

# The National Commission to Ensure Consumer Information and Choice in the Airline Industry

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American Airlines is pleased to appear today before the Commission and to present its views on the major challenges facing travel agents. The Aviation Investment and Reform Act for the 21<sup>st</sup> Century ("Air-21") directs the Commission to investigate the financial condition of travel agents. In addition, Air-21 charges the Commission to determine whether there are impediments to the distribution of schedule and fare information to the traveling public (and if so, to identify the effects of those impediments on brick-and-mortar travel agencies, on-line travel agencies, and consumers).

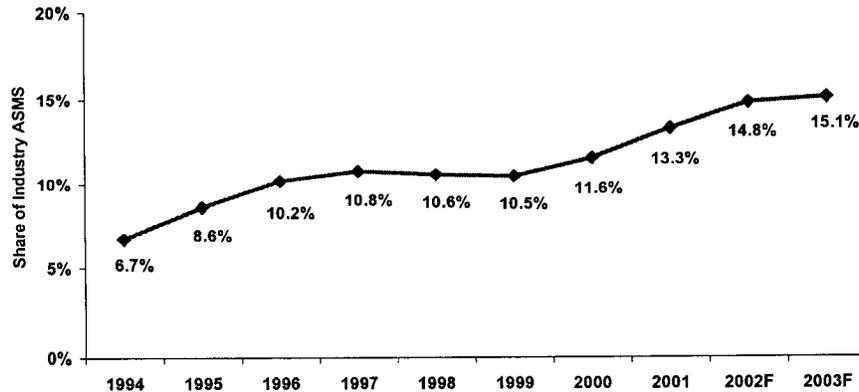
The airline industry and the travel business are an important part of modern America. In the over twenty years since Congress deregulated the domestic airline industry, air travel has become an affordable and commonplace part of American life. We saw over the past decade more people travel more often to more places than ever before. Business workers travel from coast-to-coast in six hours. Many are accustomed to "day trips," in which they travel to another major city, conduct a business meeting, and then return home, all in a single day. Families think nothing of visiting friends and relatives hundreds or even thou-

sands of miles away. Convenient air travel has made possible the enormous growth of the cruise ship business, and the destination resort business.

Today, however, the airline industry is in a state of crisis. U.S. airlines reported over \$2.25 billion in losses during the first three months of 2002, and are expected to lose over \$4 billion for the year. American alone lost over \$500 million during the first quarter. America West applied for, and was granted, \$380 million in federal loan guarantees. Earlier this week, US Airways applied for \$900 million in federal loan guarantees, and has publicly stated that it may file for bankruptcy. At the same time, as I am confident the Commission will hear in greater detail from other witnesses, travel agents face mounting challenges.

It would be easy to assume that this crisis is all the result of the events of September 11, but that would be a serious mistake. The industry was struggling even before September 11, especially major carriers such as American. American's costs per available seat mile have historically been near the high end of the industry. While we incur those costs as an element of a business strategy to provide extra levels of service that are attractive to certain customers (principally business passengers), the growth of low-cost carriers has diminished the ability of this business strategy to generate profits. As depicted on the chart on the next page, during the last eight years, low-cost carriers' share of total industry capacity has grown from 6.7% to 13.3%, and is forecasted to exceed 15% by the end of next year.

### LOW-COST CARRIER SHARE OF INDUSTRY CAPACITY



This growth leads to more competition between low-cost carriers and traditional carriers such as American. Today, American faces direct competition from low-cost carriers on about 70% of our origin & destination markets, and we can expect this percentage to increase.

One major difference between American and carriers such as Southwest and Jet Blue is how we distribute our tickets. Today, travel agents sell roughly 70% of American's tickets. Southwest and Jet Blue, however, largely avoid travel agents. Southwest participates only in Sabre, and at a lower level of functionality than all other carriers, and we estimate that less than 20% of Southwest's total sales are made through travel agents. The differences between American and JetBlue are even more striking. According to its filings with the Securities and Exchange Commission, JetBlue booked 92.6% of its sales either through its Internet site (44.1% of total bookings) or its own telephone reservations person-

nel (48.5% of total bookings).<sup>1</sup> This difference in distribution practices leads to a significant difference in costs. For example, while American pays over \$3.00 in CRS booking fees for each passenger boarded, we estimate that Southwest pays less than 50¢.

