# The Lack of Competition in GDS Markets and the Role of Regulation

Presentation to the Office of Information and Regulatory Affairs

March 30, 2011

AmericanAirlines

# Overview

- American is at the forefront of using technology to enhance the selling process and to create new products
- We hope to offer a product line that differentiates our brand and to present offerings that are more relevant to our customers
- As American's product offering expands, we understand the importance of transparency in the selling process
  - Surprising customers with undisclosed costs and fees is bad business
  - American does not oppose regulations that are properly targeted to improving transparency
- American would oppose any regulation that further entrenches the role of the Global Distribution Systems (GDSs) in the distribution of our product

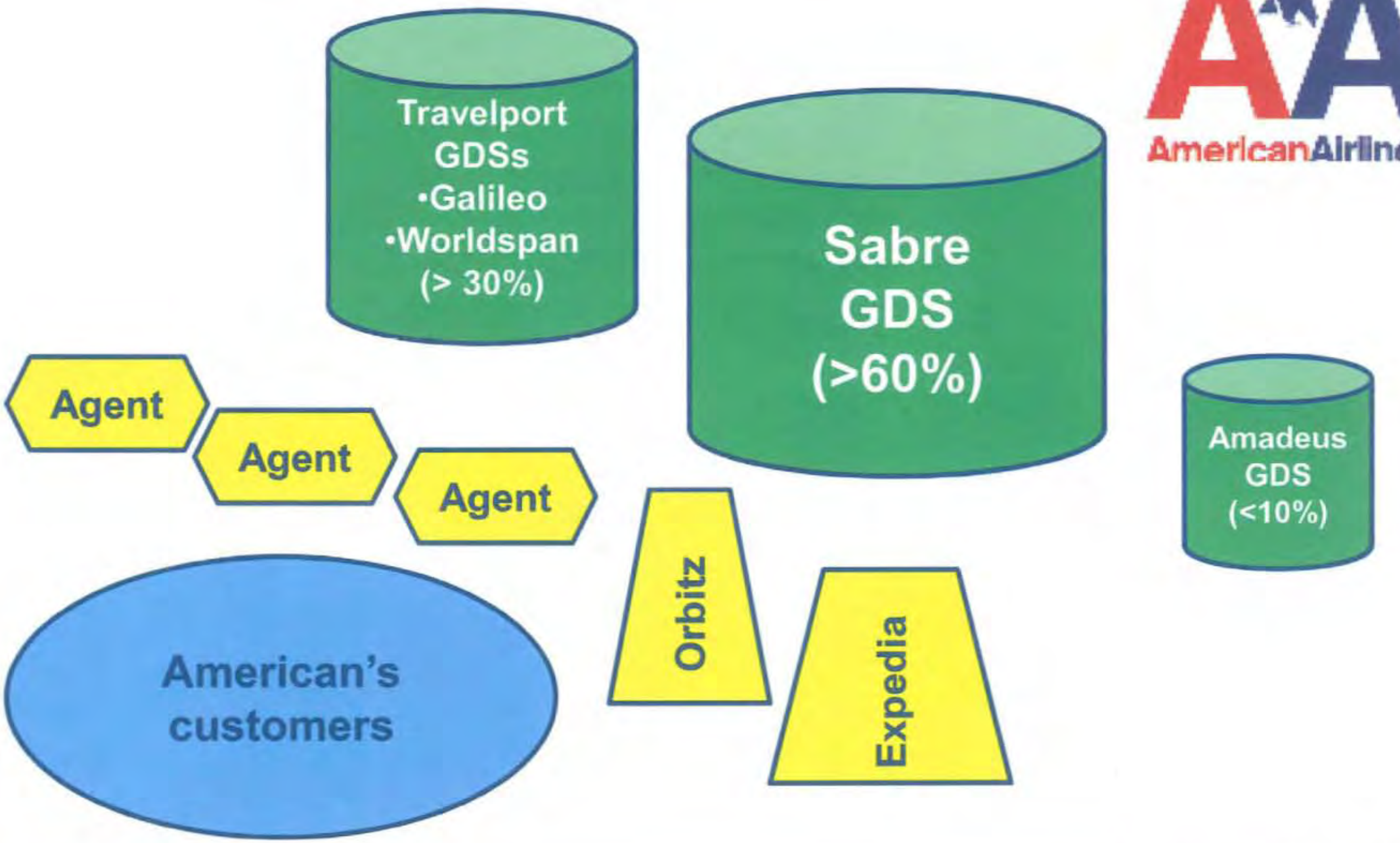
# Summary of Package

- This package explains:
  - The role of the GDSs in the distribution of airline products
  - The highly concentrated and fundamentally misaligned structure of the GDS markets
  - American's attempts to introduce a competitive alternative to GDS distribution, known as direct connect
  - Our position on GDS issues raised in the DOT's NPRM
    - DOT did not propose any rules, but did ask for comments on whether airlines should be required to provide information through the GDSs
    - Our answer is an emphatic no

# Overview of GDS Role

- GDSs provide services to travel agencies, not airline consumers
  - Online travel agencies, such as Expedia, Orbitz, and Travelocity provide services directly to airline consumers and, thus, are GDS users, not competitors
