

Statement of Michael E. Levine

Before the

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

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My name is Michael E. Levine. I am currently Professor (Adjunct) of Law at Yale University. I have had the unusual experience of studying and participating in the air transport industry as an academic, a government regulator and as a senior airline executive. As an academic, I have held professorial chairs at Yale, the California Institute of Technology and the University of Southern California; I have been Dean of the Yale School of Management; and I have taught at Harvard and Duke universities. I have written extensively on the airline industry and its regulation. As a government regulator, I was the senior staff member responsible for most regulatory activity at the Civil Aeronautics Board during the period of airline deregulation (1978-79). As an airline executive, I was President and CEO of New York Air and held executive vice presidencies at Continental Airlines and Northwest Airlines. In both my regulatory and executive capacities, my responsibilities included airline marketing and distribution, including electronic distribution. The attached *curriculum vitae* sets out my qualifications in more detail.

I submit this statement as a Commission expert, retained and paid by the Commission.

I have been asked by the commission staff to address issues raised by the fact that different airlines have chosen different distribution strategies, including different levels of reliance on travel agencies, computer reservations systems (CRS), online distribution systems and direct distribution, both by phone and online. Some of these strategies bypass travel agents entirely. In particular, I have been asked to address questions raised by the fact that some airlines have elected to emphasize web service, offer some fares exclusively or semi-exclusively through some channels (including their own websites)

rather than others, generating complaints by those entities not able to offer the fares. I have also been asked to address suggestions that airlines be forced or encouraged to offer net fares available at a discount to “posted” fares, so that any distribution channel could sell them with an additional markup.

Although the concerns that created this Commission have been intensified by rapid changes in the distribution system brought on by the advent of the Internet and related electronic and computer technologies, the differential distribution complained of by many participants to this proceeding is not new. Airlines have historically emphasized different distribution channels according to their commercial circumstances and strategies. When legally tolerated, many airlines have offered fares exclusively through one channel (for example, consolidators for at least forty years), some have sold through particular travel agencies (supplemental airlines in the 1950s and public charters in the 1970s and 1980s), and many have pursued a variety of tactics designed to encourage customers to deal directly with them rather than through intermediaries (for example, city ticket offices [CTOs] and Air Travel Cards).

Airline interest in one or another distribution technique or channel has been dictated by circumstances. Where travel required the distribution of accountable and exchangeable tickets and customers were widely dispersed, travel agents provided many “points of presence” and the ability to target particular customer groups through differing agency clienteles. The use of these channels often coincided with special incentives paid to the channels, many of which financed *de facto* rebates resulting in differential pricing. Where airlines had concentrated customer bases that could be reached through advertising or were pursuing low-fare strategies that involved “demand-pull” instead of “supply-push”, the airline would often emphasize direct sales (Southwest has been a major user of this technique). Where the airline was emphasizing “walk-on” convenience, it often emphasized direct sales as well (Eastern’s Shuttle and PeopleExpress).

Deregulation hastened and intensified these efforts. Increased competition, both from other large airlines and from new entrants focused network airline effort on loyalty programs and customer relationship management. The most visible aspect of these efforts was the development of frequent flyer programs, but these programs became vehicles for special events, customer identification for airport services and other “bonding” efforts. Airlines have spent considerable sums of money to maintain direct contact with their customers, trying to create loyalty to the airline rather than to an intermediary that might then “sell” the customer to another airline.

All these strategies were limited by the fact that most customers did not satisfy their travel needs on only one airline and often wanted reassurance that they were not paying a penalty for loyalty. Any customer wanting to search more than one airline to meet her travel needs had either to make tedious multiple phone calls or use a travel intermediary that maintained a combined schedule and fare database (first the OAG, but in the modern era the CRS), and by the fact that tickets needed to be placed in hand and changed and redelivered if travel plans changed. Many customers preferred to deal with travel agent intermediaries, who could provide one-stop information on all airlines.

