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A Conversation With...

Giovanni Bisignani  
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page 38

### INSIDE

6

g overnment regulations  
affect globalization

42

I atin American carriers  
grow regionally

50

AirAsia overcomes challenges  
to its t hai-based subsidiary

# Working in a Low-Fare Environment

*The arrival of low-cost airlines has created a need for revenue managers at legacy carriers to change their traditional practices and procedures.*

■ By Ana Maria Escobar | *Ascend* Contributor

Many articles have been written describing the effects that low-fare airlines have had on revenue management practices at legacy airlines — articles that describe new and complicated mathematical approaches or those that focus on ways to confront these aggressive new competitors. But scant few have been written about the changes revenue management professionals have had to make to adapt to this new environment.

And such analysis of the revenue management practice falls short when it comes to practical ways to address the daily challenges and changing roles revenue management professionals face.

To understand the challenges and transformation revenue management professionals have had to confront, it is important to recognize the changes the practice itself has undergone since the arrival of low-cost carriers.

## Revenue Management in a Low-Fare Environment

Traditional revenue management is based on using market segmentation — segregating business from leisure travelers, and local from connecting passengers. To accompany market segmentation, airlines offer numerous fare products. Fare restrictions are the key ingredient for creating successful inventory compartments that can be used to sell a customer higher fares when lower priced, limited inventory is sold out.

Passenger forecasts that come out of revenue management systems are relatively easy to develop as long as these fundamental premises remain in place. Forecasts remain valid if booking classes are independent of each other and demand is protected by fare restrictions.

Large amounts of historical data are collected and used by airlines to develop revenue management forecasts to establish inventory allocations. These forecasts assume that past patterns are a good predictor of near-term

demand. Key performance indicators set performance goals and targets. The technological and mathematical models that support traditional revenue management function only if and when the basic suppositions of the market exist — market and class segmentation and fare restrictions.

The world of revenue management is very different when there are low-fare airlines. The fare structures offered by LCCs are simple and transparent to consumers. Usually, unrestricted fares are offered. Most fares are one

way compared with round-trip fares that are needed to create restrictions used by legacy carriers.

Without the usual fare restrictions, booking classes are now dependent on each other because demand is related to the active fare that is offered in a given market at any given time. In traditional revenue management, fare classes are independent because they are defined by the restrictions on a given fare, and they are considered unique. Passengers are attracted to low fares, and they will typi-



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**A few traditional carriers such as Air Canada, bmi, KLM and United Airlines have adapted their revenue management systems and processes to the new airline environment to compete more effectively with low-cost carriers. In the new environment, revenue management analysts must adapt to a lack of fare restrictions, disappearing market segmentation and low fares.**



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**Traditional revenue management practices, which are based on segmenting types of passengers — business from leisure, local from connecting — are changing in light of the presence of low-cost carriers, which have simple and transparent fare structures.**

cally purchase the lowest fare available, especially when there are no differences between products.

Historical information that legacy airlines have accumulated to forecast demand may no longer be relevant. New market conditions created by LCCs can no longer be modeled using historical data when LCCs were not in the market.

Against the background of new, low-fare competition with changing market conditions, traditional revenue management systems and processes fall short in optimizing revenues. In turn, analysts using these systems and processes have had to change the way they work in an LCC environment.

## Dealing With Change

Most revenue management professionals were trained under traditional revenue management principles where systems and processes were generally reliable and time tested, and were based on accepted approaches for decision making and setting inventory levels.

With low-fare carriers expanding to more markets and remaining in place as tough competitors, legacy revenue management analysts were confronted with questions they were not equipped to answer. Previous theories and techniques they learned earlier under an environment of market segmentation and restricted fare products didn't seem to work in a low-cost environment.

The most important challenge they face is to quickly find practical solutions to address and stop revenue erosion caused by dilution under a changing environment that has:

- A lack of fare restrictions,
- Disappearing market segmentation,
- Low fares.

These problems have been and continue to be the focus of studies at universities and technology institutions. After much ongoing study and research, they are far from achieving consensus on an optimal solution that could be applied to legacy airlines encountering LCC competition. Further, if academics were to encounter a solution, it could be financially out of reach for many of the world's airlines.

Some airlines — bmi, KLM, United Airlines and Air Canada, for example — have successfully adapted their revenue management systems and have developed standard processes to compete in markets against LCCs. Unfortunately, there are many airlines competing against LCCs with inadequate revenue management systems and processes that have budget restrictions preventing them from obtaining better tools, changing processes or hiring more knowledgeable staff.

Meanwhile, revenue management professionals still have to confront their day-to-day problems and look for inventive ways to optimize revenues. At the same time, they have to address another challenge — facing pressures from management that in turn must account for declining revenues, loss of market share and reduction in average fares.

Many revenue management staff members have inadequate backgrounds and training for the job they are supposed to do. These departments are often staffed with personnel coming from central reservations control, reservations or sales backgrounds who do not have much experience performing the basic analysis needed to examine data and properly establish inventory levels.