Now, let me stop right here and say that American does not believe that the solution is to quit using travel agents. Nor is our objective (as is commonly asserted about Orbitz) to “disintermediate” travel agents. To the contrary, we are trying to drive changes, a major effect of which will be to allow travel agents to survive, because if travel agents do not survive, American will find it harder to compete effectively. Why is that so? Because in the airline business (as in most other businesses), the more complex the product or service being sold, the more the provider of that product or service will want to provide higher levels of sales support.

As applied to the airline industry, to this day, American relies heavily on travel agents because we sell a network of services that is inherently more complex than the services offered by carriers such as Southwest and JetBlue. Southwest, for example, does not fly to London, Paris, Zurich, Sao Paulo, Buenos Aires, Tokyo, or Rome, all of which are served by American. Southwest does not codeshare, or even interline, with any other carrier. To expand the scope of its network, however, American is one of the founders of **oneworld**<sup>®</sup> (a global alliance

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<sup>1</sup> See JetBlue Airways Corporation, S.E.C. Form S-1 Registration Statement, p. 38 (Feb. 12, 2002).

of carriers), codeshares with over 15 carriers to dozens of destinations around the world, and interlines with over 240 carriers.

As Southwest's success has shown, many consumers are quite comfortable making their own travel arrangements when they fly from Albuquerque or Spokane to Nashville or Orlando to visit their relatives, Opryland, or Disney-world. But these same consumers are not as comfortable making their own arrangements when contemplating travel to a country where they don't speak the language, or when they have to arrange connections between different carriers. Other customers (often large corporations) have complex air travel needs and find it more efficient to use a travel professional. American operates a complex network, and enters into various alliances, in large part in an effort to be attractive to these predominantly business customers. These customers with more complex air travel needs demand (and are willing to pay for) active management of their travel. Travel agents have served both of these types of customers for decades, and American has a strong interest in seeing that they continue to do so in the future.

To accomplish this, however, our cost of distributing tickets through travel agents must become more competitive with Southwest and Jet Blue's costs of distributing tickets directly to consumers. Herein lies the rub. Even if American pays no base commission to a travel agent, it is still more expensive to sell a ticket through a travel agent than it is to sell it ourselves. The source of these continuing high costs is plain — it is CRS booking fees that are unconstrained by

competitive market forces. And make no mistake about it — if this Commission were to find that there is some impediment to the free flow of travel information, it should find that impediment to be the high cost of CRS booking fees.<sup>2</sup>

CRSs have not only the incentive, but also the market power, to charge booking fees well above competitive levels. As the Department of Justice has observed, each CRS “has market power over airlines, which are dependent on the CRSs for the distribution of their tickets. The CRS vendors are able to use their market power to charge airlines supracompetitive booking fees. These booking fees, in turn, are passed on to consumers in higher air fares.”<sup>3</sup>

When the CRS rules were first promulgated by the Civil Aeronautics Board, and continuing through the late 1990s, CRSs were “essential for the marketing of the services of virtually all airlines operating in [the United States].”<sup>4</sup> Because each CRS provides access to a large and distinct group of travel agents, carriers have had to participate in every CRS. As the Department of Transportation recognized:

An airline’s ability to sell its services will be significantly impaired if its services are not displayed and offered for sale in each CRS used

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<sup>2</sup> I should hasten to add that American does not believe that there is, in fact, a significant impediment to the flow of information to consumers. Every year more and more consumers “go online,” either by subscribing to internet service themselves, by using a computer at work, or by going to a library, internet café, or neighbor’s residence. These consumers have ready access to virtually all travel information.

<sup>3</sup> Comments of the Department of Justice, p. 1, DOT Dkt. 46494 (Nov. 22, 1989); *see also* Comments of the Department of Justice, p. 5, DOT Dkt. 46494 (July 9, 1991) (“CRS booking fees charged to airlines are not readily subject to competitive discipline, and CRS vendors charge supracompetitive booking fees....”).

<sup>4</sup> Advance Notice of Proposed Rulemaking, Docket OST-97-2881-1, p. 2 (Aug. 28, 1997).

by a significant number of travel agents. If the airline does not participate in one system, the travel agents using that system must call the airline to obtain information and make bookings, which is substantially less efficient than using a CRS. Travel agents are less likely to book an airline when doing so is significantly more difficult than booking another airline that does participate in the agents' CRS. As a result, the non-participating airline will receive fewer bookings than it would have obtained if it participated in the agents' system. Because of the importance of marginal revenues in the airline industry, a loss of a few bookings on each flight is likely to substantially reduce the airline's profitability.<sup>5</sup>

This market structure allows CRSs to charge exorbitant fees to airlines.