The last ten years has seen the emergence of a remarkable number of new variations on these historic themes. These variations have addressed successfully many of the customer drawbacks of dealing directly with airlines. This surge of commercial ingenuity has been driven by a variety of factors:

- 1) Regulation limited the number of airlines, the number of kinds of airlines and the commercial strategies (fares, commissions, rebates, services, relationships) that could be adopted. In effect, the government tried to make airlines as alike as possible. As airlines have moved farther and farther into the deregulated era, competition has forced them to find niches they could defend, including variations along virtually all the dimensions of marketing and distribution.

- 2) The requirement that customers hold physical tickets meant that methods needed to be found to deliver them to customers dispersed at many locations. While large airlines had more points of presence and could afford CTOs in many locations, ticket generation and delivery at point of sale was very expensive. Travel agents served this function, offering locational convenience to many more customers than could be offered even by a large airline with a network of CTOs. Customers attached such importance to this convenience that they would often arrange ticketing through a local travel agent even though they had contacted the airline directly to make reservations. Over time, airlines that wished to use direct distribution to maintain the customer relationship but were concerned about the cost of doing so developed more and more sophisticated methods of delivering tickets, including tickets by mail (TBM) and express delivery. Airlines smaller than the very largest were forced to do so, since their customer density didn't permit them to compete in the number of CTOs or ATOs.
- 3) As competition squeezed airline margins between reduced yields and increasing costs per ASM, airlines became increasingly conscious both of distribution costs and the risk of losing customers who were controlled by intermediaries. They began to look for alternatives to multicarrier distribution outlets and began to carefully assess the costs of indirect distribution through CRS and travel agencies compared to direct distribution. This further broke down to assessing commission costs for sales and search and ticket issue costs between methods that involved CRSs and those that did not.
- 4) Most important, the search for new ways of distribution was facilitated by an electronic revolution. The revolution was the emergence of electronic ticketing as the means to eliminate the necessity to physically deliver a ticket to the customer and the emergence of the Internet as the means to break of monopoly bottleneck on information regarding schedules, fares and seat availability.

Many customers might have found and continue to find a single quasi-independent (remembering override commissions) source convenient for travel information and documentation. But many others welcomed the chance to reduce principal-agent problems (the problem that the incentives of the agent might be different from those of the principal) by having direct search alternatives easily available to them. As evidence that this concern is real, customer research has established that many customers who buy tickets online search more than one site to make sure that they are fully informed about their alternatives.

Some customers used electronic versions of traditional travel agencies. These agencies typically used CRS as their combined information source and booking engine. Others used programs like Sidestep that allowed them to simultaneously search many airline websites. This method had the attraction to the airline of avoiding CRS fees and reducing the cost per booking to the airline, and the advantage to the customer of making it convenient to search multiple airline sources directly. Still others visited multiple airline websites directly, since these searches were much more informative and easier when made electronically than by making multiple phone inquiries.

Most important of all, electronic ticketing and the Internet allowed the airlines a practical way of achieving the long-sought strategic goal (for many) of establishing and maintaining direct contact with the customer, either as a primary objective or as a control on the power of intermediaries to influence customers and extract revenue from carriers to steer business to them (or not steer business away from them!) As long as the customer needed a ticket in hand, most airline direct alternatives were less convenient for the customer than the travel agent, particularly if tickets needed to be changed.* As long as the consumer couldn't easily see her alternatives, she was unwilling to trust her search to a one-brand dealer (the airline). But search engines and easy website alternatives changed that, allowing search and then contact. In fact, some airlines like American so valued the opportunity to make direct contact with customers that they actually made the

* This became particularly true for urban business travelers as costs forced airlines to close CTOs.

fares and schedules of competitors available on their own websites in order to reassure the customer that dealing with them directly would not disadvantage the traveler.

Airlines were prepared to invest both in website development and in creating customer incentives to deal with them directly. They also had a strong interest in the development of as many alternatives to the CRS monopolies as possible, so they encouraged and invested in the development of Orbitz. Still other distribution models, such as electronic consolidators and auction engines like Priceline, have been enabled by the electronic/cybernetic forces I have described and are used with varying degrees of intensity and success by different airlines.

