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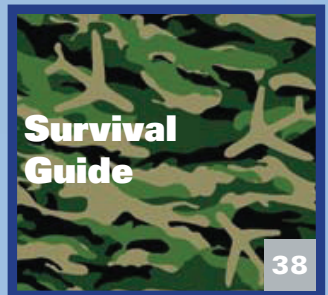
Taking your airline to new heights

A Clear Vision

A Conversation With ...
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Special Section



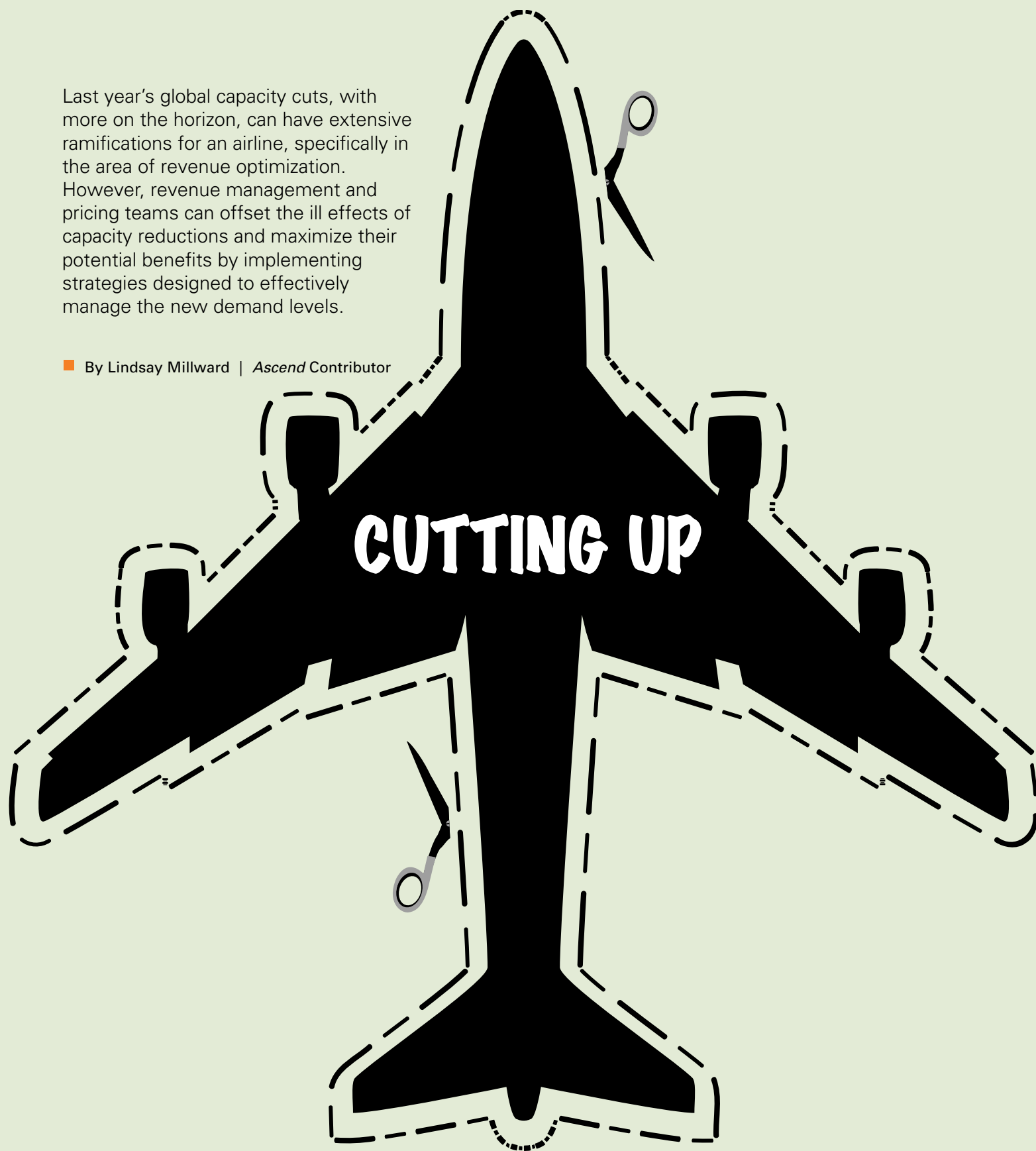
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Last year's global capacity cuts, with more on the horizon, can have extensive ramifications for an airline, specifically in the area of revenue optimization. However, revenue management and pricing teams can offset the ill effects of capacity reductions and maximize their potential benefits by implementing strategies designed to effectively manage the new demand levels.

