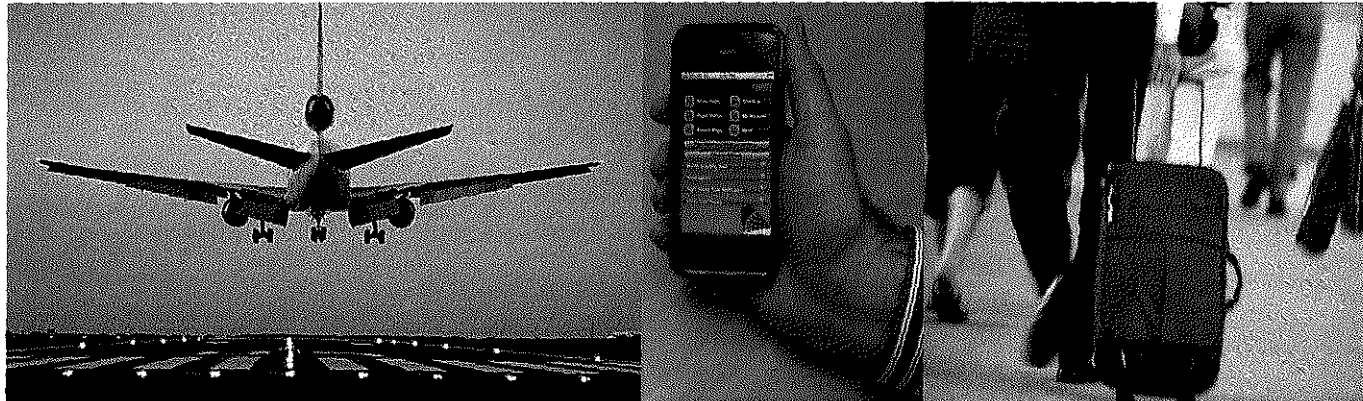


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## Cost-Benefit Analysis of Proposed Consumer Rule 3

Prepared by  
Mike Tretheway, InterVISTAS-ga2 Consulting, Inc.

Confidential Draft of 9 May 2013

# Proposed Consumer Rule 3

## Consumer Rule 3 may mandate, via regulation,

- that airlines display or sell some or all ancillary services through the GDS channel

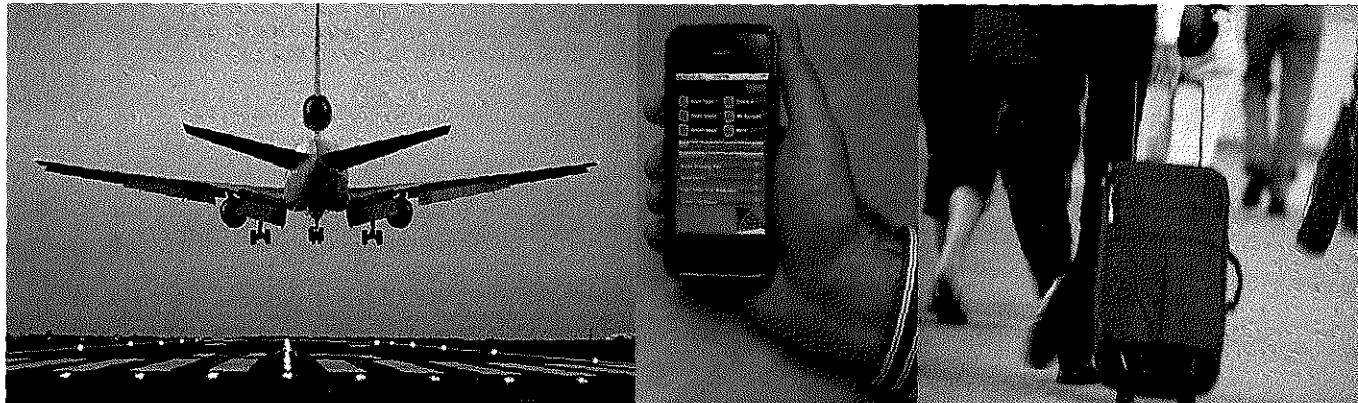
## The stated goal of the proposed regulation is to:

- Increase transparency of air fares for consumers
- Which presumably would enhance competition between airlines
  - horizontal competition

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## Background on Ancillary Fee Issues



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# Ancillary Charges

**CR3 appears to be based on the (incorrect) assumption that charges for ancillary services are uniform**

**But charges are NOT uniform**

- **The correct ancillary charge can vary**
  - **by route, flight, date and individual**
  - **And by customer relationship with the airline**
  - **And the package of services being offered to the customer**

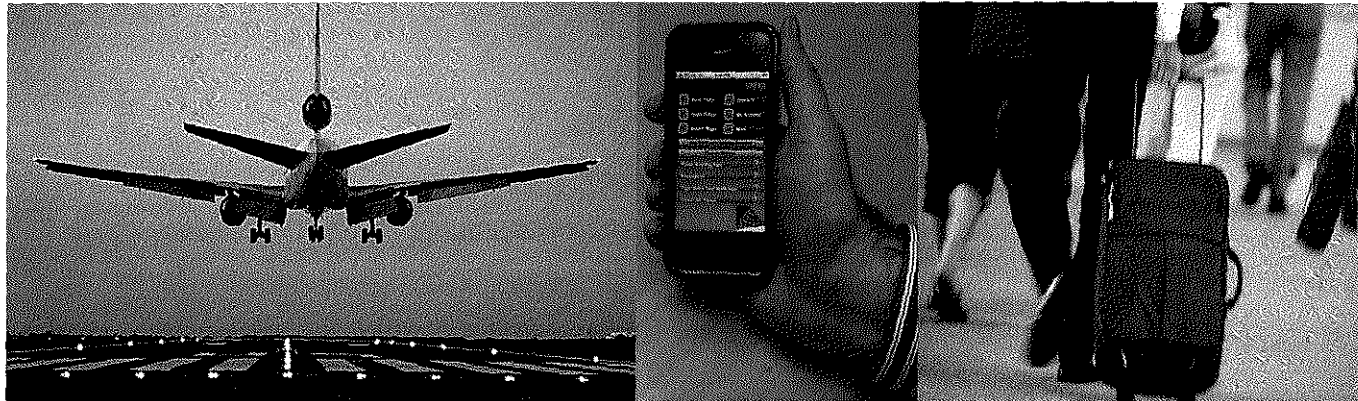
**Even with CR3, GDSs will quote incorrect all-inclusive fares to some travelers**

- **Because a static GDS display won't work when fees vary**

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## Background on the Aviation Value Chain and the Role of GDS



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# Horizontal and Vertical Competition

## The stated goal of CR3 is:

- greater transparency to consumers of all-inclusive fares
- enhancing horizontal competition between airlines

