that such a pricing policy should be adopted, despite its superficial attractions.

The situation regarding air services across the Atlantic between the UK and the USA helps make the case for the advantages of Differential pricing. Twenty years ago, there were only a small number of gateway points in the USA for travellers from Britain. Direct services were available from the UK only to New York, Washington, Boston, Chicago, Miami and Los Angeles. Any passenger whose final destination was away from these cities had to take a tiring and time-consuming domestic flight in the USA. In addition, flight frequencies were sometimes poor, with some of the gateways served only on an inconvenient less-than-daily basis.

The situation today is substantially better. The number of gateways receiving direct service has increased to over 20, with almost all of them served with frequency of a daily flight or better.

The reason for the improvement is that during this time, the market has grown, by a factor of more than 4 times. Some of the growth has admittedly come from increased amounts of business travel, but a far greater proportion has been the result of a rapid growth in leisure air travel. This has in turn been stimulated by an increasing availability of low fares as airlines have adopted a Differential pricing policy and have refined their ability to control the resulting low fares through more sophisticated Revenue Management systems.

We have now made the case that airlines should base their pricing policies on the Differential principle. Despite all these potential advantages, though, an airline decision to adopt a Differential pricing system should not be taken lightly. Indeed, competitive conditions in the industry today suggest that in the past, Differential pricing has been applied in too extreme a form, and that many of the problems being experienced by today's 'Legacy' airlines result from the fact that this has been done. We will now look at some of the counter-arguments.

The first drawback of Differential pricing is that, inevitably it leads to tariff structures that are very complex. The watchword adopted by the revenue manager is often that they should 'Capture the Value' available in the market – in other words, that each segment of the market should be charged a fare which is as near as possible to its willingness-to-pay. This will mean many different fares, reflecting the varying demand elasticities of the different segments. Worse still, as we shall discuss in the next section, in this mix of fares, all the lower fares will need to have restrictive conditions associated with them. If these are not in place, people with a

higher willingness-to-pay may take advantage of lower prices aimed at more elastic segments.

It is almost impossible to exaggerate the drawbacks that a complex tariff brings. Airlines will be faced with a very costly training task. The typical time taking to train a new reservations and ticketing agent joining a 'Legacy' airline in the past has been a matter of several weeks, all needed to explain to the new recruit how to use reservations, ticketing and pricing concepts the airlines themselves have dreamed up. Once they have been trained for such a long time, these people rarely stay for more than a year or so, such is the boring and repetitive nature of the work they are asked to do.

Tariff complexity also gives airlines a very difficult selling task. When someone wishes to buy a ticket, they will presumably seek out the best value-for money. In trying to find out which fare will give them this, they will have to assess not only the level of prices, but also the availability of reservations and the extent to which they can meet the fare conditions applying to each of the different prices which are available. This will mean either a time-consuming phone call, or the need to navigate an airline's website. The latter is a notoriously difficult thing to do when each of the cheaper fares on offer may have a page or more of restrictive conditions associated with it.

In such circumstances, it is hardly surprising that in the past many people have decided that the effort is just not worthwhile. Instead, they have turned to a travel agent to do the hard work for them. In the past, this will generally have been an off-line agent, but increasingly today (as we will discuss in the next chapter) there are a large number of on-line agents which can be used. In both cases, the customer can expect a 'best-buy' recommendation, based on a survey of the whole market. From the airline viewpoint, though, such activity can only lead to an increase in the cost-of-sale as incentives have to be offered to the travel agents and search engine firms to ensure that the 'best buy' proposition goes in their favour.