A few airlines, like Easyjet and Ryanair in Europe, have attempted a direct-only strategy, largely web-based. Others, like Southwest and Jetblue, have attempted a strategy that makes some use of intermediaries, but strongly biases customers toward direct dealing. For most US airlines, especially larger ones who can spread development costs over many customers, website development has become the most attractive way to attract customers, maintain a relationship with them and lower booking costs in the bargain. These airlines have offered customers incentives to use their websites, but have tried to hedge their bets by preserving relationships with other distribution channels. Second-best has been to find intermediaries like Orbitz who promised not to interfere with the customer-airline relationship and offered lower booking costs as well. And third-best is to deal with intermediaries, electronic or physical, who had to be paid to influence customer choice. Unfortunately, paying intermediaries to move business to an airline is a two-edged sword, since the same intermediary that can move business to one airline can move it to another who offers the intermediary a better deal. In addition, the intermediaries used CRS's that charged relatively high booking fees.

On the other hand, using intermediaries as a primary distribution strategy may make perfect sense for airlines with little market presence and exotic destinations marketed as part of elaborate journeys. These airlines, often foreign carriers, have elected to maintain

emphasis on intermediaries who can call them to customers' attention and combine travel on them with other trip services.

In choosing these strategies, airlines have been faced with the question of how to influence consumer choice of which channel to use. Among the most obvious techniques chosen is to provide financial incentives to travelers, rather than to intermediaries, as a way to provide an impetus to use the more direct or lower-cost methods of distribution. Accordingly, airlines have offered website fares. They have also agreed to make the fares available to Orbitz in return for lower booking costs and a guarantee of neutrality. While they have sometimes made these fares or similar fares available to other intermediaries, they have been unwilling to guarantee to do so because to guarantee to do so is to give up any leverage to achieve customer neutrality and lower booking costs. Equally importantly, it means giving up an important incentive to maintain the direct relationship with the customer that many airlines desire.

Unsurprisingly, those intermediaries who have lost the level of control of the distribution process that was theirs "naturally" as a result of their control of information and the need to deliver paper tickets are unhappy at this development. They are "victims" of a changing world, much as are independent nonspecialist bookstores and midsize general retail merchants. They have chosen, as did mom and pop grocery stores in the 1930s and 1940s, to try to maintain their position in the market by preventing suppliers and consumers from taking advantage of the technology that threatens their existence. But this is ultimately inefficient and doomed to failure. Their challenge is to find ways to make what they offer so attractive to customers that airlines will want to use them voluntarily as a way of accessing their customer base. They can do this by making themselves more convenient to use than airlines, by providing knowledge and other travel services that airlines cannot do as well, by providing "back-office" services to corporate customers, by specializing in client bases or the travel products they offer, or by other differentiation strategies that customers will be willing to pay for or demand.

Some intermediaries have suggested that a place be maintained for them in the distribution system by requiring that airlines offer wholesale (“net”) fares that can be resold by anyone with a markup tacked on. While it makes perfectly good sense to encourage the use of net fares in some or all channels by those airlines whose business model is consistent with the strategy, there are many airlines that would prefer to be selective in their use or not to use them at all. It should be obvious from the foregoing discussion that I believe that forcing every airline to use net fares would interfere with the development of a variety of airline distribution strategies that benefit consumers. Should Southwest and JetBlue be required to pay intermediaries whose services they have designed out of their business model? Should they then be required to pay full booking fees to CRS’s to “level the playing field” with other airlines? Would consumers benefit from the fare increases necessary to compensate these carriers for the new layers of costs imposed on them?

But perhaps even worse than the direct costs imposed by this plan are its implications for implementation. An airline that did not wish to use the intermediaries who expect to be compensated by the markup could set the markup at an arbitrarily small amount – one dollar or one cent. To prevent it from doing so, the regulator would then have to specify the size of the markup, in the process required by the Constitution and the law to make findings to determine an appropriate amount or methodology. The airlines would then have to file tariffs to which the law would require them to adhere. For those looking for a backdoor way to reinstitute rate regulation, this might have some attraction, although surely it would be less arbitrary to institute ratemaking and required commissions directly. All others, including those whose memories extend back to the “old days” of regulation, with its high fares, enforcement proceedings and desperately cumbersome proceedings (e.g. the infamous DPFI) imposed to avoid arbitrariness and those who have benefited from the low fares and expansion of discount carriers brought about by deregulation, should run, not walk, in the opposite direction.