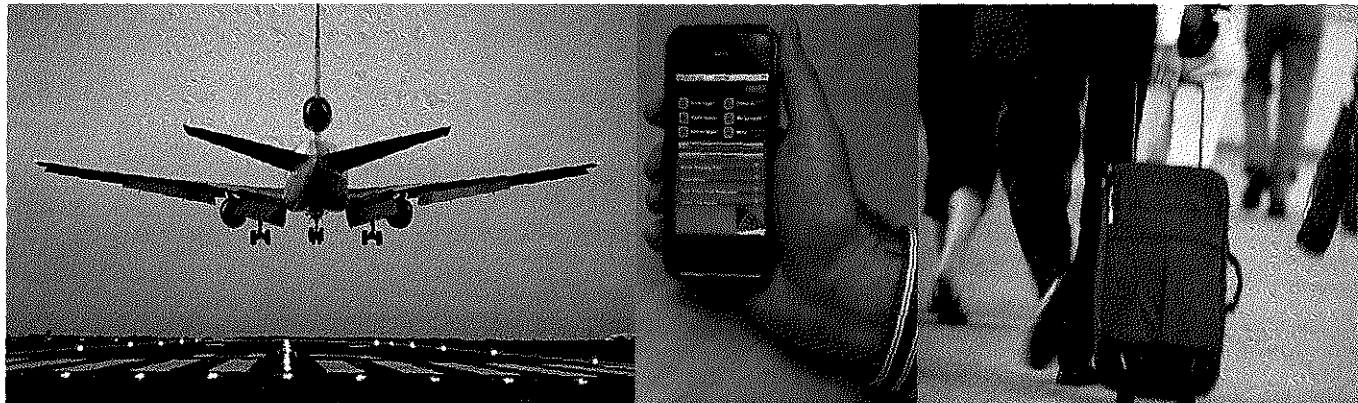
## Key questions for cost-benefit analysis are:

- Would CR3 actually increase horizontal competition?
- Would CR3 cause harm to some consumers via overstating all-inclusive fare?
- What are the implications (costs) of CR3 for reducing vertical competition and delaying vertical efficiencies?
  - Airline goal: reduce GDS market power rents
    - Reducing GDS costs
    - Reduce premium above costs embodied in GDS rates to airlines
- Would reduced vertical competition/efficiency outweigh any benefit of horizontal competition?

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## Cost Benefit Analysis



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# Cost Benefit Framework

## Conceptual Benefits

- **Reduction in search time for all-inclusive fare (with ancillary charges)**
  - We strongly doubt that there would be a reduction in search costs under CR3
  - Nevertheless, we assume in the CBA that there would be a reduction
- **Reduced airfares from increased horizontal competition**

## Conceptual Costs

- **Compliance costs**
- **Overpayment of fares**
  - CR3 could/would result in display of incorrect information on ancillary charges (hence all-in fares) for a portion of travelers
- **Higher GDS cost (deferral of investment and innovation in GDS)**
- **Higher GDS rates (Perpetuation/expansion of GDS market power)**
- **Deadweight loss**



# Approaches to CBA

## Two approaches were used to create range of CBA results

- **Method 1**
  - **CR3 reduces search costs for travelers booking via GDS channels who require an ancillary service**
  - **But some travelers (using GDS distribution channels) overpay due to incorrectly quoted all-inclusive fares**
- **Method 2**
  - **CR3 reduces search costs for the portion of travelers booking via GDS channels who require an ancillary service**
    - *But not for as many as in Method 1, as some must engage in additional search time to obtain a correct all-inclusive fare quote*
  - **Method 2 eliminates the cost of paying incorrectly quoted higher all-inclusive fares**
    - *But the benefit of reduced search time is lower*

# Conclusion

## Two methods were used

- **Method 1:**
  - CR3 does not have a strong and robust positive NPV
  - Has a sizeable negative NPV
- **Method 2:**
  - CR3 does not have a strong and robust positive NPV
  - Has a small negative NPV

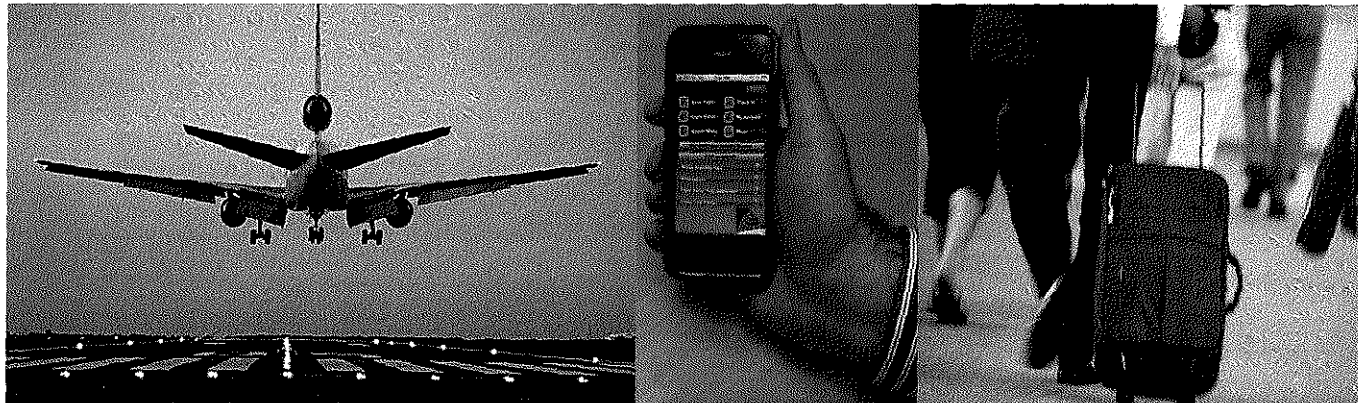
## Regardless of which method is used

- **CR3 does NOT meet the CBA test**
  - of a positive benefit-cost result
  - of a result that is robust to different methodologies or assumptions

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## Benefits



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# Benefit Category 1: Search Time Savings

## Search cost savings are a critical parameter

- **Key issues:**
  - **#1: How many passengers (or their travel agents) would realise search cost savings with CR3?**
    - 65 million under Method 1
    - 48 million under Method 2
  - **#2: How much search time is saved?**
    - 10 min per search based on our market research
  - **#3: What is the value of these savings?**
    - US DOT recommended values were used
    - \$42/hour weighted average based on business and leisure travel, adjusted for inflation
  - **Benefits must be incremental to CR2**

