

Yielding to the LCCs

Legacy airlines find themselves having to rethink their revenue management strategies in the face of the low cost onslaught.

By Michele McDonald

Air Transport World, March 2006, p.36 [Buy this issue](#)

Low-cost carriers now account for about a third of the US market. For the most part, despite five years of restructuring and a few bankruptcy reorganizations, legacy carriers have yet to pare their costs down to the levels of JetBlue and Southwest.

The newer carriers increasingly are writing the rules of competition and the legacy lines, which are experiencing LCCs on 60% of their routes, must compete on their terms. Thus they are adopting some of the hallmarks of their low-cost brethren—not only their fares but their fare structures. Their efforts range from Delta Air Lines' SimpliFares, which eliminated some restrictions and briefly put caps on domestic fares to Alaska Airlines' new fare grid that shows every available fare on every available flight. But these moves have not simplified the lives of airline revenue managers. Rather, they have made the legacy carriers "schizophrenic," according to Peter von Moltke, senior VP of Amadeus North America's Airline Business Group. "Revenue management is going off in all directions," he says.

Traditional revenue management comprises forecasting and optimization: Predicting demand for a particular flight, then coming up with a pricing system that extracts as much revenue as possible from each passenger.

It's a myth that low-cost airlines don't practice revenue management; they simply use different tools that measure different things, such as a flight's load factor at any given moment. The rules by which they play change the math: Just disconnecting the outbound and return flights and selling one-way fares exclusively radically alters the equation.

LCCs generally have a mere handful of fare categories and smaller differences between the fare levels. They don't require a Saturday-night stay. Fares are usually nonrefundable and instant purchase often is required, but the penalty for changing a ticket may be lower. That produces fewer no-shows, so conservative overbooking—or in the case of JetBlue, a no-overbooking policy—is the norm.

"You still have to open and close the fare buckets," von Moltke says. "But the whole philosophy is different, so as you implement these LCC fare structures, you have to redesign your revenue management and retool the principles behind it."

The problem for legacy carriers is that they are operating in both environments: A simpler fare structure on routes where they compete with LCCs and a traditional structure

everywhere else. Where it gets really interesting is where both modes are in operation on the same flights.

For example, "Delta has connecting traffic at its Atlanta hub, but it competes with AirTran on short-haul routes to and from Atlanta," says Ben Vinod, chief innovator for Sabre Airline Solutions. "There is an electronic curtain on those flights." The virtual partition separates "the two types of customers on the same flight"¶ the regular tariff is applied to connecting traffic while local passengers are offered LCC-style fares.

This "hybrid" model has necessitated the creation of tools that can forecast the two types of demand. "Typically in the old world you had product that was defined by the restrictions on a given fare," he says. "The airline views a 14-day fare as a different product from the seven-day fare. We always assumed that these products were unique." In this model, he adds, there is independent demand for each product.

On the other hand, "In a restriction-free and one-way fare environment, the fare is the only determinant of the product," he says. "I have six fares in the market, and all these fares are the same in that they are restriction-free. The only difference is the fare level. That is a fundamental difference." Demand, therefore, is "dependent on the active fare that is offered in a given market at any given time. That has huge implications in terms of forecasting and optimization. We have to assume dependence on price."

The traditional methods of forecasting won't work. An airline needs to determine the price/demand curve for each fare based on the underlying relationship between demand and price.

Sabre began devising revenue management tools for the low-cost model in 2002, when a new pricing model was taking hold in Europe. In response, bmi spawned bmibaby and needed new methods of demand forecasting. Sabre developed Low-Fares Manager, which now also is in use at Estonian Air, Copa, TAM and WestJet. The LCC optimization model tells an airline when to activate fares. "Say you have three fares¶ \$59, \$79 and \$99¶ on an Austin-Dallas route," says Vinod. "The \$59 fare is active 28 days from departure; the restriction-free optimization model determines when the next fare should be made active based on current demand. It might tell you to shut down the \$59 fare and go to \$79 in 10 days."

When Delta introduced SimpliFares, it began using Sabre AirMax Revenue Manager, a combination of revenue management decision support and rules for closing fare classes. Delta VP-Revenue Management Gail Grimmett says the SimpliFares structure stimulated demand and provided "a logical opportunity to enhance our capabilities through a new O&D-based revenue management system. This system has functionality that better understands where our demand is coming from, the timing of the demand, and optimizes connecting versus local traffic."