As we have seen in Section 4:2:3, it is instructive to look at the approaches to pricing that have generally been taken by Low Cost Carriers, in comparison to those adopted by their Legacy competitors. LCC's certainly vary their fares over time. In order to gain access to the cheapest prices – certainly to the prices which these airlines publicise in their media advertising – a passenger will probably have to book weeks or even months before the flight that they want departs. Near to flight depart time, these carriers may be low cost, but their fares are often surprisingly expensive. There is, though, one crucial difference in their approach. At the time someone looks at the airline's website to ascertain how much it will cost them to travel on a particular flight, there will only be one price available. The customer can therefore make a simple 'take-it-or-leave-it' choice. This

is in strong contrast to the situation of looking at the site of an airline attempting to take full advantage of the ‘charge-at-the-willingness-to-pay’ principle which has underpinned Revenue Management approaches at so many Legacy airlines for so long. It is not coincidence that the whole basis of the business model of the Low Cost Carriers has been an almost exclusive concentration on on-line sales, which have in turn resulted in enormous savings in commissions and booking fees. It is an example of where there has been a close interplay and tradeoff between pricing policies and distribution strategies.

Important though the arguments about training and distribution costs are, they are not the most important reason why in today’s very competitive industry environment, Differential pricing in its extreme form must be used with a great deal of caution.

As we have seen, the assumption of revenue managers in the past has been that pricing at the willingness-to-pay of different segments of the market will produce an optimum revenue situation for the airline. Such arguments now appear dangerously out-of-date. They will work well in any situation – at least in the short-term – where entry into the market is highly regulated, as of course it was during long periods of the industry’s evolution. They will continue to do so even when entry controls are relaxed, providing all the carriers in the market follow the same pricing policies. They are likely to do so if they all have similar high costs, where the yield premium of charging high prices to supposedly price inelastic segments will be valuable for all of them.

The situation changes when new entrant carriers appear, with much lower costs. For them, the use of Differential pricing by Legacy airlines presents an irresistible target. They can take advantage of the fact that past ‘Legacy’ views of Revenue Management have been based on one fatally-flawed building block. The assumption has always been that some segments of the market – those mostly made up by business travellers – have a very high willingness-to-pay. They often don’t have. Instead, their using of high fares has reflected the fact that they have had no choice. All the airlines in the market have adopted the same policies of charging very high prices for flexible tickets of the kind that business travellers often need, and have limited the value of lower priced tickets by such expedients as the length-of-stay rules and cancellation penalties which we discuss in the next section.

It is now clear that the use of extreme forms of Differential pricing by Legacy airlines has had the effect of building up a great deal of resentment amongst business travellers who have been forced to pay very high prices under a Differential pricing policy. Most would accept that there is a pricing premium to be paid if a flexible ticket is needed very near to the

departure time of a flight. What has angered them is that if they have booked far in advance – and for many business commitments such as regular board meetings advanced booking is certainly possible – they have paid very much more than a leisure passenger would pay who had booked on the same day, simply because of what they regard as absurd and discriminatory conditions being placed on the lower fares on offer.

Once such levels of resentment have been established, the task of Low Cost Carriers seeking to invade the markets of the Legacy airlines becomes a very easy one. They offer choice, which passengers are only too ready to exercise given their anger at past pricing policies.

The early months of 2005 saw some interesting developments in the pricing policies of the Major airlines in the United States. The period before this had, of course, been one of incredible financial bloodletting by once strong and confident airlines. In January 2005, one troubled carrier, Delta, announced a radical reform of its pricing policies. There were actually several facets to this reform, but the most notable change was that Delta announced a unilateral reduction in most of its highest domestic fares, and an ending of the length-of-stay restrictions on many of its cheaper tickets.

The Delta move was widely attacked by other US Legacy airlines. Delta's Legacy competitors all accepted that they would have to respond to its move, and they argued that it would significantly lower their yields in what was already a disastrous revenue situation. However, there can be little doubt that Delta's policy was sound, and that its new concept represented its 'least bad' option. It was under severe attack from new entrant Low Cost Carriers, notably so from the very aggressive Jetblue Airways. Jetblue was already finding it easy to appeal to former Delta passengers, who were attracted by fully flexible fares which were a fraction of those available from Delta. Worse still, the continuing existence of very high prices on routes where Delta did not yet face Low Cost Carrier competition meant that in many cases it was only a matter of time before it did. The abandonment of extreme forms of Differential pricing was therefore an essential defensive measure.