# Search Time Savings: Method 1

Source: US BTS T-100 data

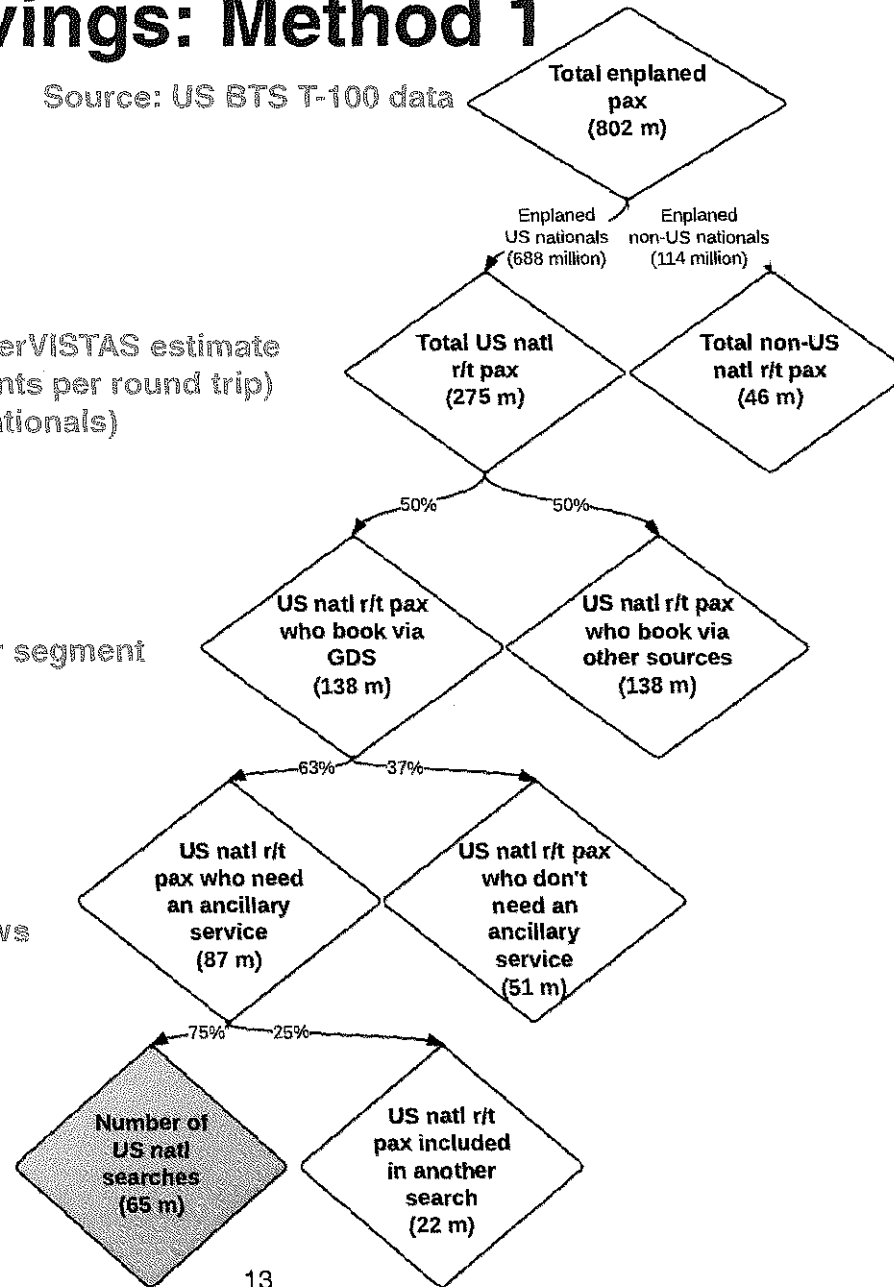
Source: US BTS T-100 data

Source: InterVISTAS estimate  
(2.5 segments per round trip)  
(86% US nationals)

Source: InterVISTAS estimate  
from GDS data on revenue per segment

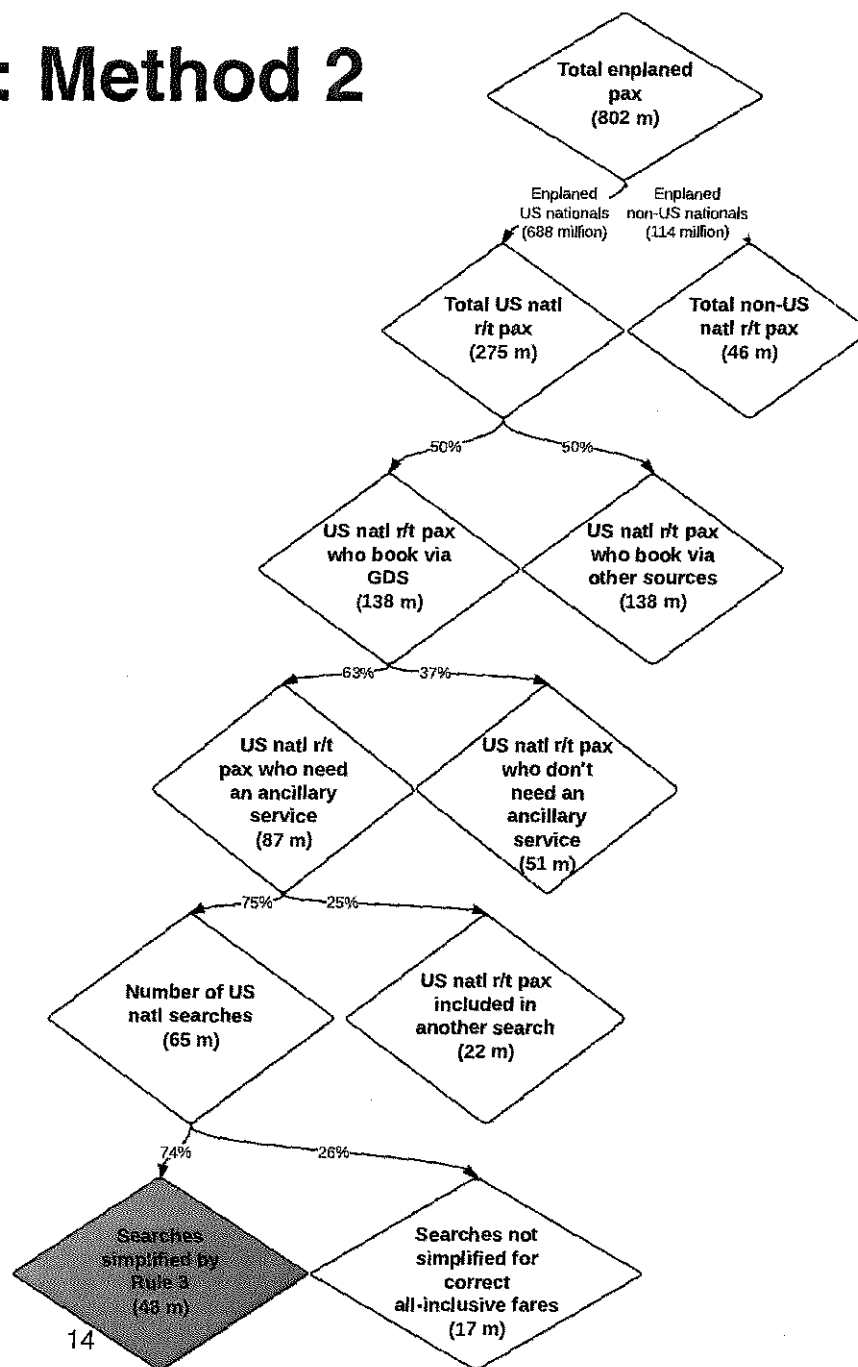
Source: InterVISTAS assumption  
but based in part on carrier interviews

Source: InterVISTAS estimate  
(1.3 round-trip tickets per PNR)



# Search Time Savings: Method 2

U.S. Department of Transportation Bureau of Transportation Statistics



Source: InterVISTAS estimate  
 (26% of passengers eligible for  
 waived or reduced fee ancillary service  
 and need to research correct all-inclusive fares)

# Search Time Savings

## Search cost savings (#1 \* #2 \* #3)

- **What is the value of these hypothetical savings?**
  - At \$42/hour and 10 minutes/search, the search cost saving is \$7 per GDS round trip ticket requiring an ancillary service
- **\$450 million per year (Method 1)**
  - (65 million \* \$7/search)
- **\$331 million per year (Method 2)**
  - (48 million \* \$7/search)
- **A 7% discount rate was used for NPV**
  - 7% real (inflation adjusted) discount rate recommended by OMB



Office of Management and Budget

## Benefit Category 2:

### Reduced Fares from Airline Competition

We project this possible benefit from CR3 as zero

- **Rule 3 would not reduce airline costs**
  - Hence no fare reduction from cost savings
  
- **Is there potential for fare reductions by CR3 reducing alleged *airline* market power?**
  - Airlines have the lowest rate of return in the value chain
    - Return is less than airline cost of capital
  - It is difficult to project any meaningful and sustainable reduction in air fares from CR3
  - Air fares already have unprecedented transparency
    - Travelers have ready access to information on ancillary charges
    - ... via easy connection to airline.com, airline call centre or by direct connect



