Chapter 1

THE DEVELOPMENT OF THE DISTRIBUTION SYSTEM

U.S. airlines have sold tickets through third-parties almost from the beginning of commercial service in the 1930s. At first, the relationship with third-parties was unofficial. Frequently these representatives were not even professional advisers, but bellhops, taxi drivers, or terminal employees.[1] Often they represented individual airlines rather than the entire industry. Airlines found this system unsatisfactory. Consumers were not able to gain reliable information about the services of the still-nascent industry and airlines did not have reliable information about reservations for their services.

So in 1940 the Air Traffic Conference (ATC), a division of the airlines' trade group, the Air Transport Association, created a new travel agent accreditation program. Through a series of agreements, the airlines jointly determined not only the necessary qualifications for travel agents, who would now represent all airlines, but also important details of how they would operate, including the amount the airlines paid for their services. Pursuant to the Civil Aeronautics Act, these agreements were approved by the Civil Aeronautics Board (CAB) and granted immunity from the antitrust laws.

Because of World War II, the ATC did not fully implement the program – many aircraft had been turned over to the war effort and commercial traffic was very limited. After the war, airlines were more interested in signing up agents, especially to help them attract travelers away from the then-dominant railroads and steamship lines, and implemented the agency program. Airlines paid agents a commission for their services, based on a percentage of the ticket price.

For many years, airlines limited the number of accredited agents according to a so-called "need" clause. Airlines added agents only if, in their view, there were not enough to meet demand in a particular area. The limitation was part of the airlines' attempt to restrict agents from certain categories of traffic. They viewed agents as promoters of air travel and saw their role as generating new traffic from passengers who would otherwise not fly.[2] Through various restrictions in the agency agreements, airlines attempted to retain for themselves the non-discretionary sales; i.e., passengers who would otherwise have flown and merely needed ticketing services. But as agents became more prevalent, they not only promoted new discretionary air travel, but increasingly served existing travelers who sought their services. In 1959, the Civil Aeronautics Board banned the "need" clause, granting unfettered entry into the travel agency industry.[3]

The introduction of efficient jet aircraft in the late 1950s meant airlines were charging lower fares, which made flying more affordable. Unsurprisingly, passenger demand boomed, and airlines and the traveling public increasingly turned to agents to advise travelers and write tickets. Relying on a pool of common agents to provide information and dispense tickets was more efficient for airlines than setting up parallel and competitive distribution channels.

This was especially true in light of pervasive CAB regulation, under which the agency limited route competition among carriers. A significant amount of air service was provided jointly, with passengers changing not only airplanes but airlines on the way to their ultimate destination. As a result of the limits on route flexibility, plus the near total ban on price competition, a jointly operated distribution system made even more sense. Travel agents had become an important cog in the airline ticket distribution system.

Despite the ban on the “need” clause, the CAB continued to permit airlines to regulate agents extensively, in almost all facets of their business. The agreements covered many areas of agency operation, including location, qualification of staff, bonding, and financial responsibility. They not only provided some assurance that customers were receiving accurate information, but also that airline reservations were made and tickets were issued correctly.

Agents also controlled blank ticket stock and validation plates, valuable commodities that require special monitoring and storage. Anyone able to acquire them could write tickets that airlines had to accept for travel. And, because passengers needed that paper ticket in order to travel, the agent became an important vehicle by which airlines delivered tickets to their passengers.[4]

The most important agreement set commission rates to be paid to agents. By the late 1970s, airlines were paying agents base commissions of seven percent, and higher rates for air travel sold as part of tour packages.[5]

A. Deregulation and the Travel Agent Industry

For several decades, travel agents experienced substantial growth under the ATC agency system. Starting from a total of less than 600 recognized agents in 1941, total locations reached 6,021 by 1968. By 1977, the year before airline deregulation, the figure had more than doubled, to 13,454, the result of an average annual growth of 10 percent during the 1970s.[6] But the biggest boom was yet to come, owing to passage of the 1978 Airline Deregulation Act and the introduction of computer reservation systems ("CRS"). Deregulation gave travelers a vastly wider range of flight and fare options, and CRSs became the tool that travel agents used to deal with this increased array of travel choices.

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Under regulation, the CAB determined not only the carriers that could offer interstate air service but also the routes each carrier could serve and the fares they could charge. Therefore, carriers had only a limited ability to establish prices on a route. As a result, passenger fare and flight choices were limited. Even connecting passengers had only a few options and, in any case, under regulation, connecting passengers paid the same fare, regardless of routing or carrier.

With deregulation of pricing and entry, the situation changed radically. Airlines were free to enter and exit domestic routes and to establish their own prices. In order to operate efficiently and gain traffic, airlines restructured linear route systems created under regulation, and began to organize their route systems around hubs. These new networks increased the number of city-pairs served and reduced the time consumers spent in the airport transferring from one flight to another. At the same time, new and formerly intrastate carriers, often with substantially lower costs and lower fares than the once-regulated incumbents, began to compete in many markets throughout the country.

However, more choice brought more confusion in deciphering the available options and choosing which option to select. Accordingly, travelers began to look more to travel agents to explain the options and find pricing value.[7] Airlines anxious to take advantage of their new freedom started so many new routes that they had to rely on agents, who had immediate information available in their CRSs, to inform travelers about the rapid changes to their networks. In fact, the well-established travel agent industry now made it easier for airlines to reshape their networks.

