

Logistics

Escaping the Air Cargo Bazaar

How to Enforce Price Structures

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Escaping the Air Cargo Bazaar - How to enforce price structures

Price wars have in common that hardly anyone ever wins and almost everyone loses a lot of money.

In the current market situation of the air cargo business, it is nearly impossible to make reliable forecasts. Instead of the expected growth figures, stagnating tonnages and revenues are reported again and again. The market is still waiting for a significant recovery from the shock of 2001. However, optimism for a return to better times does exist. Airlines are starting once again to expand their capacity, either by ordering new aircraft or by reactivating those stored in the past months.

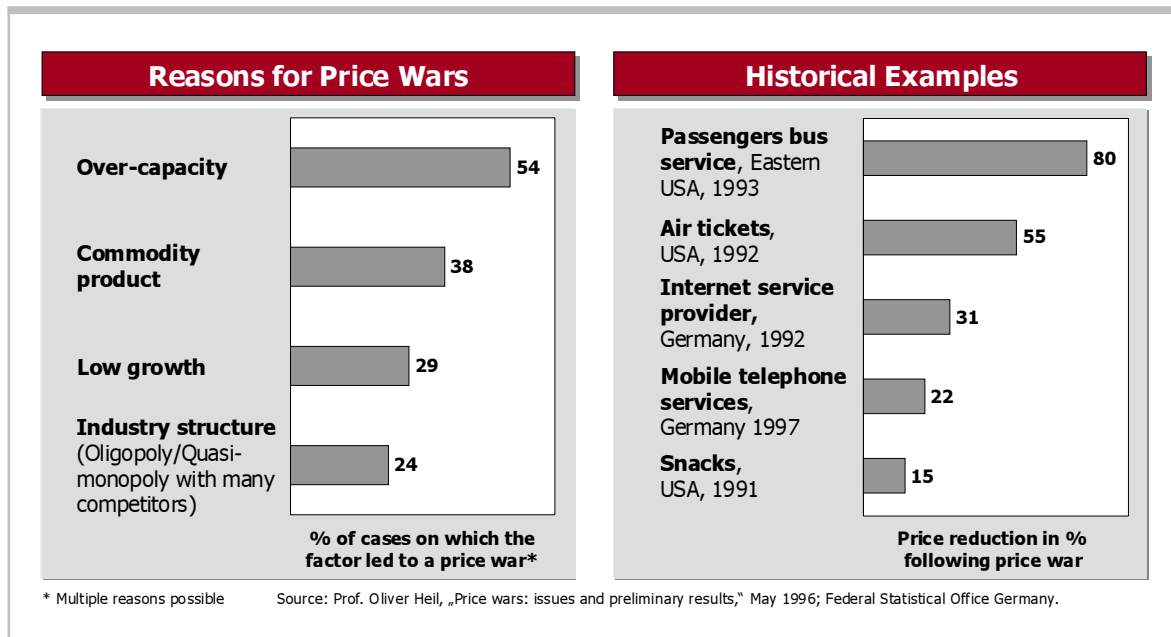
Unfortunately, a lack of growth coupled with increased capacities are making the pricing situation in the air cargo industry even worse, leading to a continuous price spiral. The risk is great that such a market situation will ignite a price war (cf. picture 1).

Price wars can occur in any industry and they all share one trait: Hardly anyone ever wins and almost everyone loses a lot of money.

Although managers in the air cargo carriers' headquarters may be aware of the risk of price wars and the need to avoid them, their knowledge has in fact only little influence on the actual prices offered in the markets. The available pricing instruments in the air cargo market are multifarious, and it is mostly the sales representatives who are free to choose one of them.

The TACT rules, which are the gross rates published by the IATA, give the first clue as to how much to charge for an air cargo shipment. But, similar to the prices you find on the list in your hotel room, only rarely will this be the actual price on the bill.

The official standard price lists of air cargo carriers already include a first discount on top of the TACT rates. Because electronic distribution makes price comparisons between carriers easier, this published rate sheet is rendered obsolete to the majority of forwarders. As a result, business with regular customers is usually concluded with individually negotiated special rate agreements. For the short-term ad hoc business, even lower spot rates are offered. From this point on, carriers are stuck in the air cargo bazaar.