Thus, when the Department of Transportation modified the CRS rules in 1992, it concluded that "booking fees charged by the major vendors have been found to be substantially above their costs."<sup>6</sup> Since 1992, the situation has only gotten worse. According to the Inspector General of the Department of Transportation, booking fees per segment have increased 70%, despite substantial reductions in computing and telecommunication costs.<sup>7</sup>

CRS booking fees set above competitive levels harm American and other airlines, consumers, and travel agents. First, high CRS fees put airlines who rely on travel agents using CRSs at a competitive disadvantage to airlines that rely

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<sup>5</sup> *Id.*, at p. 5 (citations omitted); *see also* Comments of the Department of Justice, p. 11, DOT Dkt. 46494 (July 9, 1991) ("Currently, withdrawing from a CRS in response to an increase in booking fees would be very costly for a carrier, far more costly certainly in the short run than for the CRS vendor.").

<sup>6</sup> Final Rule, 57 Fed. Reg. 43779, 43831 (Sep. 22, 1992).

<sup>7</sup> Testimony of DOT Inspector General Kenneth Mead before the Senate Committee on Commerce, Science, and Transportation, p. 16 (July 20, 2000). While it is true that CRS functionality has increased as well, so that some portion of today's higher fees are properly attributed to improved functionality, in other areas of computing technology, improvements in functionality and speed have been accompanied by significant cost reductions, not increases.

more heavily on lower-cost distribution channels. Second, because booking fees are incremental to the costs of providing airline service, a large portion of them are ultimately borne by consumers in the form of higher average fares.<sup>8</sup> Third, when booking fees are set above competitive levels, they reduce aggregate demand for air travel, which in turn reduces both the demand for air travel on American, and the demand for travel agent services.

By continuing to sell tickets through travel agents using high-cost CRSs, American and travel agents who sell tickets on American expose themselves to a competitive threat, as consumers increasingly patronize those airlines (such as Southwest and JetBlue) that offer lower fares in part because they enjoy lower overall distribution costs. Unfortunately, American has little ability to reject exorbitant CRS fees, and to date, travel agents have not recognized their long-term incentives to choose CRSs that charge lower booking fees to airlines.

American's ability to resist high CRS fees is sharply limited not only by each CRS's access to a discrete group of travel agents, but also by the Department of Transportation's CRS rules. In particular, the mandatory participation rule (14 C.F.R. Part 255.7) frustrates airlines' ability to bargain with CRSs over the level of CRS fees. If the mandatory participation rule were to be withdrawn, one or more carriers might seek to withdraw from at least one CRS. This in turn would trigger the sort of negotiations that take place daily in unregulated indus-

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<sup>8</sup> See Comments of the Department of Justice, p. 6, DOT Dkt. 46494 (July 9, 1991) ("Supracompetitive booking fees cause airfares to rise and can adversely affect airline competition. They are passed along to consumers in the form of higher fares.").

tries, and CRSs would begin to be exposed to the normal market incentives to preserve the breadth of the information and services they offer to travel agents by charging lower fees to airlines.

Travel agents lack normal short-term market incentives to subscribe to lower-cost CRSs because travel agents generally do not pay for CRS services.<sup>9</sup> Instead, CRS “productivity payments” for additional bookings often outweigh any payments made by the travel agent to the CRS, so that the CRS, in effect, pays the travel agent to use the CRS. Thus, at least in the short run, travel agents have an incentive to subscribe to the CRS with the highest booking fees because those higher fees will fund greater incentive payments to the travel agent.

This situation cannot persist indefinitely. Airlines that continue to sell a large portion of their tickets via travel agents using high-cost CRSs can be expected to continue to lose market share to airlines that distribute air transportation services with little or no use of travel agents using CRSs. As this happens, airlines that rely heavily on travel agents will shrink, as will the travel agents supporting these airlines. One response to this might be for CRSs to raise booking fees even higher, and use the proceeds to offer greater and greater incentives in a fight for a larger share of a shrinking base of travel agents. A second response might be to change the traditional ways in which airlines, travel agents, and CRSs have done business. American has sought to embark on the second

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<sup>9</sup> CRSs typically obtain a travel agent’s commitment to a minimum number of monthly airline segments booked per installed terminal. As long as these thresholds are met,

course of action. We have done this by embracing a distribution strategy designed to enhance our competitiveness by lowering our distribution costs both in the short run and (by trying to create competitive pressures on CRS booking fees) in the long run. Specifically, we have adopted a strategy of furthering the growth of the internet and other low-cost distribution channels, which we hope will eventually diminish CRSs' market power, which would then lower the costs of the brick-and-mortar travel agent channel.

