A MAGAZINE FOR AIRLINE EXECUTIVES
2010 Issue No. 1

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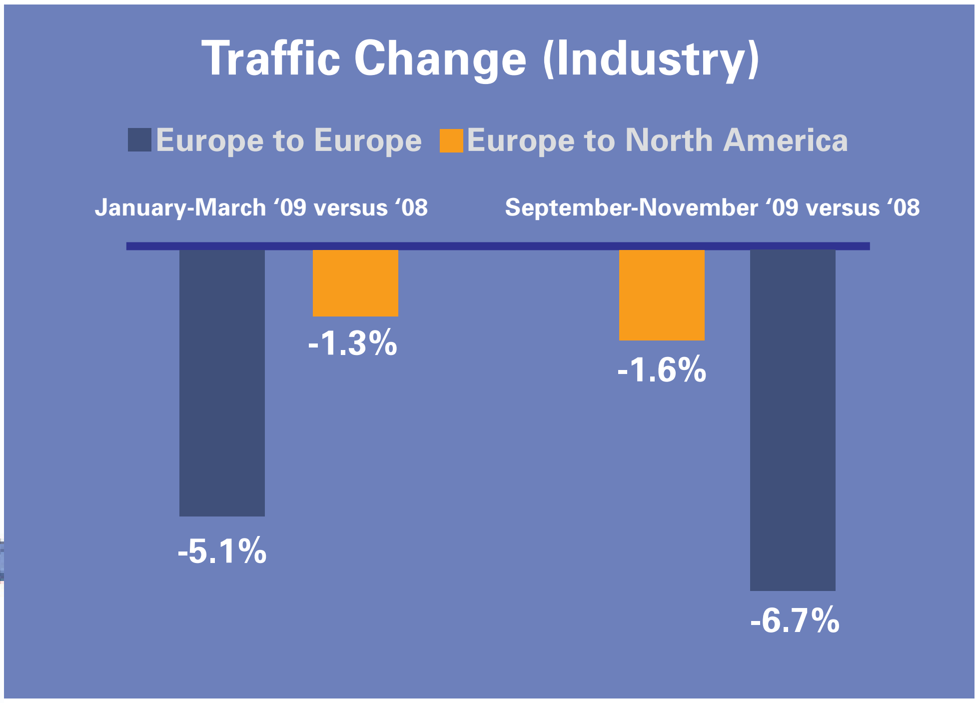
Play By The Rules

Traditional revenue management and pricing processes and technology solutions cannot fully cope with the current competitive landscape. Today, demand, capacity and pricing volatility coupled with the ever-more relevant ancillary revenue opportunities are changing the rules of the "revenue game." New processes and IT systems are needed to effectively compete and pave the way for a successful future.

By Alessandro Ciancimino | *Ascend* Contributor



Industry showed a considerable decrease in short-haul traffic first (first quarter 2009 versus the same period the previous year) and then in long-haul traffic (September through November 2009 versus the same period in 2008). The "evaporation" was due to the recession itself and the threat of an unprecedented impact of such recession. This traffic decline was compensated by an industry capacity cut that has been able to keep industry load factor almost at the same level year over year, but at a considerable lower price.

One thing all airline industry executives share is the unprecedented impact of the global recession on their industry. In fact, some actions being taken are also without precedent: sudden speedup of consolidation and cross-border investments, development of joint ventures in markets where it was not an option just a few months ago, employees being asked to temporarily work for free, bailout offering to peers close to bankruptcy.

Even though the industry has previously shown several instances of demand bouncing back after a crisis, what is alarming this time is that the depth and breadth of the current recession may leave, once the recession has ended, some structural changes in the marketplace. For example, those traveling in business class or with fully flexible economy fares — what was previously considered business traffic — have now learned, or have been forced to learn, that it is feasible and acceptable to travel with restricted economy fares even for business purposes. Hence, one of the questions currently alarming the industry is to what extent will traditional business traffic bounce back when the worst part of the recession is over?

The current downturn could represent a crucial cornerstone for air transportation, and airlines need to quickly adapt themselves to different paradigms governing the industry. And this time, more than ever, the way out is represented by a substantially improved revenue-generation capability that airlines need to establish rather than further draconian cost-cutting initiatives. Controllable costs have been, in fact, heavily addressed during the last few years as soon as either pressure on yield started or uncontrollable costs, such as fuel, increased dramatically. So now the game has to be more on the revenue side and, to put it in Darwinian terms, airlines need to evolve to survive and have a successful future in the new decade.