# Summary of Results : Benefits

**Method 1:** Figure ES-1: Summary of Costs and Benefits of Proposed Consumer Rule 3  
 Method 1: reduced search cost but with incorrectly stated all-in fares for some travellers  
 (using a 7% discount rate)

|   | Annual Benefit or Cost<br>(million\$) | NPV<br>(million\$) | Period<br>(years) |
|---|---------------------------------------|--------------------|-------------------|
| <b>Benefits</b>                                     |                                       |                    |                   |
| 1. Reduced search time                              | \$450                                 | \$3,161            | 10                |
| 2. Reduced fares from increased airline competition | none                                  | none               | none              |
| <i>Total benefits</i>                               | \$450                                 | <b>\$3,161</b>     | 10                |

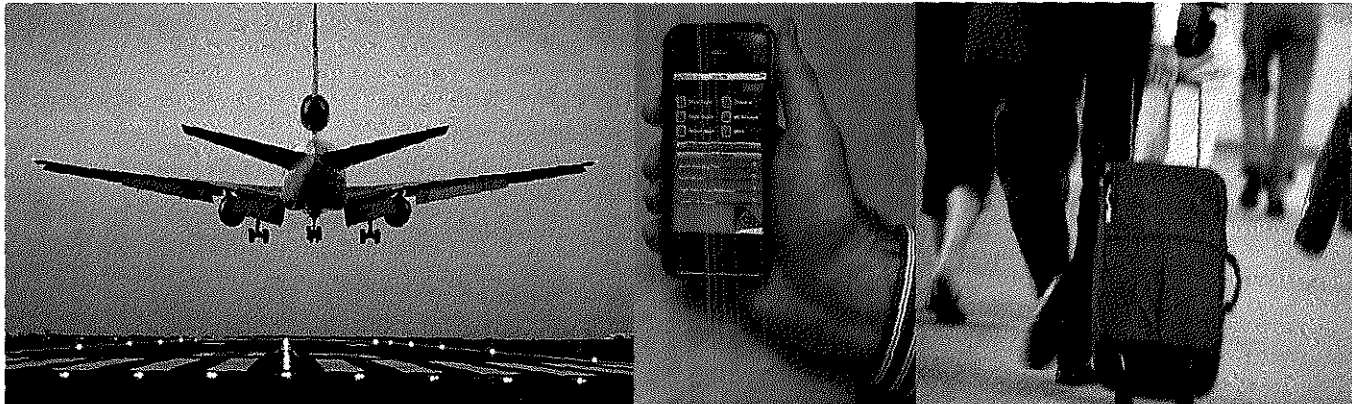
**Method 2:** Figure ES-2: Summary of Costs and Benefits of Proposed Consumer Rule 3  
 Method 2: additional search to offset GDS overstatement of all-in fares for some travelers  
 (using a 7% discount rate)

|   | Annual Benefit or Cost<br>(million \$) | NPV<br>(million \$) | Period<br>(years) |
|---|--|---------------------|-------------------|
| <b>Benefits</b>                                     |  |                     |                   |
| 1. Reduced search time                              | \$331                                  | \$2,327             | 10                |
| 2. Reduced fares from increased airline competition | none                                   | none                | none              |
| <i>Total benefits</i>                               | \$331                                  | <b>\$2,327</b>      | 10                |

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## Costs



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# Cost Category 1: Compliance Costs

## Annual airline compliance costs

- **Compliance costs per airline assumed to be \$5 million**
  - This is based on InterVISTAS experience with airline IT systems and support
  - And interview with a major US carrier using GDS channel
  - Annual costs of compliance for 6 major US carriers were estimated to be **\$30 million**
  - Likely understates the true cost of compliance
    - based on feedback from the industry
- **We have not included any implementation costs for GDSs**
  - Doing so would increase cost, and thus reduce net benefit

# Cost Category 2: Overpayment of Fares

## Method 1

- **Computes cost of some travelers overpaying due to incorrect all-in fares for ancillary services**
  - Different passengers participate in different reward programs or affiliation programs and qualify for different ancillary service fees
  - GDSs cannot offer 'customized' all-inclusive fares
  - Thus there is a cost in the form of overpayment by some travelers

**Annual cost: \$2.4 billion**

## Method 2

- **Assumes travelers will research correct all- in fares**
  - There will be no cost of overpayment
  - But the passengers eligible for waived or reduced fees for ancillary services will need to incur higher search costs even under CR3

**Annual cost: \$0**

## Cost Categories 3 & 4: GDS Monopoly Rents

### GDSs have market power vis. a vis. airlines

- US DoT/DoJ noted at 2004 deregulation of GDSs that there may be remaining market power for GDSs
- **The weak competition in distribution channels allow GDSs**
  - **to perpetuate high cost systems**
    - Cost category 3
  - **To perpetuate high mark-ups above cost**
    - Cost category 4

# **Cost Category 3: Deferral of Innovation in GDSs**

## **Perpetuation of higher distribution cost per ticket due to deferral of investment in innovation by GDSs**

- **In the airlines' view, CR3 would force them to standardize prices for ancillary services to conform to GDS systems**
- **This would**
  - enable the GDSs to stick with their inflexible expensive proprietary solutions that serve to inhibit new entry/competition and delay adoption of new modern technologies that are more cost-effective.

**Annual cost: \$323 million**

# Cost Category 4: Expansion of GDS Market Power

## Perpetuation of GDS market power premium

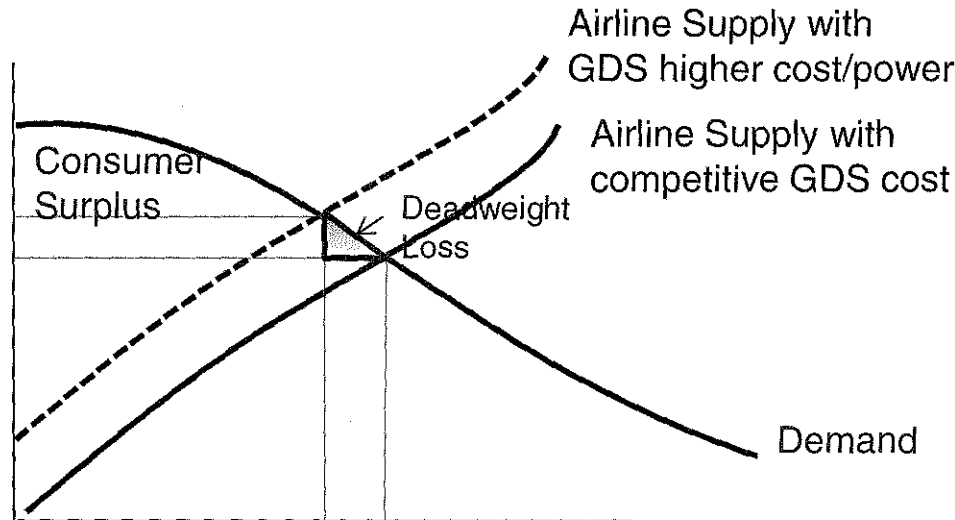
- **McKinsey finds**
  - GDSs earn 29% rate of return
  - Significantly in excess of either CoC or normal RoIC
- **US DoT/DoJ noted at 2004 deregulation of GDSs that there may be remaining market power for GDSs**
- **While average fee per segment is in \$5-6 range, costs to GDS of providing the service is much less**
  - \$4.00 cost (IATA) vs \$5.14 fee per segment (Farelogix)
  - Costs in other regions can be \$1.00 (new Chinese GDS)

