CARRRESEARCH

THE UK'S SKY HIGH HOLIDAY PRICES

Vassily Pigounides exposes the social consequences of a pricing technology called revenue management.

WHAT ARE THE SOCIAL CONSEQUENCES OF THE WAY SERVICE PROVIDERS SET PRICES?

Is it really a surprise that prices for flights and hotel accommodation become more expensive during school holidays? Not if we believe in the age old law of supply and demand. But when parents start pulling kids out of school because vacation packages are cheaper during term time, skyrocketing holiday prices becomes a national political problem.

Term-time holidaying is a common practice in the UK according to a recent poll conducted by ComRes for ITV News. Among parents with children under the age of 18, 35 per cent say they have already removed children from school, while another 51 per cent say they would do so if they could snag a cheaper holiday.

In February, the issue was brought to the attention of legislators who were asked to curb the damaging effects of price induced absenteeism on the education of British schoolchildren. One solution imposes fines: parents may continue to take their kids out of school if they pay the £60 forfeit, per child. Another asks schools to simply break with tradition: by giving head teachers more autonomy to set their own term dates, holiday periods could be staggered, which is already the case in other European countries.

The UK's holiday debate raises an interesting question that rarely gets discussed: what are the social consequences of the way service providers set prices?

Pricing is a far more complicated process than the average consumer might think. In the tourism industry, the core of price formation is a technical system called "revenue management" (RM), also known as "yield management" in the airline industry. RM is especially useful in service industries which have what economists call 'capacity constraints' – not everyone will receive service if all buyers show up at the same spot.

The objective of RM is to enhance a company's profit by recalibrating prices and categories of consumers. To use the technology, managers create different segments in the market, say business and leisure, which are then allocated a certain number of seats at different prices, at different times.

RM works wonders. In 1986, the year after American Airlines implemented its system, the company reported a revenue increase of 14.5 per cent and its profits were up 47.8 per cent. When the hotel chain Marriott adopted RM by the mid 1990s, it earned an additional $150 to $200 million in annual revenue.

RM might not be transparent to consumers, but travellers around the world are familiar with its peculiar effect on prices. Under this system, ticket prices depend on the date of purchase; in general, the earlier the reservation is made, the lower the fare. That's how passengers seated in the same row, on the same flight can end up paying radically different amounts for essentially the same service. By adjusting and readjusting prices, the technology incentivizes buyers to commit their hard earned cash as soon as they can, while penalizing latecomers.

Consumers are developing strategies to deal with the logic of RM. As people overcome the initial feeling of incomprehension or unfairness about the way prices vary unpredictably, they are rapidly adapting their behaviour to root out the best possible offer. Tools like online price comparison engines help people make smarter calculations. There are, of course, limits to how much people can anticipate. Even the savvy consumers cannot foresee the unexpected and will pay more for travel to attend to personal emergencies.

RM also has a big hand in why holidays are becoming a luxury that fewer can afford. In peak seasons, the highest priced ticket can cost as much as ten times that of the lowest on some flights. The consumer is never left entirely without choice. To fill spaces, firms offset exaggerated prices by flooding the market with discounts and special offers. You can definitely find a more affordable option if you're willing to travel late on 31 December just when all the New Year's parties are kicking off.

Such sleights of hand are not anecdotal. If applied to suburban transport RM could have a major impact on city lifestyle. The technology would have the Greater London Authority charge regular riders more during peak periods, and steeper fares than occasional travellers. Such a measure would clearly go against the interests of people living in the suburbs who expect to have an affordable commute to the city centre.

RM has already worked its magic on privatized national rail service in the UK where the most expensive journeys are the most convenient for weekly commuters. The cost-conscious are left with little choice but to leave Sunday at sunrise and return Saturday afternoon, since the seats on Monday morning and Friday evening come at such a heavy premium.

Managers who use RM are somewhat cynical about its effects. "Revenue management consists in offering affordable service when customers do not need it, and making it prohibitive when it is essential," shrugged one revenue manager of a large hotel company.

Will there be a backlash to the price volatility introduced by RM? Economist Daniel Kahneman and his colleagues have shown that customers believe they are entitled to a reasonable price; they also believe that firms are entitled to a reasonable profit. A public revolt, then, will largely depend upon whether consumers and politicians find RM prices "unfair".

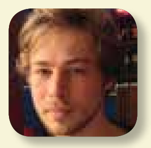
Education Secretary Michael Grove thinks it is. "It's quite unfair that holiday companies are attempting to essentially fleece parents by trying to ramp up prices at particular times of the year," he openly declared on television. And yet, just after he said this, he placed responsibility for change squarely on the shoulders of the educational system. "One of the things we've done to make it easier is allow schools to vary the school holiday so that some schools can choose to close early or open late, to ensure parents have an opportunity to take holiday at an offpeak time to benefit from cheaper prices," he explained.

Westminster, as a whole, has concluded the prices are fair. Price caps were rejected and not a single MP backed price regulation.

Producers and revenue managers invest considerable time and money to deal with perceptions. A reference handbook on RM by Kalyan Talluri and Garrett van Ryzin identifies several strategies managers can employ to help consumers accept RM pricing. For example, they suggest that companies should underscore the rationale of the discount instead of just quoting consumers a price. If a discount is not available on a particular date, companies can offer another date on which the discount is available.

This second strategy has been particularly effective in settling Britain's school holiday affair. It convinced parents and politicians that rigid school policy, not corporate pricing, is the underling source of ticket inflation.

The government has left people to fend for themselves. The good news is, consumers aren't passive. By observing teams of revenue managers in large companies, I have learned that consistently strategic consumers can erode an industry's profit margins by slipping outside the classical classification schemes inside RM systems. In the end, sharp differences in price created to increase profitability can undermine companies' control over the market. All it takes is a population willing to break old conventions.



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