    - Common ownership positions with GDSs and incentive payments made by GDSs have co-opted online agencies into the GDS model
  - Traditional brick and mortar travel agencies also remain critical to network carriers
    - These agencies often specialize in servicing corporate customers who adopt sophisticated travel policies, need access to a wide range of travel products, and seek to maximize the value of the agreements that they negotiate with multiple airlines
    - Consumer sites like, Kayak or Orbitz, and airline owned sites, like AA.com, are not well positioned to serve this segment of travelers
  - Despite deregulation and the growth of the internet, agencies using GDSs still account for the majority of network carrier revenue

# The Legacy (GDS) Distribution Structure



# Historical Overview of GDS Regulation

- In the 1970s and 1980s, airlines pioneered the electronic distribution of their services by providing travel agents with access to their internal reservation systems, known as computerized reservation systems, or CRSs
- Fearing that airline owned CRSs could distort airline competition, in 1984, the Department began regulating CRS contracts with participating carriers and travel agency subscribers
  - These rules required CRSs to offer non-discriminatory fees and services to all participating carriers
- In 1992, the Department revised its CRS regulations and imposed a "mandatory participation" requirement on any airline that had an ownership interest in a CRS
  - At that time, this requirement encompassed all of the major network carriers and required them to provide all fares and content to each GDS