This has been a long, involved, but necessary discussion on the merits or otherwise of Differential approaches to airline pricing policy. It will always be necessary for airlines to vary their fares over time, to even out variations in demand and to ensure that they fill as high a proportion of their seats as possible. Some efforts to take advantage of varying demand elasticities between market segments are also justified – we will continue with the theme of how this can best be done in the next section. However, it is now clear that in the past, Legacy carriers have taken these measures too far. They have done so because extreme Differential pricing offered

them the advantage of the maximisation of short-term revenues, something which they needed because of the fundamental weakness of their position – as ‘Legacy’ airlines their costs were too high. They are now having to accept that their cost problem must be addressed directly, and that it cannot be hidden by the fig leaf of suitably high yields gouged out by Differential pricing.

6:2:2 Management of Discount Fares

If, at least to a degree, a Differential pricing policy is to be employed, it needs to be managed and controlled properly. If it isn’t, excessive amounts of so-called ‘revenue dilution’ will occur when too many people use the lowest fares in the range, and too few the higher prices.

Decisions about price levels must be made in an increasingly deregulated market, where airlines must both respond to the pricing initiatives of their competitors and decide when they should lead the market by a pricing initiative.

Control of discount fares is exercised in two ways. Firstly, and to an increasing degree, the Revenue Management system is used to decide on the number of low-fare seats which are available on different flights. As was discussed in Section 6:1, on off-peak flights, a large number of seats will be made available at low prices, reflecting the low marginal costs of filling seats which would otherwise be flown empty. On peak-time flights, however, few if any low fares will be offered, forcing people who need to travel on these flights to pay higher prices.

The second way in which control should be exercised is through the setting of restrictive conditions on discount fares. With these conditions, the best of them do not aim to simply make a fare unusable by business travellers whom in the past airlines have assumed would then pay them more. Instead, they should make a fare available to all who are prepared and able to meet the condition, and ensure that, if the correct cost allocation methods are used, that the passenger who pays a lower price is carried at a genuinely lower cost. We now move on to discuss some of the more common conditions associated with discount fares, in the light of this requirement.

1. Minimum Stay Conditions

Many discount fares in the past have required passengers to spend a minimum amount of time at their destination. On short-haul routes, a Saturday night stay has often been specified. This has meant that passengers could not make return journeys earlier than the Sunday morning following their outbound trip. On longer routes, a minimum period of days

– usually seven – which must be spent at the destination was sometimes defined. In both cases, passengers could return early if they wished to do so. However, they would have to pay the full fare.

These conditions, whether set as a Saturday night stay or a period of days, all had the same purpose. They were designed to restrict the business travellers' freedom of action. The Saturday night stay condition meant that they had to use the full fare to spend the weekend at home. Also, business trips usually last for only a few days in any one place. Indeed, a salesperson on a sales tour may visit several countries on a two or three week business trip. The Minimum Stay Conditions on the cheaper fares ensured that they had to buy a full fare ticket in order to obtain the flexibility they needed.

To some degree, length-of-stay conditions met the criterion set down in the last paragraph, of being cost-related. In particular, A 'Saturday Night Stay' rule could be said to do so. Most airlines find that their flights on the evening before the weekend begins are very full, but on Sundays generally loads are much lower. Therefore, a condition which encourages at least some passengers to delay their return may have the beneficial effect of lessening the extent of a peak, whilst lower prices may generate additional trips at off-peak times which will fill otherwise empty seats at lower, but still profitable, yields.

Generally, Minimum Stay rules are amongst the most effective of the conditions designed to protect airlines' high yielding traffic, providing they are strictly applied.

2. Maximum Stay Conditions

Maximum Stay Conditions define a maximum length of time that passengers can stay at their destinations and still return home using a cheaper discounted fare. If they stay longer than the stipulated maximum – 45 or 60 day periods are often allowed – they will have to pay the full fare to return.

Generally, Maximum Stay Conditions are a less effective way of controlling discount fares and their usage by airlines has declined in recent years. They may, though, have some effect in controlling dilution in that sometimes someone who is travelling to a destination and staying for several months may not be on holiday. Instead, they may be travelling on a business contract, in which case their employer will be paying the fare. They may be able to pay a higher price as a result.