**Annual cost: \$241 million**

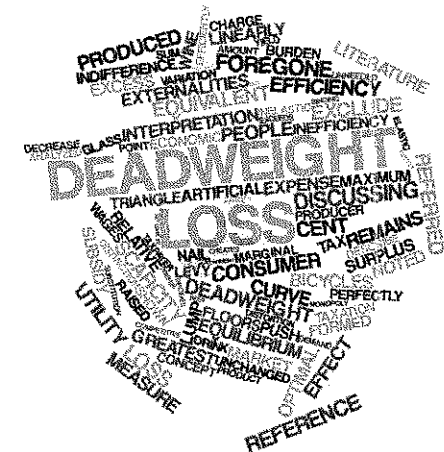
# Cost Category 5: Deadweight Loss

## Deadweight loss

- The loss of economic welfare (economic efficiency) due to prices that are too high



Annual cost: \$29 million





# Summary of Cost Results (Method 1)

**Figure ES-1: Summary of Costs and Benefits of Proposed Consumer Rule 3  
Method 1: reduced search cost but with incorrectly stated all-in fares for some  
travellers**  
(using a 7% discount rate)

|  | Annual<br>Benefit or Cost<br>(million\$) | NPV<br>(million\$) | Period<br>(years) |
|--|--|--------------------|-------------------|
| <b>Costs</b>   |  |                    |                   |
| 1. Compliance costs  | \$30                                     | \$79               | 3                 |
| 2. Overpayment of air fares due to<br>incorrectly constructed ancillary<br>services prices | \$2,359                                  | \$16,569           | 10                |
| 3. Deferral of technical change in<br>GDS services   | \$323                                    | \$1,081            | 5                 |
| 4. Cost of perpetuation or<br>expansion of market power by<br>GDS providers                | \$241                                    | \$1,694            | 10                |
| 5. Deadweight loss from reduced<br>travel  | \$29                                     | \$201              | 10                |
| <i>Total costs</i>   | \$2,982                                  | \$19,624           |                   |

# Summary of Cost Results (Method 2)

**Figure ES-2: Summary of Costs and Benefits of Proposed Consumer Rule 3  
Method 2 – additional search to offset GDS overstatement of all-in fares for some  
travellers**

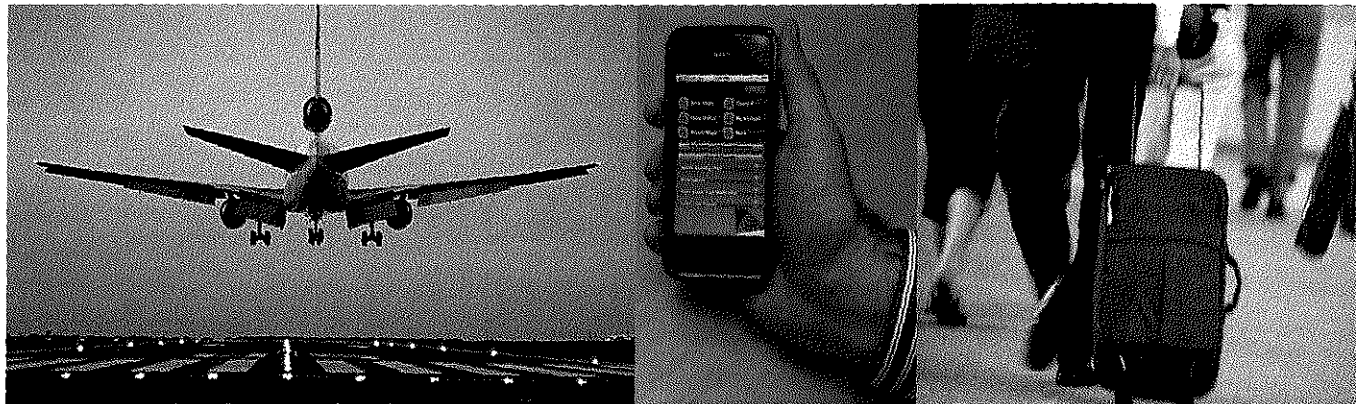
(using a 7% discount rate)

|  | Annual<br>Benefit or Cost<br>(million\$) | NPV<br>(million\$) | Period<br>(years) |
|--|--|--------------------|-------------------|
| <b>Costs</b>   |  |                    |                   |
| 1. Compliance costs  | \$30                                     | \$79               | 3                 |
| 2. Overpayment of air fares due to<br>incorrectly constructed ancillary<br>services prices | \$0                                      | \$0                | 10                |
| 3. Deferral of technical change in<br>GDS services   | \$323                                    | \$1,081            | 5                 |
| 4. Cost of perpetuation or<br>expansion of market power by<br>GDS providers                | \$241                                    | \$1,694            | 10                |
| 5. Deadweight loss from reduced<br>travel  | \$0.2                                    | \$2                | 10                |
| <i>Total costs</i>   | \$594                                    | <b>\$2,856</b>     |                   |

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## Net Cost-Benefit



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# Summary of Results

## Method 1 Results

- **Total Net Present Value of CR3**
  - Benefits: \$3 b
  - Costs: \$20 b (bulk of costs from ancillary service overcharge)
  - NPV: -\$17 b

## Method 2 Results

- **Total Net Present Value of CR3**
  - Benefits: \$2.33 b
  - Costs: \$2.86 b
  - NPV: -\$0.53 b

## Conclusion

### Two methods were used

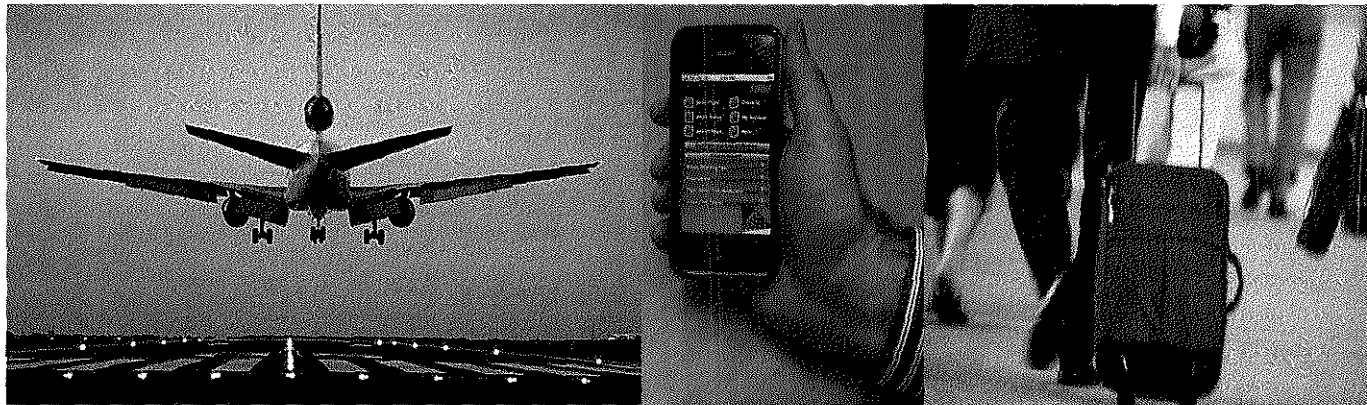
- **Method 1:**
  - CR3 does not have a strong and robust positive NPV
  - Has a sizeable negative NPV
- **Method 2:**
  - CR3 does not have a strong and robust positive NPV
  - Has a small negative NPV