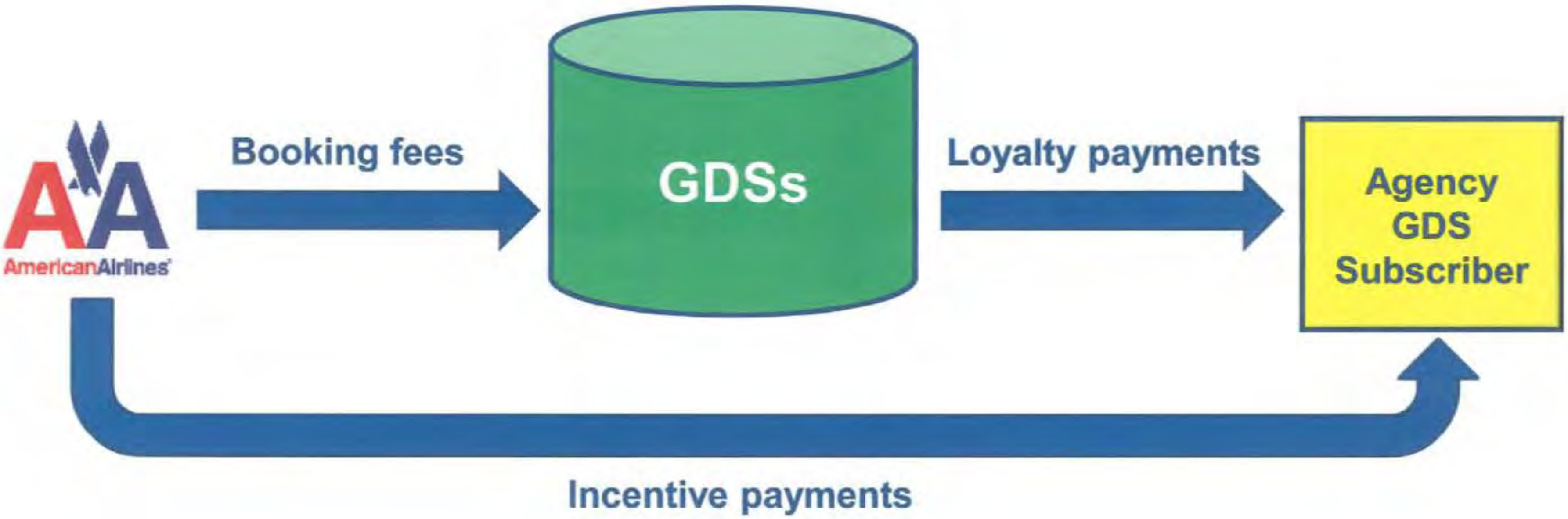
# Historical Overview of GDS Regulation

- By the late 1990s and early 2000s, the airlines began to divest their ownerships interests in CRSs
  - CRSs had become powerful, stand-alone, businesses and had re-named themselves, global distribution systems, or GDSs
- In 2004, citing the divestiture of airline ownership and the expected entry of new competitors and technologies, the DOT eliminated its CRS regulations
- In deregulating the GDS industry, both the DOT and the DOJ expressed significant concerns about the state of GDS markets
  - DOT and DOJ found that GDSs exercised market power over airlines and that booking fees were at supracompetitive levels (Appendix A)
    - DOJ and DOT identified misaligned incentives as a fundamental problem in the market (Appendix B)
  - DOJ and DOT concluded that mandatory content requirements had eliminated competition among GDSs for airline content and further enhanced GDS market power (Appendix C)

# The Failure of GDS Markets

- The GDS market suffers from a fundamental misalignment of incentives
  - GDSs share the supracompetitive booking fees that they collect from the airlines with the travel agents that use their systems, and thereby financially incentivize agencies to drive booking through the GDS, despite the costs
  - Airlines are forced to pay supracompetitive rates or forego access to these agencies which generate billions of dollars in ticket sales
- Despite the fact that airlines pay GDSs billions of dollars a year, GDSs view the travel agencies, not airlines, as their customers
  - In effect, the agencies are paid for their continued subscription to the GDS services, which allows the GDSs to retain their market power over airlines