3. Advanced Purchase

Advanced purchase rules are still sometimes applied to discount fares. They mean that passengers must book and pay for their ticket a defined

minimum period in advance. They must also accept that there will be a substantial penalty if they wish to alter or cancel their booking once they have made it.

Advanced Purchase conditions bring airlines a number of advantages. They improve cash flow. They also ease the task of capacity management in that they force low yielding demand to come forward at an early stage. Their most telling advantage, though is again that they make it difficult for the business traveller to use a lower fare. Many business trips arise in response to last-minute emergencies and cannot be planned far in advance. Even where they can be, business executives often cannot accept the limits on their flexibility that a cancellation or rebooking penalty will cause.

4. Standby

Standby fares can be booked at any time. They do not, though, guarantee the passenger a seat on a particular flight. Instead, the passenger must report for a flight and wait. If there is an empty seat, they will travel. If there isn't, because the flight is full with higher yielding demand, the Standby passenger will not be given a seat. Instead, they will have their money refunded, or will have to wait for a later flight.

Standby fares bring a number of advantages. They are a genuinely cost-related lower fare, in that they are profitable as long as the fare paid exceeds the passenger-related costs of filling an otherwise empty seat. Also, they are often sold at the airport or at an airline's downtown ticket offices. Therefore, no commission has to be paid on them. They permit airlines to exploit a market for last minute, unplanned leisure travel decisions. Advanced booking requirements do not allow this. Of most importance, though, is the fact that, if properly managed, Standby fares protect airlines from revenue dilution. Except in the circumstances discussed below, a business traveller who has to attend an important meeting is unlikely to use a Standby fare to reach it, in view of the uncertainty involved.

Despite these advantages, the use of Standby fares remains controversial, and many airlines have backed away from them in recent years. They are certainly unpopular with airport operators, because of the risk they carry that airport terminals will become crowded with people holding Standby tickets waiting for many hours – perhaps days – for flights on which they can be offered a seat. Also, a passenger holding a Standby ticket for a particular flight has an incentive to phone the airline to make extra bookings using false names, addresses and contact phone numbers. Finally, business travellers may find it surprisingly easy to take advantage of a Standby ticket. All they need to do is to buy a full Economy ticket in advance of their flight. On arrival at the airport they check to see if the

flight is fully booked. If it isn't, they then buy a Standby, fully confident that they will be offered a seat. The full-fare ticket is, of course, refundable. They would merely keep this ticket to claim their refund at a later date. Had they found the flight full, they would have used their full-fare ticket in order to get on it.

A final point about Standby fares is a particularly important one. Airlines should not offer Standby fares on their off-peak flights. This is an apparent contradiction. Off-peak flights are those with the greatest number of empty seats, which the Standby fare can help to fill. If, though, Standbys are allowed on off-peak flights, the dilutionary effects of doing so will be severe. Passengers who need to take the flight in question will still have a very high probability of getting it, despite the fact that they only hold a Standby ticket. In contrast, Standbys bought at the peak season will carry with them a significant risk that a seat will not be available. Business travellers in particular may not therefore be able to use them.

5. "Preferential" Fares

Airlines today still offer many types of cheaper fare which are only available to named groups of passengers. These fares can be divided into two types. First, what are known as *stage-of-life* fares. Examples include the special low fares offered to children, young people and to senior citizens. Second, airlines offer many *occupation-related* cheaper fares. Special fares are, for example, often given to seamen, to military personnel and to diplomats.

These "Preferential" fares (they are sometimes, and better, described as "Discriminatory" fares) give preference to named groups. Unfortunately, it is impossible to support them as a form of pricing for airlines. Those carriers that use them often find that they are offering an increasing number of discounts to a wider and wider range of their passengers. The reason is, of course, that once a discriminatory discount has been offered to one group, there are no reasons of principle to deny it to others. Airlines will therefore be subject to constant lobbying, to some of which they may eventually have to give way. Also, after a discriminatory discount has been introduced, it will be very difficult for airlines to withdraw it. Once a particular group has known the privilege of cheaper fares on a preferential basis, they will fight hard to retain this right.