### Regardless of which method is used

- **CR3 does NOT meet the CBA test**
  - of a positive benefit-cost result
  - of a result that is robust to different methodologies

# InterVISTAS

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   QR 514  09 P9 A0 Y9 B9 L9 M9 /DOH  CAI 2  1315  15
   Q9 K9 H9 V9 T9 W0
  
```

## Thank You!

[www.intervistas.com](http://www.intervistas.com)

# InterVISTAS Consulting Group

## Offices

- Washington (Bethesda), Vancouver, London, the Hague
- Team of 80 professionals

## Sectors

- Main focus is aviation
- Airlines, airports, air cargo, business aviation, air navigation

## Methodologies

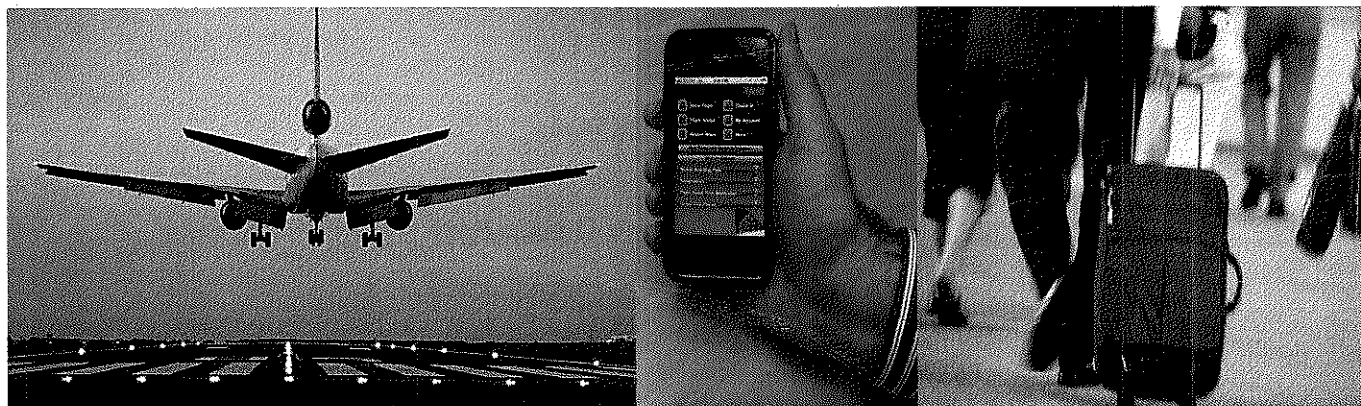
- Network & route planning, privatization & finance, border & security facilitation
- Economic analysis: cost-benefit analysis, pricing/elasticity, traffic forecast, etc.

## Background Information

Authors

Cost-Benefit Analysis

Aviation Value Chain



```
AN20HARCAIDXB/AOR*25HAR
** AMADEUS AVAILABILITY - AN ** DXB DUBAI.AE
** JT STAY FLEXIBLE RATE AT JUMEIRAH EMIRATES TOWERS
** SPACIOUS CLUB EXECUTIVE RMS INCL APT MEET + GREET & LIMC
1  QR 515  9  P9 A9 Y9 B9 L9 M9 /CAI 2 DOH  1555  195
   OS K9 H9 V9 T9 W9
   QR 114  9  P9 A9 Y9 B9 L9 M9 /DOH  DXB 1  2045  225
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2  QR 515  9  P9 A9 Y9 B9 L9 M9 /CAI 2 DOH  1555  195
   OS K9 H9 V9 T9 W9
   QR 102  9  P9 A2 Y9 B9 L9 M9 /DOH  DXB 1  0045+1  025
   OS K9 H9 V9 T9 W9
** AMADEUS AVAILABILITY - AN ** CAI CAIRO.EG
** FA  *SHERATON NOW HOTEL HELIOPOLIS UNDER FA CHAIN CODE
** SKM FR CAIRO INTL APRT * FREE SHUTTLE SERVICE >HAFACAI3E
11. QR 101  9  P9 A9 Y9 B9 L9 M9 /DXB 1 DOH  1105  110
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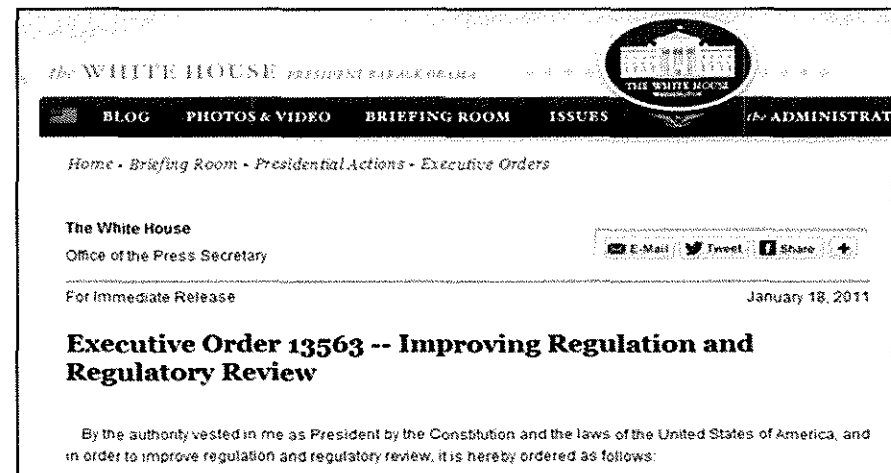
# Dr. Michael Tretheway