# GDS-Based Payment Flow



# The Failure of GDS Markets

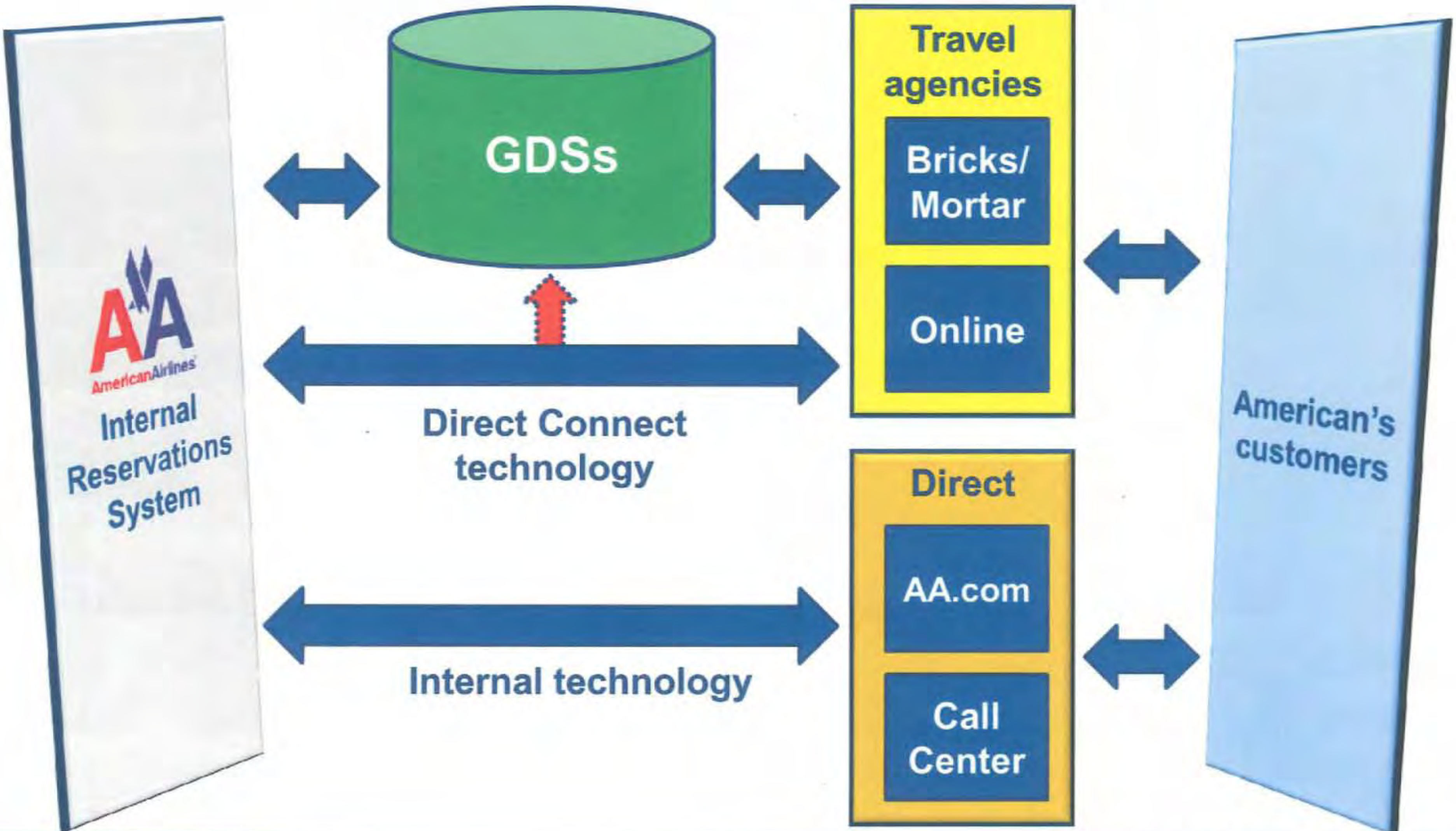
- Two companies, Sabre and Travelport, control over 90% of bookings made by U.S. based travel agencies
  - New entrants have tried to enter this industry, but all have failed in the face of anticompetitive practices by the GDSs
- Airlines must seek to charge higher fares to recoup supracompetitive GDS fees
- The billions in GDS fees disproportionately impact network carriers, and thereby also distort competition among carriers (Appendix D)
- Since the beginning of this decade, carriers have worked vigorously to reduce costs throughout their entire operations, but GDS costs have remained stubbornly high
  - GDS booking fees are three to four times the costs of alternative technologies
  - GDS fees have far outpaced other technology costs – which have generally seen a radical reduction

| | Memory Per Gigabyte | GDS Booking Fee Per Segment | Note |
|---|---|---|---|
| 1980 | $700 | $1 | Airline owned CRSs, no incentive fees |
| 2009 | $.10 (down 99.99%) | $3.10 (up 310%) | Industry Estimate |

# American's Direct Connect Strategy

- American no longer needs to rely on GDSs to make its information easily and widely available to travel agencies
  - The Internet and related XML technologies can efficiently connect travel agencies directly into American's internal reservations system
  - On the other end, competitively priced products exist that allow travel agencies to seamlessly integrate American's information into shopping results that display information from other airlines
    - In fact, some of the most capable of these content aggregation products are sold by the GDSs
    - GDSs are deciding that some carriers, but not others, can use these new products to integrate information from direct connections
- Direct connect technologies are not only less expensive, they are more flexible and technologically capable than the legacy GDS systems