6. Fares Only Available as Part of a Tour Package

These conditions limit the sale of fares to wholesalers, who are then supposed to add in the accommodation and other features which make up a packaged holiday. Only these complete holidays should then be retailed. If

these rules are complied with, again the proposition becomes an unattractive one to the business traveller.

6:2:3 Pricing Response and Pricing Initiatives

Today, in price-competitive markets, pricing managers will be constantly faced with situations where they have to decide whether or not to respond to the pricing initiatives of their rivals. This may involve questions of responding – or not doing so – to the fares discounts that a competitor introduces. There may also be opportunities to lead the market either in terms of discounts, or in the raising of prices to improve yields.

In all these situations, it can, of course, be argued that every case is unique. Whilst this is undoubtedly true in principle, it is an unhelpful proposition in terms of airlines deciding on what their pricing policy should be. Instead, it can be argued that there is a series of questions which should always be asked. The answers to these questions will ensure that there is at least a consistency in an airline's pricing philosophy.

If we begin with the situation of a rival airline coming into a market with discounted fares, the most fundamental question of all is to decide why they are doing so. There is a wide variety of possible reasons for an airline to offer discounts, reasons which will explain whether or not the initiative may be limited and short-term – in which case it may be possible to ignore it – or substantial and long-term, demanding action from competitors.

In terms of possible reasons for lowering fares, by far and away the most common is that the airline is suffering from an overcapacity problem. It may have taken delivery of an aircraft type which is too big for the prevailing demand, or over-ordered in terms of the number of planes entering its fleet. Such mistakes may be exacerbated by the Trade Cycle entering a downswing, so that forecast increases in demand – which might have filled the new capacity – do not materialise.

In such a situation, other airlines will have little alternative but to respond to the challenge with which they are being faced. By responding, they will risk running into a loss-making situation. By not doing so, though, the fall in their market share may cause even worse problems.

Closely related to price discounting caused by overcapacity is the situation where an airline cuts fares in order to raise cash in the short term. A carrier on the edge of bankruptcy will need to find the cash in order to pay off its most demanding creditors. If it cannot do so, these creditors may insist on the liquidation of the company, seeing this as the best hope of securing at least some of the money they are owed.

This type of pricing is often characterised as the “Dash-for-Cash”. It

poses an awkward problem for other airlines challenged by it. Their first reaction might be to respond fully by matching or even undercutting the lower prices of the failing airline. By doing so, they would hope to speed its decline into bankruptcy, resulting eventually in the removal of the competitor from the market altogether.

Today, such a reaction might be over-hasty. If an airline disappears, it will certainly be replaced by another, probably stronger, carrier. The long-term result of a weak airline going into bankruptcy may therefore be that a favourable competitive situation is replaced by an unfavourable one. It is often better to allow a weak airline to raise sufficient cash to stay in business, by not fully responding to any desperate pricing initiatives it may undertake. Such a conclusion may be especially true in the USA where Chapter 11 of the bankruptcy code may allow an insolvent airline to survive for a considerable time using the expedient of court protection from its creditors. Whilst it does so, it may be able to price in a cavalier and destructive fashion because it knows that only its short-term creditors (in order to persuade them to continue to forward necessary supplies) rather than its long-term creditors will need to be paid.

There are other reasons why an airline may offer lower prices. A start-up airline may do so, in order to gain useful publicity and to persuade people to try its services. Equally, a mature airline might do so when launching a new route serving a market where it is not well-known. In both cases, established players will have difficult decisions to make. If they match, or even undercut the newcomer they will undoubtedly make life very difficult. They will, though also dilute the yield obtained from the large number of passengers who would have continued to fly with them anyway, despite the newcomer's presence. They may also (within the European Union at least) risk court action being taken against them, with the accusation that they have abused a dominant position under the terms of Article 82 of the Treaty of Rome.

Once a view has been taken as to why a competitor is engaging in fare discounting, other questions then come into play.