CURRICULUM VITAE

MICHAEL E. LEVINE

PERSONAL

Born April 8, 1941, New York City
Married Carol Stover Levine, 1967
Two children, Sara Rebecca (1973) and Anna Rachel (1976)

Address:
34 Pease Road
Woodbridge, CT 06525

Yale Law School
New Haven, CT 06511

EDUCATION

Law and Economics Fellow, University of Chicago Law School, 1967-68

Graduate Studies in Economics, Yale University, 1964-65

LL.B., 1965, Yale University

B.A. (Philosophy), 1962, Reed College, Portland, Oregon

EMPLOYMENT

Yale Law School, Professor (Adjunct) of Law, 2002-

Harvard Law School, Adjunct Professor of Law, 1999-2002

Chairman, Rohn Industries, Inc., 1999-

Northwest Airlines, Inc, 1992-99:

Executive Vice President, Marketing and International, 1994-1999; Executive Vice President, Marketing, 1992-94

School of Management, Yale University, 1987-92:

Dean, 1988-92. General George Rogers Clark Professor of Management Studies, 1987-90; William S. Beinecke Professor of Management Studies, 1990-92

University of Southern California Law Center, 1968-1987:

William T. Dalessi Professor of Law, 1985-87; Professor of Law, 1972-84; Associate Professor of Law, 1970-72; Assistant Professor of Law, 1968-70 (on leave, 1972-73, 1977-79, 1981-84)

California Institute of Technology, 1973-83:

Henry R. Luce Professor of Law and Social Change in the Technological Society (joint appointment with USC, on leave 1977-79, 1981-83)

New York Air, President and Chief Executive Officer, 1982-1984

Continental Airlines, Executive Vice President, Marketing, 1981-82

U.S. Civil Aeronautics Board , 1978-79:

General Director, International and Domestic Aviation, 1979; Director, Bureau of Pricing and Domestic Aviation, 1978

Academic Visitor, Department of Economics, London School of Economics and Political Science, 1977

Law and Economics Fellow, University of Chicago Law School, 1967-68

Special Assistant, Task Force on Economic Growth and Opportunity, Chamber of Commerce of the United States, 1966-67

Attorney, U.S. Civil Aeronautics Board, 1965-66

Management Intern (Defense and Foreign Affairs Organization), Executive Office of the President, Bureau of Budget, 1964

OTHER ACADEMIC POSITIONS

Visiting Lecturer, Institute of Air and Space Law, McGill University, 1978

Visiting Scholar, Institute for Advanced Legal Studies, London, 1977

Referee for Journal of Law and Economics, Rand Journal of Economics, Journal of Law, Economics and Organization, Harvard University Press, others.

AWARDS

Transportation Research Forum Distinguished Transportation Researcher Award, 2000

Civil Aeronautics Board Award for Excellence and Distinguished Public Service, 1979

PUBLIC CONSULTANTSHIPS (selected):

U.S. Department of Justice, 2001

OECD, 1991-92

U.S. Department of State, 1989-91

Corporation and Consumer Affairs Canada, 1988-89

National Council on Public Works Improvement, 1987-88

Port Authority of New York and New Jersey, 1984-85

U.S. Civil Aeronautics Board, 1977, 1980

U.S. Interstate Commerce Commission, 1980

California Air Resources Board, 1976

National Science Foundation, 1975-77

State of California, Energy Resources Conservation and Development Commission, 1976

Subcommittee on Administrative Practice and Procedure, United States Senate, 1974-75

Commonwealth of Puerto Rico, 1974

MEMBERSHIPS AND POSITIONS OF TRUST

Fellow, National Academy of Public Administration, 1997-

Trustee, UNR Asbestos Victims Trust, 1989-

Board of Trustees, Reed College, 1984-

Board of Directors, Institut du Transport Aerien, Paris, 1984-

Member, National Academy of Sciences Committee on Airline Service and Safety Since Deregulation, 1989-91