■ By Lindsay Millward | *Ascend* Contributor



Last year, the airline industry saw the most dramatic cuts in capacity since 9/11, with promises of more to come. As oil prices continued to soar up to an eventual peak of US\$147 a barrel, airline executives saw no option but to take drastic action — reducing capacity. The belief was the action would result in lower costs and that removing seats would sustain or even boost ticket prices, leading to an increase in yields.

“The events allowed for needed capacity reductions that wouldn’t have happened otherwise,” said Robert Crandall, former chairman and chief executive officer of AMR Corp.’s American Airlines, during the 2008 Airline Strategy Summit in London. “It is this ruthless reduction in seats that will preserve ticket prices and margins and thus ensure that a few carriers survive.”

Although the action was taken as a result of oil prices, which have since declined significantly, it appears the right decision was made for an unexpected reason — the abrupt softening of demand. Whether the decision was good luck or good judgment, the capacity decreases could not have come at a better time.

Early signs of a slowing economy started to snowball with banks and financial institutions reaching crisis point and governments providing huge bailout packages. The inevitable cuts in corporate travel budgets and leisure travel followed, and demand softened noticeably. Numerous predictions have been made on the revenue impacts to the industry. The International Air Transport Association

has forecasted a fall of US\$36 billion in revenues compared to the last downturn, which saw a drop of US\$1 billion. Others have forecasted decreases to lesser or more severe degrees, but all have agreed that the airline industry is facing one of its most challenging years.

Capacity declines have not been seen globally, however. Comparing the fourth quarter of 2008 versus the fourth quarter of 2007, there is a clear distinction regionally. In typical fashion, North America has made the most drastic cuts, while European and Asian carriers have implemented a more tempered decrease. The Middle East, Australasia and South America, meanwhile, continue to see a marked increase in available seat kilometers, up by 8.9 percent, 4.3 percent and 6.0 percent, respectively. And while North America capacity is down overall, Southwest Airlines bucks the trend with a slight increase in available seat miles.

Commercially, capacity cuts have far-reaching repercussions across an airline, and few areas are more affected than revenue optimization. When this type of change occurs, revenue management and pricing departments need to respond appropriately to maximize the benefits that should be gained. There are tactical steps revenue management and pricing teams can take and strategies that can be implemented to effectively manage these new demand levels.

Pricing Strategy

Typically, the pricing strategy for a market is based on various factors that need to be reas-

sessed given a capacity cut. These factors include price sensitivity, market segmentation, seasonality, market performance, market share, capacity share, schedule and competition. As capacity decreases in a market, the pricing structure needs to be reviewed accordingly. In fundamental economic theory of supply and demand, the reduction of supply would result in an increase in the price that can be charged for goods. However, in the current economic climate, given the diminishing demand and the reduction in companies’ corporate travel budgets, pricing analysts need to be even smarter in formulating strategies based on the characteristics of their markets.

In some markets, no action will be required. Where a comprehensive pricing structure exists and competition is minimal, the revenue management system should optimize those flights, thereby controlling the fare availability given the decreased capacity. However, in more competitive markets that have seen more drastic capacity cuts by multiple carriers, certain questions need to be answered:

- Do the high-yield fares go high enough?
- Are there sufficient price increments of a reasonable size to encourage up-sell opportunities among the fare classes?
- What action has the competitor taken so far?
- What is the current strategy for this market? This is based on market type:
 - Expand — Low market share but high yield, whereby product segmentation could minimize dilution.