Vinod says Sabre has developed an integrated workflow that gives an airline a side-by-side view of what is going on with both models. It also is in the process of launching a

"choice-based" forecasting model based on customer preferences, slated to debut in the first half of this year. Sabre processes 40% of the world's airline bookings, he says, and captures the shopping sessions of travel agents using the GDS and consumers using Travelocity. The new-generation forecasting model will use "choice parameters" such as displacement time, elapsed time and preference for time of day. "It will be the first of its type to model consumer preferences. Based on the initial results, it does better than traditional forecasting," he says. "Anytime you have schedule changes or competitive price changes, we can explicitly model the relationship between the changes and demand."

Buyer Beware


Some aspects of the LCC model are making revenue management even more important, notably the move to direct distribution, says Frank Arciuolo, executive VP of Airline Automation Inc. "One of the issues you get when you put inventory into the hands of the consumer directly is the uninformed consumer making bad decisions," he says. For example, a user may have a slow connection so he hits the purchase button twice, resulting in a duplicate reservation on one PNR. "Invariably, the airline refunds the second reservation," he notes. "The three highest sources of no-shows are the airline's own website and two of the top three online agencies. It's still a necessity to ensure the quality of the reservation."

Other factors also are stirring the revenue management pot. "Some of the initial preconceptions of revenue management have been challenged," Arciuolo says. "Traditional airlines always saved the highest-priced tickets for last. Now they are having distressed inventory sales closer to the departure date."

Meanwhile, the move to simplified pricing has generated a new phenomenon that could add some wrinkles to revenue management: "Rationalized" pricing. "If I'm a business traveler, no matter when I pay, the price I pay should dictate what I get," Arciuolo argues. The aisle or window seat should cost more than the middle seat, for example. "Eventually, this rationalization will get to the point of stratifying frequent-flier miles. If you want all that stuff, you'll pay for it."

An example is Air Canada's move to five fare classes, all with one-way pricing, that are displayed on a grid on its website each with a separate level of service and flier awards ranging from Tango to Executive Class. A customer booking a Tango fare, for example, must pay \$15 for advance seat selection. Arciuolo likes this concept because passengers prefer paying a premium upfront for additional services rather than paying a penalty.

Von Moltke says that once an airline implements this technique, the consumer can make an informed choice, and often that choice is a higher fare. "Before, the lowest fare was the only thing they could relate to," he says. "Now they associate the fare they pay with the value they are looking for." The disconnection of outbound and return flights allows them to buy a Tango fare for one segment and a higher fare for the other if they choose, which also will boost an airline's revenue. "The numbers we've seen immediately after



implementation show that yields jump an average of 6% and revenues by an average of 30% on those particular routes."

If today's simplified fare structures seem familiar, it's because they bear a marked resemblance to the ill-fated Value Pricing scheme introduced by American Airlines in 1992. Vinod believes the system has a better chance of survival in the current environment. "The difference between 1992 and today is that over the last five years the low-cost carriers have had tremendous penetration," he notes. "This time around, the simplified structure is here to stay."

But he has reservations as to whether they can sustain the shift successfully: "Most airlines that are going through fare simplification initiatives see demand stimulation. The fundamental question is, can it be sustained and can revenue dilution be contained without risking the loss of market share to low-cost carriers?" Part of the problem is that the whole fare structure is lowered significantly, and "at those prices, they can't make money. It's quite a challenge."

[Click here for copyright permissions!](#)

Copyright 2006 Penton Media

Ads by Google

[Microsoft Dynamics-AX](#)

Simplifying the management of complex business processes.

www.axtin.com

[Pricing Analysis Software](#)

Proven In Manufacturing, Chemicals, High-Tech & Other B2B Industries!

www.Vendavo.com

[CharterHub.com](#)

Comprehensive List of Aircraft For Charter & Charter Operators

www.charterhub.com

[Customer Data Web Cast](#)

Live web cast on customer data, IRM, industry trends and solutions

www.Nimaya.com/webcast.asp

ATW Media Group

If you have a technical question about this site, please [contact the Webmaster](#)

[Site Use Agreement](#) · [Privacy Policy](#) · [Digital Dropoff](#) · [Media Kit](#)

[Copyright ©2006 Penton Media, Inc.](#)

[XML](#)



Penton Media