Member, U.S. Aviation Safety Commission, 1987-88

Board of Trustees, Wenner-Gren Foundation for Anthropological Research, 1983-89

Executive Council, Section on Antitrust and Economic Regulation, Association of American Law Schools, 1974-78, 1987-91

Advisory Panel, Airport and Air Traffic Control System, Office of Technology Assessment, 1980-81

Editorial Advisory Panel, Environmental Law Reporter, 1971-77

Board of Trustees, Center for Law in the Public Interest, Los Angeles, California 1971-76

PUBLICATIONS IN SCHOLARLY JOURNALS AND BOOKS

"Price Discrimination without Market Power", Yale Journal on Regulation , Winter 2002

"Law and..." in Theory and Practice: The USC Style and Its Influence", Southern California Law Review, November , 2000

"Regulatory Capture", in New Palgrave Dictionary of Law and Economics (1998).

"Scope and Limits of Multilateral Approaches to International Air Transport", in International Air Transport: The Challenges Ahead (OECD, Paris, 1993).

"Comment" on J. Macey, "Organizational Design and the Political Control of Administrative Agencies," Journal of Law, Economics and Organization, March, 1992.

"Airline Deregulation: A Perspective," Antitrust Law Journal, Vol. 60, Issue 2, 1991.

Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis" (with Jennifer L. Forrence), Journal of Law, Economics and Organization, Fall, 1990.

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"Airline Competition in Deregulated Markets: Theory, Firm Strategy and Public Policy," Yale Journal on Regulation, May, 1987, reprinted in Mohring, ed. The Economics of Transportation (1993).

Le Fonctionnement du Marche des Transports Aeriens aux Etats-Unis apres las Dereglementation: Bilan de Huit Ans d'Experience ["The Behavior of Deregulated Airline Markets in the United States: Evidence from Eight Years' Experience"], translated into French by A. Pappalardo, in Revue International de Droit Economique, University of Louvain, March, 1987.

"Regulating the Automobile Industry: Problems and Pseudo-problems," in L. Graymer and F. Thompson, ed. Reforming Social Regulation (1982).

"Pricing in International Aviation: Review and Prospects," in H.A. Wassenbergh and H. van Fenema, ed. International Air Transport in the Eighties (1981).

"Revisionism Revised? Airline Deregulation and the Public Interest," Law and Contemporary Problems, January, 1981.

Discussion of J.C. Panzar, "Regulation, Deregulation, and Economic Efficiency: The Case of the CAB," American Economic Review (Papers and Proceedings), May, 1980.

"Communication and Agenda Influence: The Chocolate Pizza Design," (with Linda R. Cohen and Charles R. Plott): in H. Sauerman, ed., Contributions to Experimental Economics, Vol. 7. (Tubingen: Mohr, 1978).

"A Model of Agenda Influence on Committee Decisions," (with Charles R. Plott), American Economic Review, March, 1978.

"Agenda Influence and its Implications," (with Charles R. Plott), Virginia Law Review, May, 1977; reprinted in D. R. Kinder and T.R. Palfrey, Experimental Foundations of Political Science, 1993.

"Financial Implications of Regulatory Change in the Airline Industry," Southern California Law Review, May, 1976. Earlier version entitled "What are the Financial Implications of Regulatory Change?" appears in Regulatory Reform and the Federal Aviation Act of 1975 (DOT-TST-76-59).

"Alternatives to Regulation: Competition in Air Transportation and Aviation Act of 1975," Journal of Air Law and Commerce, Autumn, 1975.

"Regulating Airmail Transportation," Journal of Law and Economics, October, 1975.

Review of Airport Economic Planning, George P. Howard, ed., Journal of Business, Vol. 48, No 2, April, 1975.

"Toward Descriptive Grading," Southern California Law Review, Spring, 1971.

"Landing Fees and the Airport Congestion Problem," Journal of Law and Economics, April 1969; reprinted in Silk, ed. Readings in Contemporary Economics (1970).

"Is Regulation Necessary? California Air Transportation and National Regulatory Policy," Yale Law Journal, July, 1965; reprinted in L.M. Friedman and S. Macaulay, Law and the Behavioral Sciences (1969).

GOVERNMENT REPORT

Local Air Service Policy, Civil Aeronautics Board, 1966.