As a byproduct of the recession and the consequent decline in traffic and yield, demand has become extremely volatile; this translated into two key outcomes:

- Market sizes and yields have been changing considerably year over year,
- Within most markets, worldwide air transport capacity has also changed either because airlines have trimmed their capacity to try to cope with changing market conditions or because airlines have been going in and out of markets with a frequency that rarely was observed in the industry's history.

Revenue management and pricing practices, in addition to network planning and scheduling, are the core drivers of the commercial effectiveness of airlines. So how should they change and adapt to the changed market conditions?

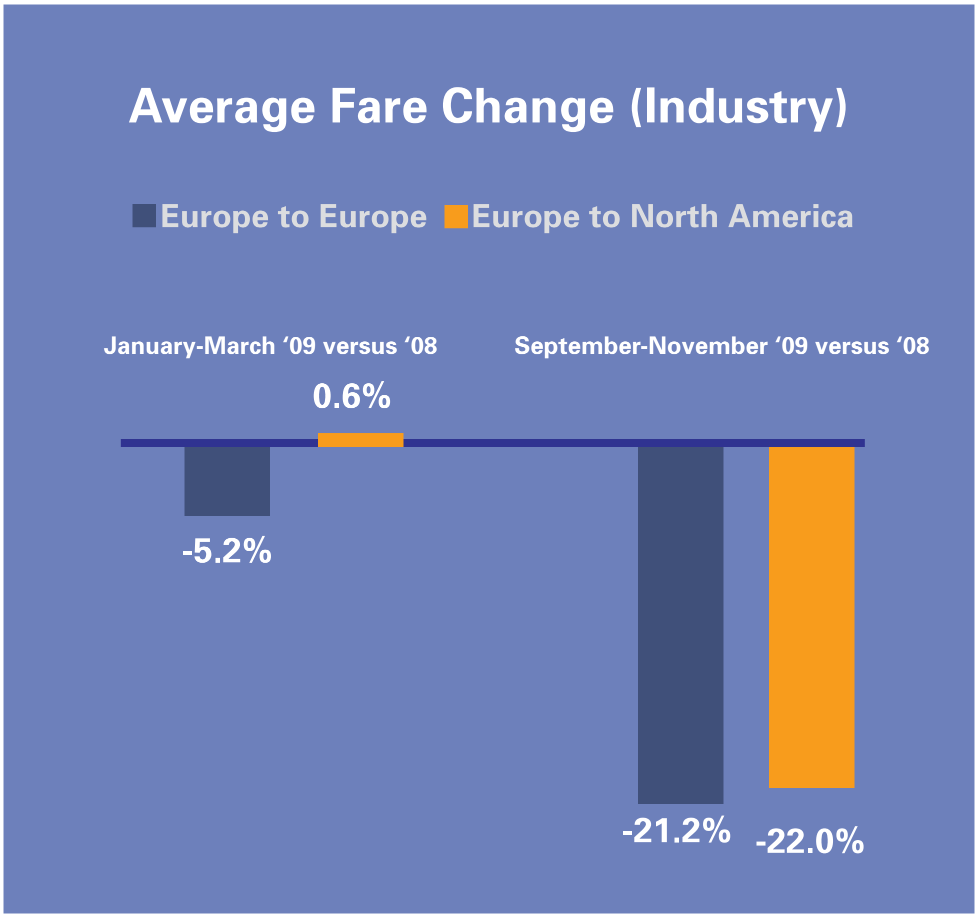
Traditionally, revenue management practices have based inventory control actions on historical data: deciding what to do tomorrow based on what happened yesterday. This used to work during a stable economy where no big changes happen from one year to another. And it still works fairly well in the few mature markets where unconstrained demand could be predicted on the basis of historical data. Additionally, traditional pricing practices are based on standard bucketed fares, with limited pricing strategy for ancillaries or branded-fares offerings.

Much of this is no longer sufficient and/or adequate. Therefore, it's clear that revenue management and pricing practices must cope with rapidly changing market conditions where new competitors enter and leave markets virtually every week, competitors attack the same markets with different business models and demand dramatically varies every month.

But there is also another important dimension on the revenue side that needs to be addressed by revenue management and pricing in an effort to design and offer to airline guests what they individually want as opposed to the traditional one-size-fits-all model.