Picture 1: Price wars: the threat

THE AIR CARGO PRICE BAZAAR

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The customers – agents and air cargo forwarders – are in a comfortable position. They are aware of the air cargo carriers’ dependency on load factors and the pressure on them to offer individual, reduced prices so not to lose business. Operating in a market with a limited number of key players makes it possible for customers to check each carrier’s price offer before deciding on the best. The best is not always the cheapest offer, as in some cases a long-term business relationship outweighs price importance. But even these relationships are lose out if the competing carrier offers 30% lower prices. And as long as carriers still have free capacities, hard discounting or even dumping become a part of day to day business, especially for companies with a weak market position.

Furthermore, the relatively low variable costs in the air cargo business ‘naturally’ boost load factor optimization as a main target of business: even a price of a few cents is favored over the alternative of selling nothing. Consequently, lowest fill up rates and special promotions are common business.

In the business-to-business sector in general, offering discounts to hard negotiating customers is nothing special.

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Developing thousands of customized rates for every lane, product and weight segment, customer by customer, is not normal – even in the B-to-B sector.

The sales force usually has no information at all about the costs that different shipments can generate. As a result, they are quite in the dark regarding the required average minimum prices per flight.

But developing thousands of customized rates for every lane, product and weight segment, customer by customer, is not normal. Why doesn't this industry have a standardized pricing approach? The answers to this question are diverse.

The first reason is that every forwarder is different. Depending on the individual tonnage and product mix per destination, the forwarder requires specific service and pricing solutions that perfectly fulfil his needs. The second reason is that every flight is different. The specific capacity situation of each flight determines the level of the short-term spot rates. Third, the cargo business is characterized by intense personal relationships between forwarders and the airline's sales reps. Offering a specific, tailor-made price list only for one specific customer is exactly what the forwarders demand. But the main reason why the air cargo industry does not use standardized tariffs is the one which can be attacked the least: It is simply the way the market structures have developed and been established in the last decades.

WHY CHANGE PRICING?

"If I have 2000 customers on a given route and 400 different prices, I am obviously short 1600 prices." (Robert L. Crandall, former CEO of American Airlines).

So why change pricing, when individual negotiations give you the opportunity to offer a price to a customer that exactly equals the willingness to pay? In the following section we will explain why there are several important reasons for changing air cargo pricing

The lack of cost consideration is the first motive for changing pricing. For most air cargo companies, the clear assignment of single cost categories to a certain shipment is still a black box - only known to a limited number of specialists in the controlling department. The sales force usually has no information at all about the costs that different shipments can generate. As a result, they are quite in the dark regarding the required average minimum prices per flight. Designing optimal prices requires knowledge about variable costs. Without a clear pricing guideline, developed systematically and with the carrier's cost structure in mind,

More work is generated when customers request an individually designed special rate agreement. Both the sales reps and accounting invest great effort into the negotiations and processing of the individual rates.

Forwarders often do not know – or are at least not interested in – the conditions that led to their individual price level.

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The second reason for changing pricing is workload reduction. When a customer asks for a quote on the spot market, the sales representative first checks and blocks open capacities (sometimes through the central revenue management department) and then calculates the potential price he will offer. After he has done that, the sales rep waits until the customer chooses a carrier. This process can be repeated over and over again if the customer does not accept the offer but later contacts the sales rep again for a better rate.

Similarly, more work is generated when customers request an individually designed special rate agreement. Both the sales reps and accounting invest great effort throughout the year into the negotiations and processing of the individual rates.

A third reason for changing pricing is the fact that in many cases today, prices are not connected to a promised volume within a defined period. As a result, forwarders often do not know – or are at least not interested in – the conditions that led to their individual price level. This makes the negotiations difficult for the air cargo carrier if the forwarder delivers decreasing volumes or starts to cherry-pick by giving attractive business away to competition.

Furthermore, the customers' volume development is frequently not monitored in a systematic way by the airline carriers. This lack of price controlling and general discount rules deteriorates the relationship between price levels and lowers the value that a customer represents for a carrier.

The fourth reason for change is to improve the price setting competency. The price setting process is usually local. In other words, the various sales areas have full price authority. For the major carriers, this applies to the hundreds of stations where good sales people with strong pricing competencies are necessary. But how many companies are so blessed to have so many sales representatives who are specialists in price optimization? And who has the capacity to thoroughly optimize e.g. a million prices p.a. in a network of 150 stations with 5 products and 5 weight classes in 2 seasons for 100 customers?