## InterVISTAS Chief Economist

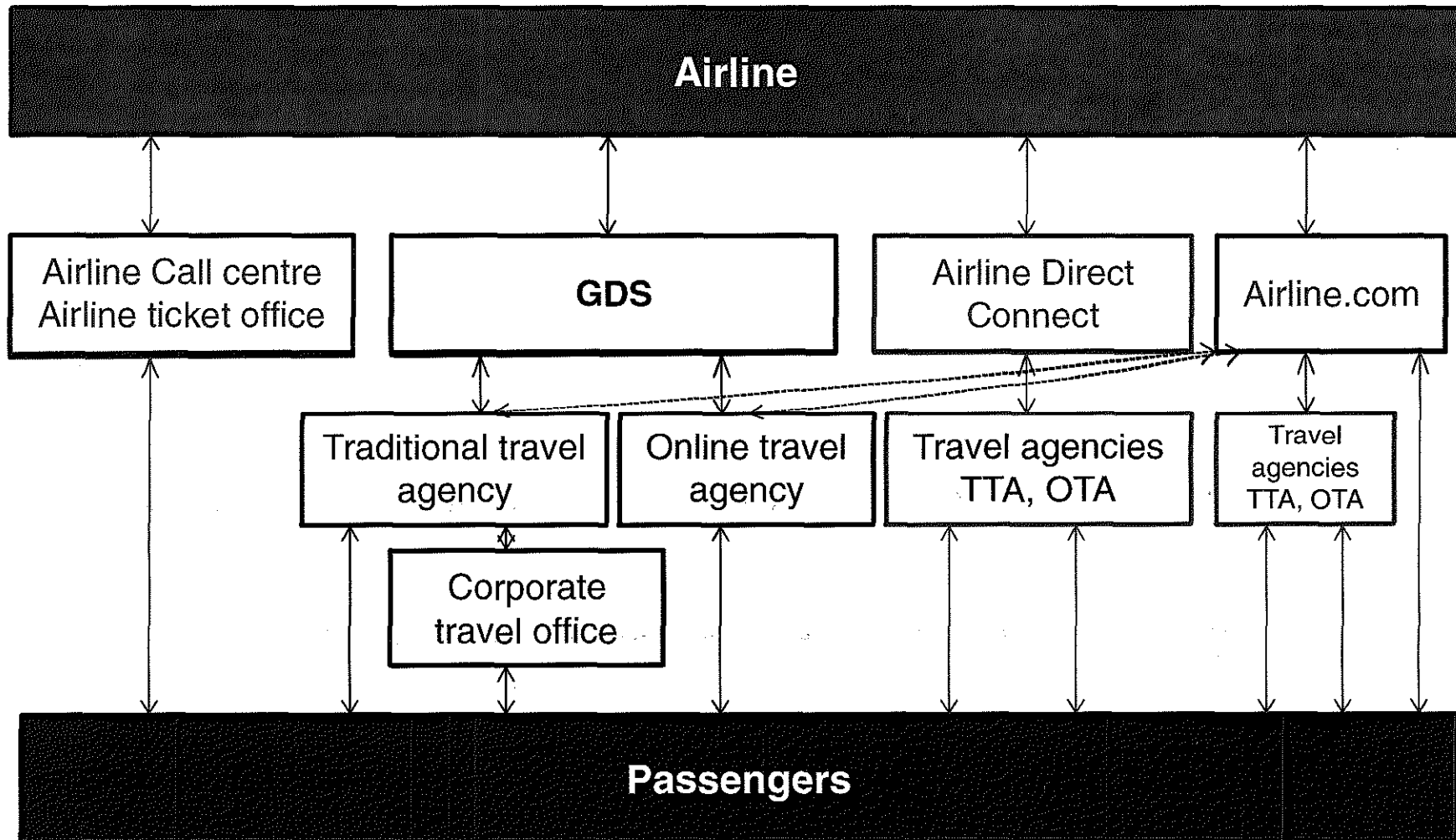
- **PhD in Economics (Wisconsin)**
- **Expert witness (testified in roughly 50 proceedings)**
  - US, Canada, Australia, New Zealand, UK, EU, Hong Kong
- **Professor**
  - Transportation Management & Economics, Managerial Economics
  - University of British Columbia
    - Taught social cost-benefit analysis for 14 years
- **Fellow, Australia Bureau of Transport Economics**
- **5 books, 40 peer reviewed papers**

# Cost-Benefit Analysis of Proposed Consumer Rule 3

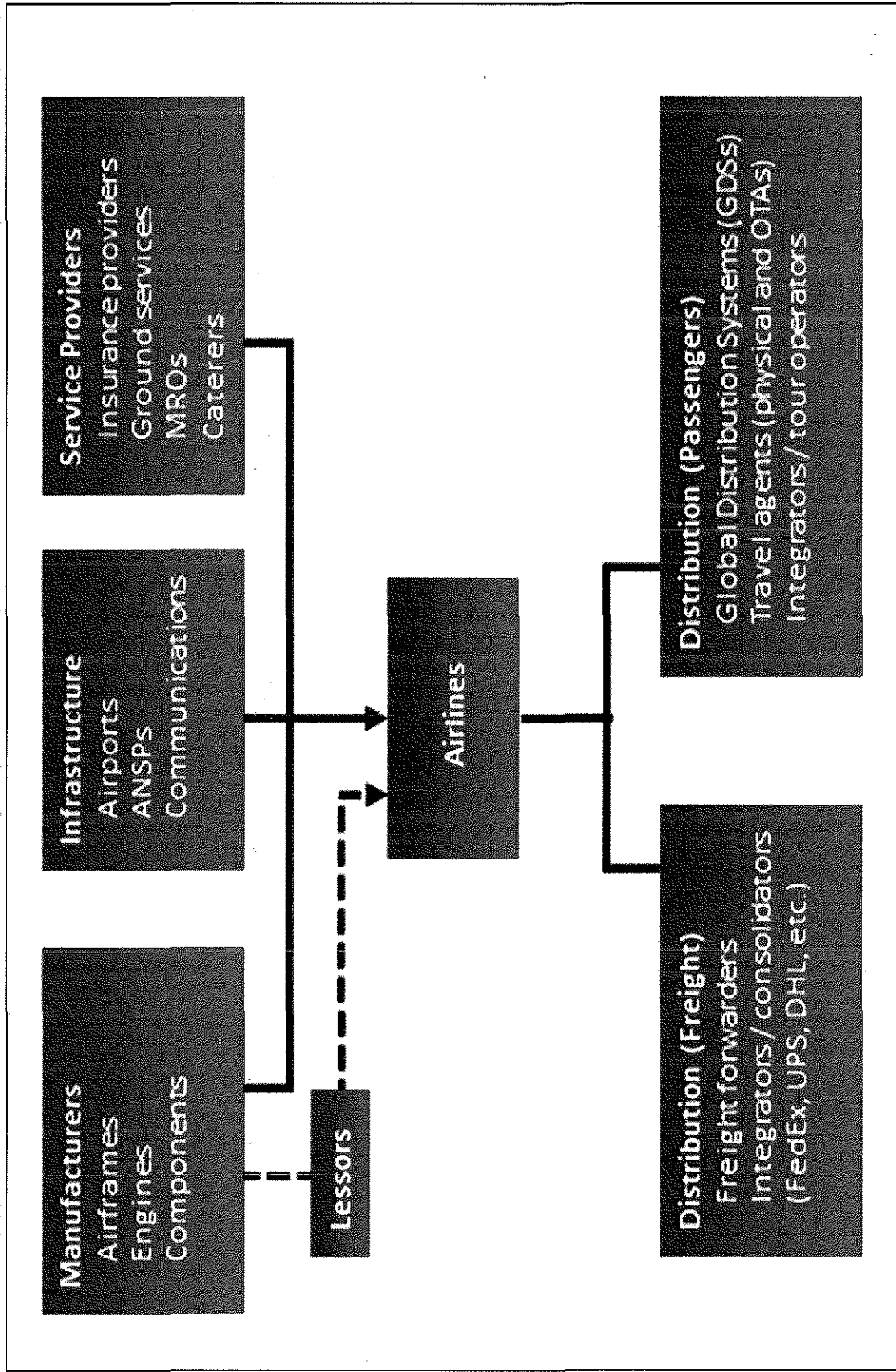
- **CBA provides a decision making framework for assessing the merits of a proposed policy**
- **Any new federal regulation in the US requires a cost-benefit analysis to be completed prior to approval**
- **President Obama's Executive Order (13563)**
- any new federal regulation must be supported by a cost-benefit analysis which shows a clear net benefit from the regulation