During the last couple of years, airlines have successfully expanded ancillary offerings, unbundling traditional products with the objective of giving their guests the ability to create their own product without losing loyal customers or leaving new ones to the competition. The overall objective is to shift the business model from being airline-centric to customer-centric, allowing each customer to pay for what he cares about and not what other customers deem valuable. Thus, unbundling the product offering and avoiding revenue dilution has become one new rule of the game. Ancillary revenues have seen a phenomenal growth in recent years. In 2006, ancillary revenues for the airline industry totaled US$2.3 billion. In 2008, the total reached US$10.3 billion — a 500 percent growth. For those leading the way in terms of ancillary services, such as hybrid and low-cost carriers, ancillary revenues currently represent up to 20 percent of their total revenue.

As ancillary services further expand and are distributed through additional channels other than the traditional airline.com — either through specific GDS functionality (such as branded fares and pay-for-seat functionality through the *Sabre®* global distribution system) or through the ATPCO Optional Services — ancillary revenues will definitely continue steady growth, gaining a higher percentage share of total revenue.



Keeping industry load factor at a level similar to the previous year has been reached at the expense of the average fare that dropped significantly during the last months of 2009. In a figurative way, the industry observed a traffic shift from the business cabin of traditional carriers to the economy cabin of the traditional carriers and from the economy cabin of the traditional carriers to the LCC. In the end, the average fares were considerably impacted.

Ancillary revenue, therefore, represents a large portion of airline income that so far has not been included in the revenue management equation. For example, inventory control actions are typically taken without considering the total revenue associated with a booking but rather only the pure fare-related revenue.

In essence, the "next-gen" revenue management and pricing processes and solutions need to address three main aspects:

- Demand is extremely volatile and historical PNR data and booking-class revenue value may not be as relevant in certain markets to predict future demand by fare. What is critical in such markets is the real-time offering in terms of capacity and fares that competitors are deploying, such as the real-time competitive landscape that has a substantial impact on customer behavior when it comes to making a booking.
- Within the same markets there are competing airlines that implement different business models (network carriers, hybrid carriers and LCCs), implying that within the same markets, some airlines might be offering traditional fenced-pricing structures and other airlines are instead deploying restriction-free, one-way pricing.
- The revenue value of each potential booking is not represented only by the associated fare-bucket historical value. It needs to include any ancillary service associated with the booking.

The impact of the above aspects is that next-gen revenue management solutions need to be able to:

- Provide continuous monitoring of competitors' available entry-level fare at a flight level in real time and define the inventory control actions accordingly,
- Perform real-time revenue management through integrated revenue management, inventory and reservations processes to ensure timely reaction to unexpected/unforecasted events (traditional nightly revenue management systems batches are no longer sufficient),
- Perform customer choice-model-based forecasting of unconstrained demand in addition to traditional PNR-based forecasting to be able to capture customer behavior based on the real-time competitive offering,
- Perform inventory control actions with both restricted and unrestricted fares, even in a single market with restricted fares for peak flights and unrestricted fares for off-peak flights (which requires the ability to manage parallel mixed-nesting structures from an inventory viewpoint with corresponding parallel pricing structures),
- Define revenue management decisions on the basis of selling fares as opposed to historical average booking-class revenue, since due to the volatility of the market, the average historical booking-class revenue is inaccurate,
- Define revenue management decisions based not just on revenue driven by fares but also by ancillaries,
- Ultimately, perform revenue management by each individual customer and adjust availability based on each individual customer value score, where the value score is uniquely defined by the airline based on its customer relationship management strategy.

At the same time, pricing solutions need to be adjusted as well to address:

- Mix of one-way, restriction-free and restricted return fares for peak/off-peak flights,
- Branded fares to simplify the pricing structure from a customer viewpoint but at the same time avoiding any diluting effect as much as possible,
- Pricing decision-support processes for ancillaries and branded fares definition.

Such a revolution in terms of solutions requires both business process review/re-engineering and a corresponding redesign of technology systems as well so new processes will be enabled by new technology.

This represents a double challenge. Such business and technology transformation seems to be inevitable for any airline that wants to set the foundation for a sustainable and successful future.

The new "revenue game" has laid out new rules, and players now need to quickly learn them, interpret them and equip themselves with new game-winning strategy, tactics and tools. Otherwise, it's like a traditional poker player pulling up a chair at a Texas Hold'em table without a knowing the new rules: it's not going to pay off.

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