All in all, these four reasons make it clear why new ways of

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pricing in the air cargo business are so crucial. A compromise must be found between individual negotiation and complete standardization, between load factor optimization and yield maximization and between profitability and rate attractiveness.

REQUIREMENTS FOR AIRCARGO PRICING

The air cargo pricing bazaar can be escaped by various means. But whatever the details of a carrier's final price system are – they all have to meet certain requirements which will decisively determine the success of such a system:

1. Encourage customer loyalty

In a market like the air cargo industry, the possibility of generating new revenue through natural market growth is limited due to constantly decreasing growth rates. As a result, it is crucial for the carriers to expand their market share by increasing their customers' share of wallet and attracting business from competition. Customer loyalty will consequently be a major success factor of the future.

The main reason for the weak customer loyalty is cherry-picking behavior: For each shipment, forwarders select the carrier who offers the best prices, the fastest connection or the best service. Intense business relationships that drive forwarders to focus on only one airline are rare. The conclusion the airlines draw based on this behavior is understandable: It is not enough to be the most attractive supplier only on average, but also for every single shipment or market segment competition starts again.

Instead, stronger customer loyalty would create more opportunities for the air cargo carriers. Once the company is selected as the preferred supplier, the forwarder no longer picks the best offers from the market, and the competition focuses on the carriers' overall offer instead of each single shipment.

2. Differentiated discounts per lane, product, and weight band

Air cargo shipments have many particularities and thus require more flexible discount guidelines than those applied in other industries. Simply assigning a customer to a certain discount level, say 20%, and then granting this discount on all shipment types the customer ever sends, will not

meet the needs of either the customer or the cargo airline.

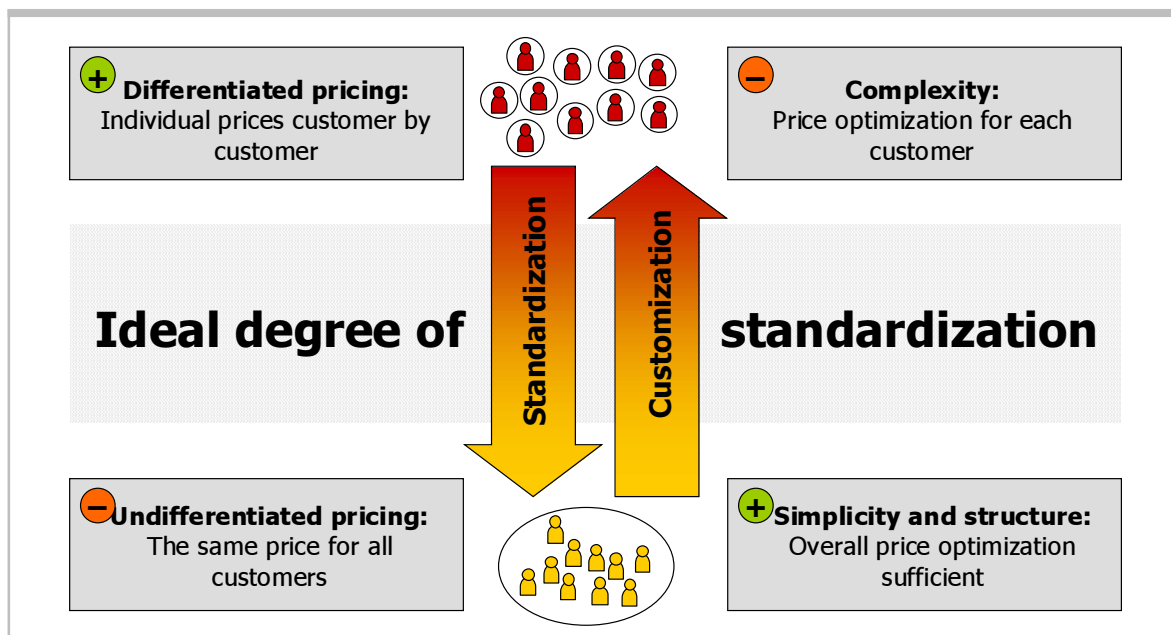
The price structure will have to take into account that differing lanes, products or weight bands require differentiated discounting. A flight to a top destination where capacities are scarce, for example, gets by with low discounts even for large customers. Similarly, small and light weight shipments below 50 kg or premium products do not necessarily call for any discounts at all.

Correspondingly, lanes running below capacity, or products and weight bands with higher competitive pressure require surpassing discount levels. A pricing guideline should therefore offer the possibility of varying discount levels without losing control of a customer's overall average discount.

