Position Paper on Pricing Freedom for Airlines

In 2017, airlines around the world carried more than 4 billion passengers and the number is expected to double to 8.2 billion by 2037. The strong demand for air travel is driven by an increase in air connectivity coupled with a fall in real transport costs. This is achieved thanks in part to the pricing freedom that airlines enjoy, which allows them to increase connectivity and ensure choice and value for consumers, while mitigating the unique challenges they face.

Importance of Pricing Freedom

To understand the importance of pricing freedom for airlines, it is vital to first appreciate some underlying characteristics of the airline industry:

- A seat on a flight is a perishable product – an unsold seat has no value once the door closes;
- Air transport is highly capital intensive with high fixed costs;
- Air travel demand is uneven and fluctuates both within and across years; and
- The airline industry is highly competitive with relatively low barriers to entry (and exit) meaning that competitive advantages are hard to defend.

The perishable nature of the airline product and a need to cover high fixed costs mean that an airline must focus on achieving the optimal combination of load factor and yield in its revenue management. Accordingly, airlines do not operate a cost-plus model, but instead rely on their ability to create and price their products freely and flexibly to mitigate the effects of demand unevenness, demand volatility and the competitive nature of the industry.

Demand Unevenness

Airlines sell a journey from the passenger's departure point to his/her destination. Each journey is thus a separate product, with a specific price attached to it based on market conditions that reflect the varying demand, which is in turn influenced by a variety of factors. For example, consider a route from A to B where B is a popular weekend travel destination. The flight from A to B on Fridays will be very popular, as will the return flight from B to A on Sundays. Airfares on these flights will thus be higher as a function of the high demand. Conversely, flights from A to B on Sundays and from B to A on Fridays will see lower demand. As the airline still needs to operate these flights, it will need to adjust its pricing in a bid to maximize the revenue to cover costs.

In addition, a journey from A to B on a direct flight is a different product from a journey from A to B via C using connecting flights. Airlines flying indirect routes via their hubs are competing with airlines offering direct ones and may offer a discount to encourage passengers to choose a less convenient connecting product. Any restriction to the flexibility of airlines to price a journey on connecting flights differently from one on a direct flight will increase the challenge of revenue management for airlines, with the likely outcome of an increase in average fares and less customer choice.

Demand volatility

Airlines also face challenges in demand volatility, which extracts a high cost given the perishability of the airline product. For example, if a passenger changes his/her ticket shortly before the originally booked flight was due to depart, the chances of the airline successfully reselling that seat will be low. Therefore, for a particular flight, airlines need to price according to the levels of change flexibility to account for the demand volatility. This is why non-refundable advance purchase fares are priced lower than fully flexible fares that can be cancelled at the last minute. If flexible fares and tickets purchased closer to the date of travel were not priced higher than non-refundable fares, airlines would be faced with higher demand volatility. Without the flexibility to offer fares at a range of prices, the average fares would increase and many marginal routes would become unsustainable commercially.

It is important to note that the non-refundable fare is a cheaper option for consumers who are ready to commit to travel and are willing to travel under specific fare conditions. Such a fare is possible only because it provides airlines the certainty of being able to book the revenue. Hence, any requirements on the refundability of tickets will likely lead to airlines being unable to offer fares at the price points of non-refundable fares, reducing the choice and value that an airline can offer to consumers.

Airline competition

The highly competitive nature of the airline industry requires airlines to differentiate themselves through individual customer service offerings, by offering a range of product choices that corresponds with the price and service standards desired by different customers. As such, many airlines adopt a building block approach to their products, allowing customers to customize them according to their needs. Hence, government restrictions on ancillary products and their pricing will deprive airlines of the flexibility to develop and price products according to their customers' needs and deny airlines the ability to provide a unique value proposition to the customer.

Conclusion

Airlines need commercial freedom and flexibility to create products that enhance air connectivity while ensuring choice and value for consumers. Any restriction on an individual airline's commercial pricing policy would make it difficult for airlines to mitigate the demand and industry challenges they face, ultimately reducing the benefits that consumers currently enjoy.