# Airline Distribution Channels

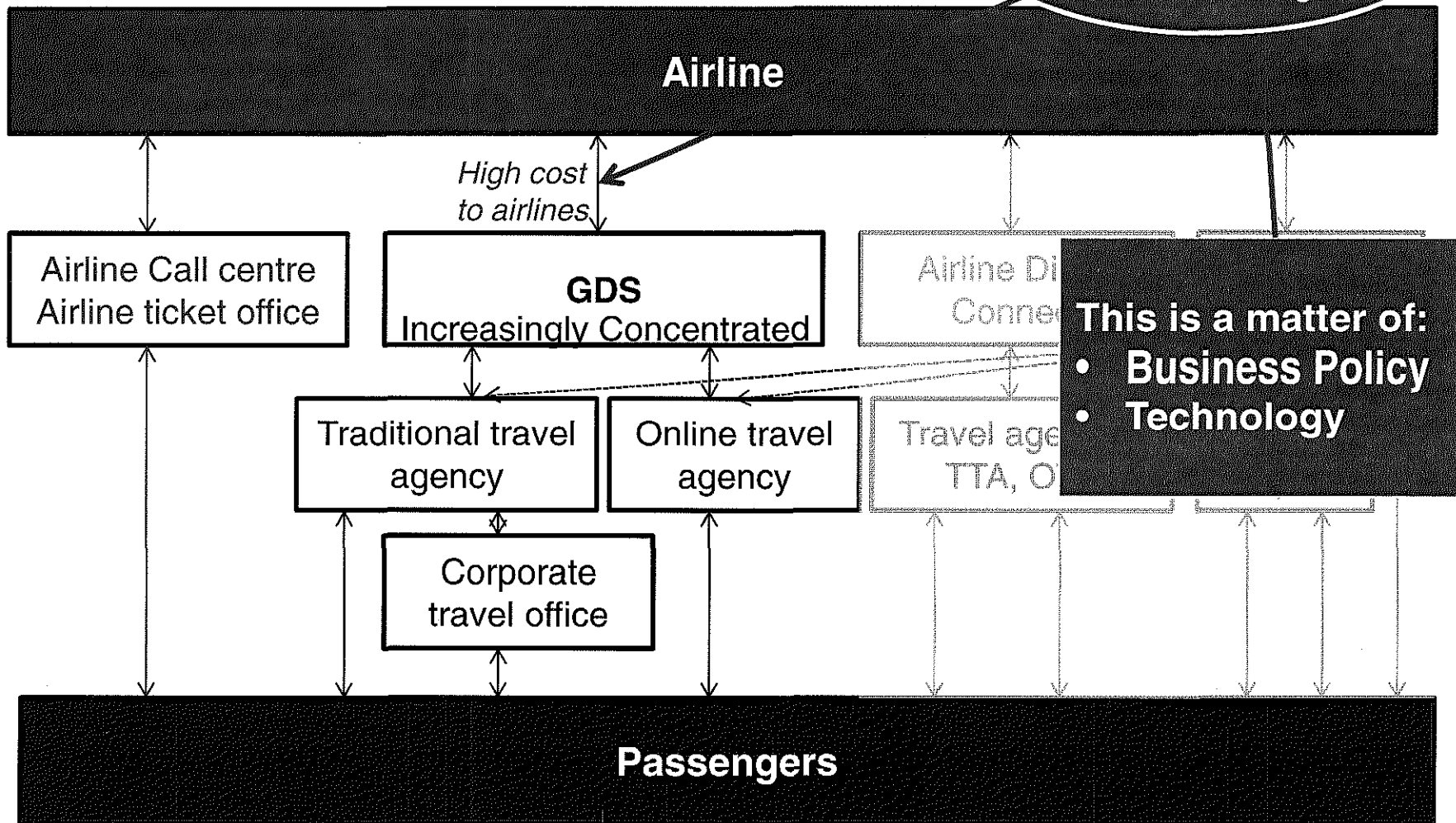


# Aviation Value Chain



# Airline Distribution Channels

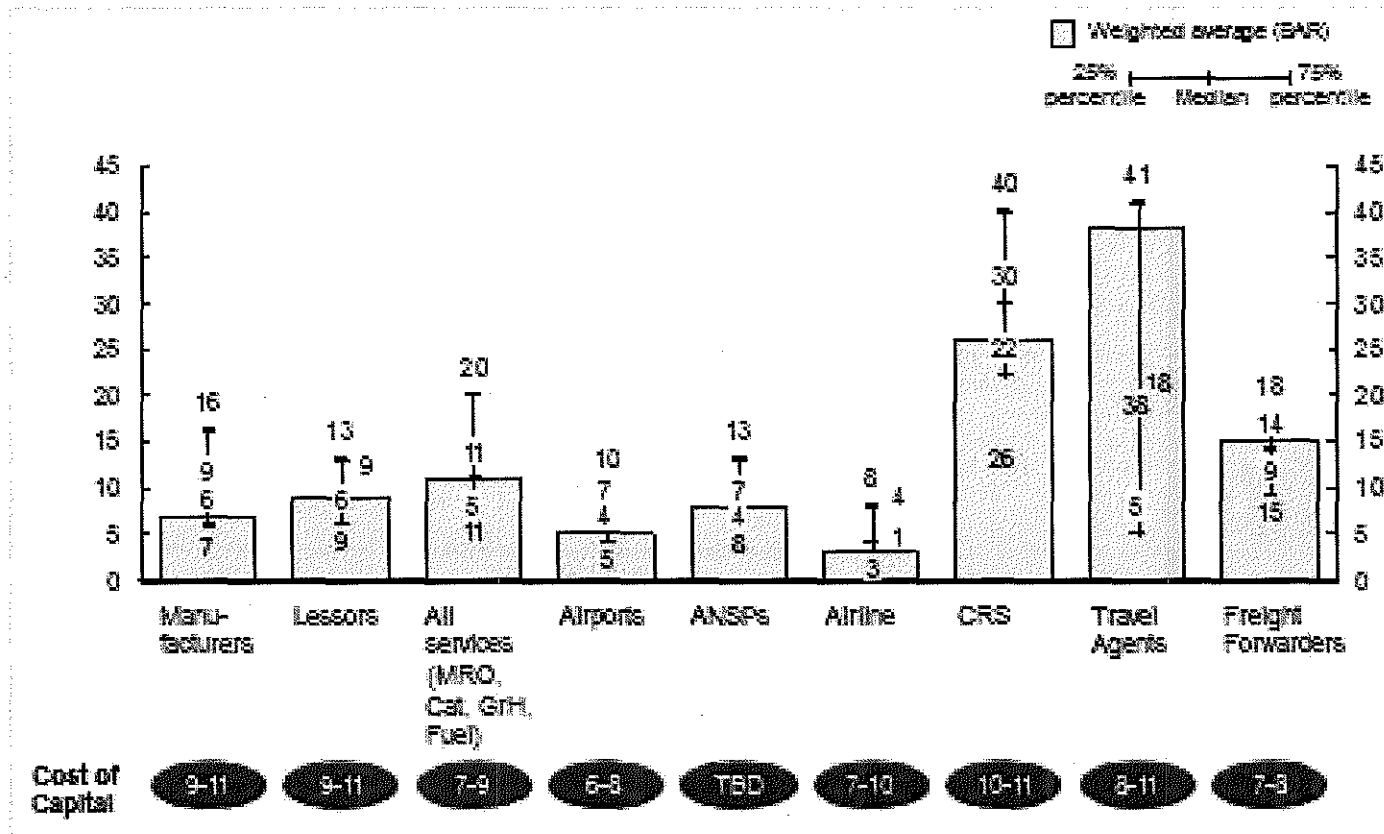
Does not reveal pax name prior to sale, thus cannot support Customisation/ Merchandising



# Aviation Value Chain (McKinsey study)

## Operating performance varies throughout the value chain

ROIC excluding goodwill, period 2002-2009, %



1 Limited sample

SOURCE: McKinsey value chain model

McKinsey & Company | 0