A systematic discount guideline always entails a standardization of pricing rules and price levels.

3. Standardization combined with customization

One of the major challenges for a company's pricing and discount concept is to strike a balance between customization and standardization. Customization is necessary to serve the customers' individual needs as well as possible; standardization is necessary to optimize the efficiency of the internal processes and to reduce the costs of price design (cf. picture 2).



Picture 2: Customization vs. standardization

The oligopolistic market structure of the air cargo sector requires that price levels and price structures are concealed as well as possible.

A systematic discount guideline always entails a standardization of pricing rules and price levels. At least for small and medium-sized customers, finding one standardized pricing scheme which still matches to their willingness to pay is necessary and critical - the reasons have been explained in the previous section.

Nevertheless, such a structure also requires enough customization so that the varying needs of customers and market segments are addressed. If a customer, for example, delivers much of their business to Asian countries, but rarely sends anything to the US, he will demand an attractive discount on shipments to Asia, whereas the prices for the North Atlantic region are much less important. For a second forwarder with the same size, this might be reversed. A good price and discount system will have to take these particularities into account.

4. Non-transparency

The air cargo business is made up of a low number of carriers, each of them facing hard competition. This oligopolistic market structure requires that price levels and price structures are concealed as well as possible.

The option of simply designing four or five official price lists, including different price levels, and distributing these lists among the forwarders, would quickly make the price structure completely transparent. A possible competitor would only need to convince a few forwarders to handing over the cargo airline's offer to him to get a complete overview of the company's price and discount structure. In light of this, the number and variety of a carrier's price lists have to be much larger.

5. Time-based price differentiation and yield management

Even the most customized price lists cannot necessarily take into account that market prices can vary over time. Even outside of the Christmas season can market prices be 50% or more above the prices during the rest of the year.

Demand for cargo capacities is usually higher on the weekends, thus prices might be lower during the week as well. Finally, we also see randomized variations of capacity utilization which result in higher or lower fill-up rates in the spot market.

Ideally, a cargo airline's consistent price structure should also be able to calculate in "seasonal" price variations.

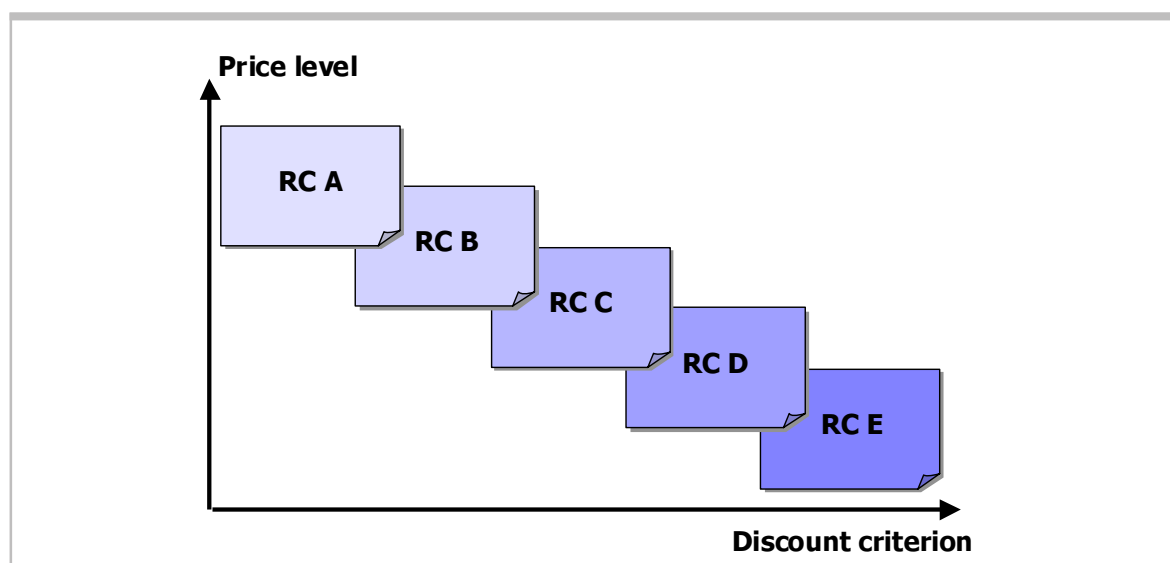
Ideally, a cargo airline's consistent price structure should also be able to calculate in these "seasonal" price variations. Otherwise, the price list offered to a forwarder will include realistic prices only for a certain share of shipments – but never for all of them.