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A softening of the global economy has caused load factors to decrease, and airlines have been dramatically cutting capacity in response to minimize the number of empty seats.

- Maintain — High yield and market share, offering the potential to improve yield and defend share.
- Opportunistic — Low market share and low yield, but opportunities exist to develop traffic and yield.
- Yield — High market share but low yield, presenting the potential to improve the traffic mix.
- Does this strategy still hold true given the reduced capacity, or does it need redefining?
- How can pricing reach the latest strategic objective?

Demand Forecasting

Typical revenue management systems forecast demand on an unconstrained basis, allowing the system to respond automatically to adjustments to capacity; however, where capacity is reduced across multiple airlines on a market or entire flights/routes are cancelled, passenger demand can be significantly affected. The prime concern for an inventory analyst in this situation is how the schedule offered to the passenger has changed. Is there less frequency? Has the capacity reduced to a level where flights are now expected to sell out? How can this demand be recaptured across other departures? And how can the inventory analyst determine what kind of demand adjustments need to be made in the revenue management system? An analyst needs to consider a number of possible scenarios and factors:

- Reduction in the aircraft size but maintenance of the same schedule — Here, the analyst needs to consider whether there is now more opportunity for up sell on this market. If capacity is significantly cut across the operating carriers, assuming there is not still surplus capacity and demand remains stable, the yields could be expected to increase.
- Cancelling a flight but continuing to operate the route — In this scenario, the analyst needs to review the competitors' schedule offering to estimate how much demand will move to the competitors' flights and how much will move to other departures on that day. Factors to be considered include the historical passenger mix on the cancelled flight. If the passengers were primarily price-sensitive leisure passengers, they can be retained by ensuring availability of competitive fares on the remaining schedule.
- Cancelling a route — The key consideration here is the impact on other markets. Cancelling a route may result in:
 - Redirection of connecting traffic through an alternative hub,
 - A significant reduction in connecting traffic formerly travelling on that leg, which may no longer be served,
 - An increase in traffic to a nearby airport.

Various data sources can assist the inventory analyst in determining how capacity changes may impact the market demand. MIDT data can provide guidance to market size and share, along-

side capacity and traffic-trend statistics. The airline's historical data may provide insight from periods where different frequencies or capacities were operated. Competitor fare data can give valuable guidance to competitor strategies following the capacity changes and, with the right tools, the analyst could choose to automatically remain in line with the competitors' fares until the new demand levels have become apparent and the situation has stabilized.

Overbooking Strategy

When overbooking far in advance to compensate for cancellations and no shows, discounted fare classes are usually made available. When significantly decreasing capacity, there is a risk of insufficient seats remaining for higher yielding passengers booking later. Typically, overbooking on lower-capacity aircraft or lower-frequency routes, even as a percentage value, will decrease because there is less room for error. Following a capacity reduction, overbooking strategies and levels must be reviewed. The revenue management system will automatically adjust the overbooking levels, but the analyst needs to be aware of flights with potential for high-yield spill, look for up-sell opportunities and adjust the strategies (including maximum permissible levels) accordingly.

Group Management

In times of capacity reductions, it becomes ever more critical to maximize the profitability of group traffic. When capacity is at a surplus, group demand is often a way of filling empty seats, but in times of reduced availability, group traffic competes for space against individual passengers often contributing higher revenue. Recommending alternate routings at a competitive price to a destination city that is in close proximity to the requested destination city can retain group demand in the airline network and prevent loss of market share. Decision support to recommend a group fare can ensure each group accept/reject decision is based on an accurate demand forecast for individual passengers.

While capacity cuts are inevitable and quite necessary for many carriers around the world, those implementing strategic revenue management and pricing practices are in a stronger position to make up revenue from the lost seats and come away with a much healthier bottom line. **F**

Lindsay Millward is a revenue management product marketing lead for Sabre Airline Solutions®. She can be contacted at lindsay.millward@sabre.com.



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In times of reduced demand, there are several factors an airline must consider such as reducing aircraft size, cancelling a flight or cancelling a route.