The question of appropriate action will be very different in the situation where the price leader is a dominant player rather than a minor market participant. A large airline in its home market will have sufficient power to ensure that whatever pricing initiatives it takes, these will almost certainly have to be followed by its rivals. A minor player, though, may well be left alone if its overall impact on the market is small.

A further question is that of the number of seats made available at discounted prices. Modern Revenue Management systems allow a precise control to be kept not only on the prices which are offered, but also of the number of seats available at each price in an airline's Differential pricing

structure. There have been accusations from time to time that some carriers use advertisements describing attractive offers of lower prices in an unscrupulous way. These offers are designed to encourage people to contact the airline seeking the very low prices described in the advertisements. In fact, the airline ensures that very few seats are available for sale at these prices. Those making enquires are told that all the very low-priced seats have already been sold, but that seats are still available at a significantly higher fare. The aim is to “bait and switch” these people into buying higher priced tickets.

Whilst the morality of such tactics is open to question, their implications for pricing policy are clear. Rival airlines should not over-react to the prices placed in newspaper advertisements. Rather, they should base their reaction on the number of seats being made available at the different fares. This can easily be checked by calling the airline in question or visiting its website and making enquiries about seat availability.

A final issue with the question of response to a discounting competitor is the need to study past situations where price discounting has occurred in a particular market. Such discounting often has a seasonal component to it. It commonly breaks out at the end of the summer peak season as airlines position themselves for the quieter winter period. Careful study of the effect on market share and yield of past decisions to match or not to match rival’s fare initiatives will certainly have a bearing on the question of appropriate responses to any current challenges being laid down by competitors.

The other major question airlines need to address in managing pricing is when they should take the risk of leading the market in terms of a price increase.

Sometimes, it will be possible to do this in consultation with rival airlines. In some international markets, it is still possible for competitor carriers to meet together at the Traffic Conferences organised by IATA. These conferences can be used to discuss the levels of the higher, fully flexible, fares with hopefully (from the airline’s point-of-view) agreement being reached that these fares should be raised in tandem. In other situations, all the different airlines serving a market may unite in a so-called Yield Improvement Programme (YIP), with again the questions of reduced availability of discount fares and fare increases on the agenda.

Today, the evidence is that such multi-airline approaches to tariffs management are only effective in situations where capacity and demand are in some sort of equilibrium. When they are not, one or two airlines will always break ranks in pursuit of their own commercial objectives. Once they have done so, any agreement will quickly break down due to the pressures of market forces. Of course, too, airlines must be very careful *not*

to discuss raising prices in any situation where this will break applicable competition laws. British Airways was reminded of this in the summer of 2006 when investigations were begun to decide if it had colluded with its competitors over the question of fuel surcharges.

In a situation where airlines are under pressure to raise their prices, it will often be the case that the requirement to do so is dictated by poor profitability. In turn, low profits or losses may be caused by cost increases. If they are, it will be vital to decide whether these increases are in “Controllable” or “Uncontrollable” costs.

“Uncontrollable” costs are those which airlines can do little or nothing to influence. Examples are the price of aircraft fuel and the level of landing fees. If these rise, they will affect all airlines more-or-less equally. Presumably all carriers will then welcome the opportunity to raise prices in order to, hopefully, allow their financial position to recover. At the time of writing, this is happening as carriers attempt to respond to rapid increases in oil prices.

“Controllable” costs are those which are within the control of airline management. By far the largest component of them for almost all airlines is that of labour costs. Typically, 30 percent of a carrier’s total costs will be made up of these costs. In pricing terms a very worrying situation is that where an airline fails to control its labour costs effectively by conceding an over-generous wage and salary settlement, or by allowing changes in work rules which damage productivity. Then, rival, better-managed carriers will not be affected to the same degree. They may in turn see competitive advantage in not matching any fare increases which might be put in place to cover higher costs, instead seeking to improve market shares on the basis of sustainable cheaper prices. Beyond any question, in a market where active price-competition is taking place, effective management of these controllable costs is one of the central tasks which management must address.