A CONCEPT THAT BALANCES FLEXIBILITY AND STANDARDIZATION

One concept can offer a means out of the pricing bazaar: the rate card concept. This concept integrates all requirements of the discount system listed above. Once implemented, it stimulates higher sales, pricing and billing efficiency.

The concept's foundations lie in the rate card system offered by many CEP providers today. It becomes innovative through the transfer into a different industry with a few similarities and a lot of differences to the CEP situation. Because the concepts of the CEP industry and the air cargo industry still are similar, we will call the price system for the air cargo industry the "rate card system".

A rate card system is defined by a set of complete price lists with differing discounted rates for destination, weight class and product combinations. Correctly designed, each rate card offers the same or lower rates than the previous one (cf. picture 3).



Picture 3: The rate card concept

Although the rate cards are an obvious simplification, they are still able to meet all requirements listed in the previous section.

These rate cards are assigned to the customer, ideally following a strict, quantifiable logic and a predefined process for potential exceptions. If the customer is supposed to receive a rate increase or reduction, this will be achieved not by changing rates for selected destinations but by switching the customer from one rate card to another.

This price bundling approach is rather different from the current pricing situation in the industry. Although the rate cards are an obvious simplification, as each customer's price level can be determined only by his rate card information, they are still able to meet all requirements listed in the previous section.

Success factors for the rate card design

How can it be that such a simple concept like the rate card approach is able to take into account the complexity of the air cargo sector? Of course, it depends on the implementation. A price system is always as good or as bad as its design. The success of the rate card system depends on the design of the following elements:

1. Encourage customer loyalty

One major element of the rate card system is the clear relationship between a customer's rate card assignment and his value according to the discount criterion: The more attractive a customer is for the airline (discount criterion), the more attractive the rate card is that is offered (rate card assignment). In light of this, the definition of the discount criterion determines how much the system can increase customer loyalty.

The easiest, but at the same time most inefficient way to define a discount criterion might be to apply the general customer segmentation approach (e.g. A-, B-, C-customers). Although such a criterion can ensure that the customers' prices decrease with increasing customer attractiveness, it definitely will not encourage customers to stick to only one supplier. Even consolidating 100% of the business to one single carrier will not lead to an upgrade for most of the small and medium customers. And as the largest customers are already in the level A, they are not motivated to be more loyal.

A price system is always as good or as bad as its design.

By choosing the customer's share of business as a discount criterion, loyal customers would directly be rewarded.

What is crucial for strengthening loyalty is that the forwarders' performances, their development over time and the fulfillment of promised volumes are strictly monitored by the airline.

The necessity to differentiate discount levels is the main reason why in industries like the logistics business, rate card concepts generally are superior to other discount guidelines.

By choosing the customer's share of business as a criterion, loyal customers would directly be rewarded: the more they concentrate their shipments on one carrier, the higher the discount they receive.

But in this pure form, a discount system would only reward customer loyalty and neglect other important aspects, like the customers' size. Therefore, choosing a discount criterion that integrates numerous factors into one discount value can be a suitable solution that supports both customer size and loyalty.

What is crucial for strengthening loyalty is that the forwarders' performances, their development over time and the fulfillment of promised volumes are strictly monitored by the airline. Furthermore, the monitoring activities will have to be actively communicated to the forwarders, so that they know: sending more or less than originally intended or promised will directly lead to a positive or negative change in their discount level.

2. Differentiated discounts per lane, product, and weight band

The necessity to differentiate discount levels is the main reason why in industries like the logistics business, rate card concepts generally are superior to other discount guidelines. The large number of prices for all kinds of weights, origins, destinations and products, all with different margins, market situations and competitive pressures, makes the segment-wise optimized discount approach necessary.

Thus, a simple and easy-to-use discount guideline, for example one that provides only maximum discount levels for different revenue categories, would be suboptimal. Such an approach would lead to the same discount levels for both premium and standard products; for low weights, the same level as for heavy weights, a.s.o.

Instead, the rate card concept includes detailed prices per market segment. If the competitive situation for only one specific segment changes – e.g. an airport's departure and arrival capacities were increased or decreased –, the rate card prices can be adapted to the new situation for this segment only – without impacting other prices.

The customer's shipment volume to continent A leads to a certain rate card level, whereas the volume to continent B can lead to another one.