There is a lack of consistency among analysts on the approach taken to manage inventory under a competitive LCC environ-

ment and across different market types, so managers need to provide clear direction and guidance to their staff to standardize procedures to deal with LCCs. Guidelines should not be subject to individual interpretation. Instead, they should follow the strategy that the airline chooses to compete against the LCC.

## Daily Challenges

Revenue management can be a hotbed of controversy within an airline. Decisions made in this area are always questioned by others in the airline, such as the sales team and upper management. Under traditional revenue management, decisions and results could be explained more easily since uncertainty could be explained analyzing historical events and supported by using revenue management systems.

However, when revenue management is impacted by LCCs, inventory allocation decisions can be difficult to support. Historical data loses a lot of its former value. Revenue management analysts have to turn to their creativity, knowledge of mathematics, analysis and understanding of the markets they manage. They face new situations every day where they have to act without all the information they need to make effective decisions. For example, there may be dramatic fare declines with price levels that barely cover passenger variable costs.

The tactical decisions and autonomy that pricing and revenue management departments historically had to set prices and availability of seats are now being influenced by upper management. Fundamental, strategic discussions between upper management and revenue management staff to decide whether their airline should match prices to levels of their LCC competitors are complex.

Revenue management analysts should reach a consensus with upper management, and many times, a lack of consensus drives frustration that causes an inability to convince leaders of the direction revenue management should take.

Revenue management analysts must decide when to close the available inventory of a fare class when it has reached a certain number of bookings or at a specific number of days before the flight departs. Either approach assumes elasticity of demand to increase revenue without losing market share. Elasticity is hard to measure since many variables, such as time of day, fare level, frequent flyer program and airline preference, can influence it. The calculation to determine market elasticity requires advanced mathematical knowledge to model different situations. Being realists even though revenue management analysts on the whole are analytical, few possess the mathematical knowledge and advanced math skills to face this challenge and get the job done right.

Under this scenario, adjusting the availability of flights comes back to a very big job, manual and tedious, since every flight is susceptible to dilution and loss of revenue. Previously, analysts focused solely on flights with high revenue opportunity and other flights were managed automatically by the revenue management system.

### Key Performance Indicators

The other challenge in revenue management is how to measure results. In a legacy environment, most airlines measure key performance indicators of spill and revenue oppor-

tunity to evaluate the performance of revenue management analysts and management. But those indicators are no longer valid when there is no demand segmentation since they are calculated based on the forecast performed by traditional revenue management systems.

In a low-cost, competitive environment, the assumptions of market elasticity and tightening of inventory that analysts put in place should be measured to determine their effectiveness. This effectiveness is measured through basic KPIs used by airlines: revenue available per seat kilometer, or RASK, combined with seat factor — the number of passengers divided by the number of seats. Depending on the relation to the actual performance indicator versus the target, analysts can make adjustments.

Given the way that revenue management analysts adjust inventory and measure results in a low-cost environment, revenue management practice becomes more trial and error than a consistent mathematical approach.

### Ideal Candidate for the Job

What is the profile of an effective revenue management analyst who can operate in today's competitive, changing environment; and what characteristics should management look for when hiring staff?

The answer is a combination of acquired skills and personal traits.

On the skills side, a revenue management analyst should have a university education with a concentration of studies in areas that can be applied to develop a logical, rational and analytical approach to solving problems.

These skills will also help when making decisions under repetitive, stressful situations as well as detecting new trends that may appear to be imperceptible to others. Typically, economics, statistics, finance, math and business university courses are the best at providing this background. Communications skills are also essential since it is important to present a point of view and gain consensus from peers and management.

For personal traits, having a positive attitude combined with a burning desire to solve problems, face day-to-day challenges, and proactively develop ideas and solutions is what many managers seek regardless of discipline. In addition, for revenue management, having a high resistance to frustration, being creative and facing repetitive change is equally important. Analysts willing to go the extra distance will also go out of the way to learn the internal, political landscape and work with others across the organization to implement ideas effectively.

Well-run departments maintain consistent procedures and approaches used by analysts to solve problems brought on by LCCs. The end result is the ability to review results, develop solutions and more readily take corrective actions. ■

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## +count it up

**12.5**

Percent reduction in average unit rates for navigation fees for Euro-control states between 2003 and 2006.

**10**

Percentage of increases in fuel efficiency airlines have committed to achieving between 2000 and 2010. Fuel efficiency in 2005 alone rose by 1.8 percent.

**13**

Percentage increase during the last four years of per-passenger costs at Europe's airports.

**2 billion**

Number of passengers safely transported in 2005 by member airlines of the International Air Transport Association.

**10**

Percentage of revenue increases for airlines during each of the last three years.

**14 billion**

Amount in U.S. dollars of the increase in jet fuel refinery margins netted in extra profits for oil companies, which expect to return US\$250 billion to investors during the next two years.