# American's Direct Connect Structure



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# Fare Search

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| | | | |
|---|---|---|---|
| Source: AA | Departure time: 07:15 - 12:50 | | Fare Price **305.40** (USD) |
| Source: FL | Departure time: 08:20 - 22:05 | Selected Price: 353.00 | Lowest Fare from **313.00** (USD) |
| Source: AA | Departure time: 11:35 | | Fare Price **330.40** (USD) |
| Source: CO | Departure time: 07:00 - 18:35 | | Fare Price **346.40** (USD) |
| Source: CO | Departure time: 07:00 - 18:35 | | Fare Price **389.40** (USD) |
| Source: AA | Departure time: 14:00 - 17:55 | | Fare Price **408.40** (USD) |
| Source: AA | Departure time: 12:50 | | Fare Price **413.40** (USD) |
| Source: CO | Departure time: 07:00 - 18:35 | | Fare Price **430.40** (USD) |
| Source: AA | Departure time: 11:35 | | Fare Price **438.40** (USD) |
| Source: CO | Departure time: 07:00 - 18:35 | | Fare Price **481.40** (USD) |
| Source: AA | Departure time: 16:10 | | Fare Price **516.40** (USD) |
| Source: CO | Departure time: 16:55 | | Fare Price **579.40** (USD) |
| Source: UA | Departure time: 08:48 | | Fare Price **590.19** (USD) |

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Results » 1-20 | 21-40

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Now sorting by lowest price.

# American's Direct Connect Strategy

- Unlike the current GDS model, American's direct connect strategy aligns market incentives and ensures efficient distribution of our products
  - American incurs the entire cost of making our content widely available to agencies authorized to sell our product and willing to implement a direct connection
  - Travel agents decide how to integrate American's information into their own IT structures and systems
    - Given their existing suite of technologies, including those that integrate multiple sources for airline information, GDSs would continue to have an important role
    - However, in this instance, the travel agent would be incentivized to select the technology supplier that provides the most value rather than the supplier that shares the highest percentage of supracompetitive booking fees
  - American and the travel agencies negotiate commissions and other fees that compensate the agent for the distribution of our product

# Direct Connect Payment Flow

# What Is At Stake

- What is at stake:
  - The ability of airlines, like American, to improve the efficiency of their businesses by utilizing new technologies that are less expensive and offer greater capabilities
  - The end to distorted airline competition caused by GDSs offering vastly different economics to different airlines
    - This is not merely a difference in price among airlines; rather GDSs are offering a few airlines an entirely different economic model
  - As DOT and DOT noted, "supracompetitive fees, even when not used to target specific airlines, are inefficient and harm consumers by artificially raising the cost of air travel."
  - The ability of new competitors, like Farelogix, to bring competition to an GDS industry that DOJ and DOT have, for decades, considered to be immune from normal market forces and where two competitors command over 90% of the market

# What Is Not At Stake With Direct Connect

- What is **not** at stake:
  - The ability of agencies and consumers to access and compare American's services
    - Agencies using direct connects have long ago disproved the argument that direct connects lead to a fragmented selling process
  - The ability of consumers to find American's fares and services from sources other than AA.com
    - American fully understands that many consumers will use online agencies to compare our services with those of our competitors, and American wants those agencies to be able to sell American's products on a unbiased basis
  - The role and importance of travel agencies in the distribution of American's products and services
    - Direct connect technologies will allow American to distribute a broader range of products through travel agencies – and in the process become more, not less, competitive with AA.com

# Responses To the Questions You May Be Asking

- If direct connect technologies are superior, why are some travel agencies and their trade associations against American's efforts?
  - GDSs have used loyalty payments to co-opt many travel agencies, particularly the largest agencies like Expedia, into the current distribution system
  - These loyalty payments amount to hundred of millions, if not billions, of dollars annually, and are the GDSs largest expense
  - For relevant DOT and DOJ statements, see Appendices A and B
- What is the role of AA.com in this direct connect strategy?
  - AA.com is a website marketed directly to consumers looking for information or services from American
  - American's direct connect strategy is not focused on forcing either consumers or travel agents to use AA.com; rather our strategy is designed to get our information to travel agents, not consumers, in a manner that is more cost effective and flexible and is fully competitive with AA.com
  - Each travel agent will decide how to incorporate and display this information into its system