Having a set of, for instance, seven rate cards at hand, with each of them divided into five different elements, this would already lead to $7^5 = 16,807$ possible rate card combinations.

3. Standardization combined with customization

The degree of customization or standardization in pricing depends directly on the number of rate cards that a company offers: offering the same rate card to all customers is the one extreme towards absolute standardization; offering each customer an individually designed rate card is the other extreme towards absolute customization. In light of this, the decision regarding the degree of customization depends on the rate card design and number.

But is it advisable to strictly offer all prices as a fixed bundle in a rate card? Definitely not! Without losing the advantages of the standardized system, world wide rate cards can just as well be divided according to several dimensions. For instance, continents, destination rankings, products or weight classes could be possible criteria for dividing a rate card into different independent elements.

For example, the customer's shipment volume to continent A leads to a certain rate card level, whereas the volume to continent B can lead to another one. When rate cards are divided into separate elements for each continent, the final rate card for a customer is a combination of these elements.

The dimension for rate card fragmentation should be chosen according to the customers' heterogeneity. When customers, for instance, differ mainly by their shipments' average weight, it might be recommendable to vary the customer's rate card assignment for different weight break prices.

If the most important differences between forwarders are their shipments' destination areas, rate cards should rather be divided according to destination areas, like continents or country groups.

4. Non-transparency

Exactly the same approach of slicing rate cards into several elements and combining those elements variably by customer creates the required non-transparency in the price system. Having a set of, for instance, seven rate cards at hand, with each of them divided into five different elements, this would already lead to $7^5 = 16,807$ possible rate card combinations. In fact, nearly every customer will receive a completely individual rate sheet.

An add-on approach makes it possible to implement a true yield management structure in the air cargo business.

5. Time-based price differentiation and yield management

The described rate card system only builds the foundation for a new pricing scheme based exclusively on the customers' value for the airline company. This basic scheme can be further improved when the prices become variable relating to different flights, weekdays, or months. But how can large price lists like those of rate cards, which only are defined by the carrier once or twice a year, be varied on a day by day basis? The answer is very easy: by pre-defining specific add-ons and add-downs for different weekdays, seasons, or capacity situations during the rate card design process.

Similar to when a customer pays an add-on for a certain additional service, like transportation in cool containers, add-ons can also be charged for certain months or weekdays, when capacities are scarce. Such a set of pre-defined time-differentiated rates could look like illustrated in picture 4.

Additional rate agreements		EUR/kg
1. Weekdays		
For flights on day 1 - 3		-0.15
For flights on day 5 - 7		0.20
2. Transit services		
Connection flights or road feeder services		0.10
To-door delivery (for shipments > 4 tons only)		0.30
Pick-up service (for shipments > 4 tons only)		0.30
3. Special services		
Dangerous Goods		0.25
Perishables		0.05
Safety transport		0.50
(...)		

Picture 4: Example weekday pricing

This add-on approach makes it possible to even implement a true yield management structure in the air cargo business, similar to those currently used in the passenger airlines

Compared to today's purely capacity-driven spot market in the air cargo industry, the "rate card plus add-on" model delivers a fair tariff foundation based on the customers' value to the carrier.

sector. By defining different reservation classes and the respective add-ons, every flight can be categorized by its degree of capacity utilization. The category assignment might even vary over time, depending on the flight's development of capacities.

Compared to today's purely capacity-driven spot market in the air cargo industry, the "rate card plus add-on" model offers not only differentiated prices for the flights' various free capacities, but it also delivers a fair tariff foundation based on the customers' value to the carrier. As a result, capacity-driven pricing basically also provides more attractive prices for more attractive customers, thus integrating the customer-specific differentiation approach into the short-term pricing strategy.

CONCLUSION

Several industries have already made the shift from rather individual pricing behavior to a consistent price system. Sooner or later this will also be the case for the air cargo business. Some agents have already demanded this kind of pricing, and they will insist that the carriers respond.

Taking into account that pricing is one of a company's most important profit drivers, it is hard to understand how a large and important industry like the air cargo sector is still unable to enforce their price structures. In this business, a price deterioration of only 1% could very well lead to a profit loss of about 10%-15%. It is no longer enough that pricing rules and decisions are made centrally. The entire price setting process, currently operating like a bazaar, must be systematized. This is a task that requires not only the support of one or two carriers, but also the concerted action of all key players.

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