Knowing that consumers have a keen interest in lower fares, American hopes to spur the growth of low-cost distribution channels by making webfares available only on the lowest-cost distribution channels. If consumers are pleased with their shopping experience using a low-cost distribution channel to find and purchase a discounted webfare, they are likely to use that lower-cost distribution channel for other ticket purchases. American will then enjoy reduced distribution costs not only on sales of webfare tickets, but also on sales of other tickets as consumers increasingly use lower-cost distribution channels. More important, as more and more consumers use low-cost distribution channels, CRSs will begin to face competitive pressures to lower their costs and to charge reasonable fees. This would, in turn, lower the costs of distributing tickets through travel agents, which is a key part of American's strategy of seeking to lower its total distribution costs.

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many travel agencies pay nothing to rent their computer equipment or to use the CRS.

Consistent with this strategy, American joined Orbitz (after others had formed it) because Orbitz offered American a long-term commitment to low-cost distribution economics on all tickets sold through the Orbitz website. In exchange for Orbitz's commitment to low costs, American agreed to make available through Orbitz all fares that American makes available over its own internet site — *AA.com*. While many have sought to suggest that Orbitz precludes American from making webfares available on other websites or via other distribution channels, that simply is not the case. Nothing in our agreement with Orbitz prohibits American from making webfares available to Orbitz's competitors, and we are more than ready, and are indeed eager, to make webfares available through any other outlet that offers us a long-term commitment to the sort of low costs on all fares, not just webfares, that we incur on Orbitz.<sup>10</sup>

American has also called upon the Department of Transportation to modify the CRS Rules in ways that would introduce some normal market forces to the setting of CRS booking fees. We have asked the Department to withdraw 14 C.F.R. Part 255.6. If the Department were to do so, it could reasonably expect

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<sup>10</sup> American's elimination of base commissions is in no way inconsistent with this strategy. Instead, by prompting travel agents to charge consumers for the services they provide, the elimination of base commissions simply puts in consumers' hands the level of travel agent services they wish to consume. Given the growth of the internet, there is little reason today for all consumers, many of whom might prefer to search for and book their own flights, to pay airfares that include the costs of base commissions. By analogy, consumers who use full service stockbrokers generally pay more for trades than do consumers who do their own trading online. For both travel agents and stockbrokers, there is nothing inherently superior about either the traditional or the online form of doing business — some consumers will choose the low-cost service, while others will choose the higher-cost service.

to see carriers bargain with CRSs, which would reduce booking fees, and in turn reduce the costs of distributing tickets through traditional brick-and-mortar travel agents. We have also asked the Department of Transportation to adopt the “zero booking fee” rule recommended by the Department of Justice.<sup>11</sup> By causing travel agents to bear the costs of the CRS service they choose, the Department of Transportation would remove the current regulatory obstacles to the natural free market incentives for travel agents to choose the most competitive CRS.<sup>12</sup>

Over time, competitive market forces, if unleashed, can be expected to result in the costs to airlines of distributing tickets via online versus brick-and-mortar travel agents to become roughly comparable, so that airlines’ incentives to withhold discounted webfares from traditional travel agents would be reduced. Of course, CRSs would have to become more efficient in order to compete with direct connect technologies, and travel agents would likely have to charge con-

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<sup>11</sup> In 1989, in what came to be known as the “zero fee proposal,” the Department of Justice proposed that the CRS rules require CRSs to charge booking fees to travel agents instead of airlines. See Comments of the Department of Justice, pp. 43-48, DOT Dkt. 46494 (Nov. 22, 1989). “Requiring the travel agents — the people deciding which CRS to use — to pay the booking fees allows the competitive process to work to hold down booking fees.” Comments of the Department of Justice, p. 9, DOT Dkt. 46494 (July 9, 1991).

<sup>12</sup> “[T]he zero booking fee rule correctly aligns the travel agents’ ability to choose among systems with the travel agencies’ incentive to do so since the CRS charges will directly affect the travel agents’ profits. Thus under the zero booking fee rule competition among vendors to obtain travel agent contracts will determine the level of booking fees paid by travel agents.” Comments of the Department of Justice, p. 18, DOT Dkt. 46494 (July 9, 1991) (emphasis in original).

sumers for the services they provide, but this is merely the normal evolution of a competitive market.

The internet is driving change throughout the world economy. Neither the airlines, nor travel agents, nor even CRSs, are immune from these forces of change; all of us should recognize the power of technological progress, and embrace change.

I thank the Commission for this opportunity to appear before you.

Respectfully submitted,  
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