# Responses To the Questions You May Be Asking

- Will American's direct connect strategy make it more difficult to find American's services?
  - Definitely not. American needs its products to be available wherever consumers may be looking for them, and travel agencies, in particular, are critically important to our competitive success
  - We understand that not all agencies will be able to implement direct connects with American, particularly in the short to medium term, so we intend to continue to participate in GDSs
- Is American trying to destroy the businesses of Sabre and the other GDSs?
  - Of course not. Nor do we have the ability to do so. American is just one of hundreds of airlines that participate in the GDSs. Other airlines must make their own decisions, and many may chose to rely exclusively on GDSs for the distribution of their services to travel agencies.
  - Moreover, we believe that GDSs have valuable products and services that could be part of a direct connect strategy. GDSs have products that are effective in aggregating information from multiple sources. The point is that the cost of these services should be determined by the value they provide, rather than the ability of GDSs to exercise market power arising from access to large sets of travel agencies.

# DOT Rulemaking

- DOT's NPRM asked whether it should require airlines to provide content to GDSs
- DOT did not propose any rule on this point, but any such rule would only:
  - Intrude upon an airlines' ability to develop and reward more efficient distribution mechanisms
  - Reinforce the market power of a GDS duopoly
- DOJ and DOT have both recognized that control over content is an essential tool to controlling airline distribution costs (Appendix C)
- A regulation mandating content to the GDSs would not further transparency:
  - DOT's proposed rules include new disclosure obligations that American supports
  - However, new regulations should not dictate how American complies with its disclosure obligations
  - Direct connect platforms, among others, are well positioned to provide this information to agencies and consumers

# Appendix A – GDS Market Power and Supracompetitive Fees

- DOJ Comments, (DOT-OST-1997-2881), June 9, 2003, "The airlines' CRS divestitures leave unaffected the incentive and ability of CRSs to fully exercise their market power in nonstrategic ways"
- "Although airline bargaining power has not in the past been sufficient to produce competitive booking fees, bargaining power could increase if their ability to shift sales to the Internet and other alternative channels continues to increase. DOT should assess, after some reasonable period, whether the alternative distribution channels have continued to dissipate CRS market power." (Pages 21-22).
- DOT Final Order, (69 Fed. Reg. 976, January 7, 2004), "We continue to believe that the systems' fees exceed competitive levels. . . We have not seen evidence that the systems fees generally respond to market forces, although two of the four have made modest concessions in exchange for access to airline webfares." (Page 990).
- We find that the systems continue to have market power over airlines, as argued by the Justice Department; that there is some potential for conduct by the systems that could prejudice airline competition (most notably the sale of display bias); and that systems could engage in practices that could unreasonably preserve their market power." (Page 986).

# Appendix B – Comments On Misaligned Market

- DOJ Comments, June 9, 2003 "DOT has not proposed a rule to remedy non-strategic supracompetitive pricing by CRSs. In the past, DOJ advocated a zero price to constrain both the strategic and nonstrategic exercise of CRS market power over price. We pointed out the advantage of a structural rule, which relies on properly-aligned incentives." (Page 3).
- "Travel agents and CRSs both benefit from the supracompetitive booking fees generated under the current structure of the market." (Page 29)
- DOT Final Order, "Airlines have generally been unable to persuade travel agencies to use one system rather than another. If they could, they would have some bargaining leverage against the systems. Airlines could then shift business to systems offering better terms for airline participants and away from systems offering poorer terms. Because travel agencies do not pay booking fees, they have no direct incentive to use the system charging the lowest fees. The record suggests, in fact, that the incentive payment programs used by the systems encourage travel agencies to choose the system that is the most expensive for participating airlines. The systems then obtain subscribers typically by offering to give them bonus payments. The revenues used for those incentive payments come from the fees paid by participating airlines (and to a smaller extent by other travel suppliers). (Page 989)