Other factors to be taken into account in deciding whether or not to lead the market with a price increase, are the questions of the stage of the Trade Cycle, and the degree of market dominance which a carrier has. Generally, it is possible to raise prices much more easily in the up-swing period of the Trade Cycle when demand is recovering and deliveries of new aircraft comparatively small (due to airlines only ordering small numbers of planes during the preceding recession).

This was well-illustrated by the upswing period in the mid-1990’s when many airlines were successful in raising prices. They were able to do so to such a degree that yields improved in real terms for the first time in many years. Something similar has occurred during the period of buoyant growth in the world economy during 2004 and 2005.

With regard to market dominance, generally it is a strong airline in its home market that will decide when prices will rise in such a market. Smaller players will often have little choice but to follow the initiatives taken by their stronger rival.

All-in-all, the questions of pricing response and pricing initiatives illustrate the enormous changes which have come about in the skills required to manage pricing in the airline industry. Today, it is a question of judging, quickly, the pricing decisions which need to be made, in the ever-present knowledge that mistakes will result in large financial losses.

6:3 The Structure of Air Freight Pricing

Pricing policy for air freight is just as controversial as that on the passenger side of the industry. It is also an area where considerable, and long-overdue, change has come about in recent years.

Air freight pricing policy has in principle to encompass almost all of the problems which occur on the passenger side of the business. In addition, a way must be found to taking account of significant differences which are unique to air freight. For example, air freight shipments vary in size from very small packages to consignments of 30,000 kilos or more. Costs, though, do not vary in the same way. Many costs, such as those of documentation and customs clearance are fixed irrespective of consignment size. Also, commodity types vary, often with an impact on cost levels. Some commodities may need extra security. Perishable goods will need refrigeration, whilst especially fragile items may need special handling. Pricing policy must as far as possible reflect these differences. A further problem is that of density. Airlines must charge shippers of low density freight on a volumetric basis. If they do not, they run the risk that they will attract excessive amounts of low density cargo which will fill the volumetric capacity of aircraft without their payload potential being fully exploited.

All these issues are important in air freight pricing. Perhaps the most difficult problem, though, is to find a cost base for pricing in a situation where airlines are using different types of capacity to carry freight.

Where freight is carried in a pure freighter aircraft, the appropriate cost base is clear. Airlines must aim to recover all the costs of operation including such items as depreciation, maintenance, crew salaries and landing fees. When the belly-hold of a passenger aircraft is used the situation is by no means as obvious. Then, some of the costs will clearly be attributable to freight, such as those of freight handling and selling, and the costs of extra fuel burnt as a result of the weight of freight carried. Many

costs of these flights will, though, be joint costs. This will be the case, for example, with costs such as those for crew salaries, maintenance and landing fees.

Many airlines now attempt to apportion these costs between the passenger and freight output of a particular flight. This may make some sense at peak times for freight, and on long-haul routes, where it might be argued that the use of belly-hold space saves the costs of the airline's freight department from operating pure freighters. It does not do so at off-peak times, or on routes with little freight demand. Then, the freight department would not operate services at all if it was free to make its own commercial decisions.

In seeking a cost base for pricing, airlines must clearly never offer prices which fall below the level of the marginal costs of freight handling and selling. They must, though, aim to do a great deal better than this. Freight must make a significant contribution to the total costs of flights where a substantial proportion of the aircraft's potential payload consists of belly-hold freight capacity. This will especially be the case if the airline is also operating freighter aircraft. Prices based merely on marginal belly-hold costs will come nowhere near the levels necessary to cover the operating costs of a freighter.

Given these various constraints, it should not be surprising that the subject of air freight pricing has been a controversial one.

In the past, it was possible to divide freight pricing into two distinct parts. Firstly, airlines offered so-called General Cargo Rates. These were pitched at a very high level, with an even higher Minimum Charge for the smallest shipments. Discounts were then offered for larger consignments, to reflect lower documentation and handling costs. The highest rates applied only to shipments weighing 45 kilos or less.

The second part of the traditional air freight rate structure was much more controversial. In addition to General Cargo Rates carriers offered a range of lower so-called Specific Commodity Rates. These were usually available only for larger consignments. Also, they could only be used for specific, named types of freight. IATA set up a complex system to allow its member airlines to define the commodities which would, and would not, be charged a lower rate.

The Specific Commodity Rate system was fundamentally in error. It was based on the principle, comparable to that used on the passenger side of the industry, that if price-sensitive users could be brought into the market, the size of the total market could be expanded with benefits to all customers. The mistake was to equate price sensitivity to commodity type, rather than to the urgency of the shipment. By using commodity type, airlines were faced with insoluble problems of commodity definition,

problems that made the industry a laughing stock. For example, should a Specific Commodity Rate covering “footwear” allow socks, bandages or indeed anything else that might be worn on feet to be set at the concessionary rate, in addition to shoes? Also, the system produced a classic problem, encountered in many discriminatory pricing systems. Once a concessionary rate had been offered for one type of commodity, there were few arguments of principle to deny them to shippers of other types of freight. As a result, the role of Specific Commodity Rates changed. They were originally intended to provide a supplement to the General Cargo Rate system. Instead, on some routes (notably the North Atlantic), they came to dominate the rate structure with a high proportion of all cargo moving under them. The implications for average yields then became significant.

In recent years, the emphasis of airline’s freight pricing policy has altered. The introduction of the so-called Bulk Unitization Programme was dealt with in Section 5:6. It largely changed the basis of air freight pricing from one of discrimination by commodity type to Freight-of-all-Kinds (FAK) instead. Bulk Unitization rates were available for any type of freight, provided it was pre-loaded into an aircraft Unit Load Device (usually a container), or stowed onto a pallet. They were therefore fairer, and much simpler to administer. The problem with them was that they gave excessive power to the air freight forwarding industry, because it was only the largest shipments (which the forwarders could provide through their consolidation activities) which qualified. They also did not differentiate between shipments in terms of urgency.

Today, most airlines by-pass the old, cumbersome structure of air freight rates. Rates are set through negotiation between customer and airline, with rates rising and falling in recognition of the balance between supply and demand in the market. Substantial discounts are generally offered to customers willing to accept deferred delivery, because this often allows airlines to fly their goods during the off-peak period at the beginning of the working week rather than at the busy time at the end of it when there may be shortages of capacity.

In the so-called “Express” market of small, urgent shipments, pricing policies have been led by the integrated carriers such as UPS, Federal Express, DHL and TNT. As was discussed in Section 4:2:6., these firms have not relied on the air freight forwarding industry for their traffic. Instead, they have invested in building strong brands, and promoting these heavily to the retail market. The brands have been divided between those which offer guaranteed next-morning delivery at a premium price, and ones which give a slower, but still time-definite, delivery. Again, this allows carriage to be delayed from peak into an off-peak period.

Such a product-based approach to pricing is simple to administer and essentially fair between different types of customer. Not surprisingly it has been followed by many combination airlines which have launched their own branded products in an attempt to compete with the Integrators. Generally, though, these have been offered on an airport-to-airport basis with the ground transportation provided by air freight forwarders who have been encouraged to sell the products on a commissionable basis.

All-in-all, the field of pricing is one of the most rapidly changing and most challenging in the whole area of airline marketing activity. Only by a flexible adherence to a set of clear principles can costly mistakes be avoided.

SUCCESSFUL AIRLINES

- ➔ Appreciate that the old days of regulated pricing have passed and will not return, and accept that the central skills now required of pricing management are those related to pricing in price-competitive markets.
- ➔ Acknowledge that different pricing strategies will be needed depending on the airline's business strategy.
- ➔ Accept that pricing in the Economy cabin must conform to a Differential rather than a Uniform principle, and that airlines must be able to justify the concept of Differential pricing to those who pay higher fares. The use of such pricing, though, must not go to the point where it raises training and selling costs to unacceptable levels, or where it leads to customer alienation.
- ➔ Control the use of discount fares by imposing, and enforcing, appropriate conditions on these fares, and by developing a state-of-the-art Revenue Management system.
- ➔ Develop and apply consistent guidelines about when a response should be made to a competitor's pricing initiatives, and when the airline should take pricing initiative.