# Appendix C – The Importance of Airline Content to Off-Set GDS Market Power

- DOJ Comments, "Practices prohibited by the mandatory participation rule are potentially efficiency-enhancing. If an airline dealing at arms-length with its CRS suppliers were free to reduce its level of participation in some systems, or to induce agents to use a low-cost system, the airline's bargaining power would be enhanced. The airline would therefore be in a better position to negotiate lower booking fees or drive booking toward lower cost outlets." (Page 23)
- "A low-cost distribution channel on the Internet may not offer the same level of functionality as a CRS, but may nonetheless be able to attract usage by travel agents if it has preferred access to desirable fares and inventory from a significant number of airlines." (Page 26)
- DOT Final Order, "Our notice of proposed rulemaking predicted that the airlines' control over access to their webfares could enable them to obtain better terms for system participation (Page 989).
- "We believe that the airlines' ability to change their participation levels and their control over access to webfares is reducing the systems' market power. Overall, however, we find that the systems currently still have market power over most airlines, although the continuing changes in airline distribution, particularly the growing importance of the Internet for airlines." (Page 990)

# Appendix C – The Importance of Airline Content to Off-Set GDS Market Power

- DOT Final Order, "We continue to believe that the systems' fees exceed competitive levels for the reasons set forth in the notice of proposed rulemaking. We have not seen evidence that the systems' fees generally respond to market forces, although two of the four systems have made modest concessions in exchange for access to airline webfares." (Page 990)
- "We have found that the systems continue to have some market power over most airlines, as explained above, although we expect that power to be diminished by the on-going developments in airline ticket distribution. Airlines should have some bargaining power against systems if each airline can choose which services and fares will be saleable through each system and the level at which it will participate in each system". (Page 1005)
- "We saw a risk that systems could try to take away the airlines' control over access to their fares, especially webfares, which airlines could otherwise use as leverage to obtain better terms from the systems." (Page 1006)

# Appendix C – The Importance of Airline Content to Off-Set GDS Market Power

- "Airlines should be free to choose to offer their webfares, or other types of fares, only through their own websites, without being obligated by system contracts to make them available through other distribution channels. Airlines can use their control over webfares to win better terms for CRS participation." (Page 1006)
- "More importantly, the [mandatory participation] rule limits the ability of owner airlines to bargain for better terms with the systems. If such an airline could credibly threaten to reduce its participation level in a system, it would have some leverage for obtaining lower fees or better service. The rule eliminates that option. As the Justice Department states, if the rule is eliminated, "the airline would therefore be in a better position to negotiate lower booking fees or to drive bookings towardlower-cost outlets." (Page 1009)

# Appendix D – GDS Market Power, Distortion of Airline Competition, and Definition of Relevant Market

- DOT Final Order, "As the Justice Department had stated in an earlier rulemaking, quoted at 67 FR 69376: Each CRS provides access to a large, discrete group of travel agents, and unless a carrier is willing to forego access to those travel agents, it must participate in every CRS. Thus, from an airline's perspective, each CRS constitutes a separate market and each system possesses market power over any carrier that wants travel agents subscribing to that CRS to sell its airline ticket." (Page 987)
- "We recognize that Southwest, JetBlue, and some other low-fare airlines operate successfully without obtaining many bookings from travel agents. Southwest and JetBlue reportedly obtain only 20 percent and 10 percent of their revenues, respectively, from travel agencies. Justice Department Reply Comments at 15, n.14. Other airlines, particularly the large network airlines cannot now practicably end their reliance on the travel agency channel." (Page 988)

# Appendix D – GDS Market Power, Distortion of Airline Competition, and Definition of Relevant Market

- "An airline's greatest leverage for obtaining lower fees or better terms for participation will be a threat to withdraw from the system. If an airline withdraws, however, it will immediately begin losing bookings from that system, and those losses will not be entirely offset by increased bookings through the Internet. Any saving in CRS participation expenses will arrive later, and will not quickly offset the revenues lost from the reduction in bookings. . . Thus the airline's revenue losses from withdrawal will be substantial and begin occurring immediately, while the system's losses in subscribers will be gradual and occur only over a period of some months. In these circumstances, the system should have the upper hand in bargaining." (Page 990)
- "We recognize, in view of our findings that each system has market power, that even the largest airlines may have little leverage to obtain lower fees despite the elimination of the rule." (Page 1010)