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The impact of deregulation on travel agent sales was quickly apparent. Travel agents accounted for 38.4 percent of total domestic sales in 1977 but by 1979, the first full year after the Deregulation Act, their share had grown to 53 percent.[8] Thus, travel agents not only benefited from the increase in air travel that accompanied the end of government regulation but also from an increase in their share of the business.[9]

The law itself did not deal with travel agency commissions. However, the CAB was required to review immunized airline agreements and determine whether antitrust immunity for them continued to be in the public interest. The agreements establishing commission rates were among the first to be reexamined. The Board removed immunity from the agreement setting international commission rates in 1978 and deregulated domestic commissions in 1980.[10] Soon thereafter, commissions paid to travel agents began increasing, which might have been expected since commissions may have been held below market levels by the airline agreements. The higher payments included both base commission rates and the newly introduced override commissions, in which the agency's compensation depended on its ability to increase an airline's share of its bookings.

Base commissions increased, as airlines matched one another in order to avoid agents shifting traffic to other carriers. As a result, average commission rates on tickets processed through the industry settlement plan went from 8.3 percent in 1978 to 9.6 percent in 1981.[11] Override commissions were paid outside the settlement plan, so actual commission rates for some agencies were even higher. In fact, average commissions grew almost continuously after deregulation and reached a post-deregulation peak of 11.80 percent in 1994.[12]

B. Computer Reservation Systems

In addition to mounting commission costs, airlines were paying more for the computerized reservation systems (CRS) used by travel agents to handle the booking transaction. Carriers pay for these systems in the form of booking fees, which currently can amount to approximately $11.00 for an average passenger ticket.[13] These fees are in addition to commission expense, and have been controversial for almost 20 years.

When they were introduced in 1976, the airline-owned computer reservation systems included not only their own flight and fare information but that of other carriers, too. Before airline deregulation, passengers often used more than one airline for a single trip. The system of exchanging passengers, called interlining, meant carriers had to store rivals' flight and fare data because each airline acted as agent for other carriers in selling their flights. The availability of data on other airlines enabled CRS vendors to offer comprehensive information on the entire industry, and also gave other airlines free access to the efficiencies of dealing with agents through the CRS, rather than over the telephone.[14]

During the early 1980s, as airlines and vendors encouraged agencies to install new systems, the cost of providing CRS service far exceeded the revenue generated from the systems.[15] In order to offset these costs and to gain assistance in marketing systems in cities where the vendor carrier provided little service, vendors created "cohost" programs.[16] Cohosts received preference in schedule displays and helped to market the systems in their territories. While early airline cohosts paid $0.25 per booking, many carriers continued to pay nothing.[17] The airline owners did not pay fees, but absorbed the losses incurred in offering the systems. They also achieved incremental airline revenues because of schedule display bias and the relationship established with the agent. As CRSs became ubiquitous, and more valuable in distributing information on schedules and fares, vendors increased fees for later cohosts. They also refused to provide service to post-deregulation new entrants until they agreed to pay much higher booking fees than cohosts were paying.

These and other tactics spurred vigorous complaints about anticompetitive behavior. In response, and as one of its last official acts, in 1984 the CAB imposed regulations on the airlines and the CRSs they owned. Two central elements of the regulations were the requirements that all airline-owned CRSs offer unbiased displays and charge non-discriminatory booking fees.

In response to the new rules, vendors established per-segment booking fees of $1.75 or more for all airlines.[18] These new booking fees represented a dramatic increase for many carriers that had been paying little or nothing. Non-CRS-owning airlines regarded the payments as not only an increase in distribution cost but also a subsidy to rivals.

Since the original charges were set, fees have increased to approximately $4.25 per segment.[19] That means an average of almost $11 for an average passenger ticket.[20] Airlines testified that the booking fees have increased by 7 percent per year, when information technology was driving costs down in other businesses.[21] Vendors respond that fees are higher because their systems have many more sophisticated functions, and computer programming costs have risen substantially. But airlines remain unpersuaded.[22]

Indeed, carriers believe that they are the unwilling participants in a transfer of income to the distribution system in the form of both commissions and booking fees, particularly because vendors transfer a portion of the booking fees they receive from airlines to travel agents in the form of "marketing incentives."[23] Because the competition among CRSs for placement of their systems in agencies is so intense, the systems actually pay travel agents that can produce substantial booking fee revenue to use their systems. In some cases, this rebate can be $1.00 - $1.50 of the $4.25 paid by the airline. Galileo testified that more than half of its expenses are "commission costs," which include incentive payments to agents.[24]

These increased booking fees have had direct and important consequences for travel agents. As each additional CRS booking adds little to the vendor's operating cost, signing up an additional travel agent subscriber is quite profitable. The $4.25 segment fee, even after the travel agent rebate, far outweighs any added cost. Thus, developments in the CRS industry did more than increase travel agent productivity. For many agents they also generated an added source of revenue, as rival CRS vendors offered them attractive financial inducements to use their systems. Agents do undertake obligations in connection with these financial packages. The contract terms offered by the CRS vendors are weighted heavily in favor of the vendor, and often have the effect of locking the agency into a relationship that can become unfavorable but inescapable. Typical CRS contracts impose a financial penalty on the agency when its CRS bookings fall below a specified threshold. An agency attempting to reduce its reliance on air sales faces a similar problem.

C. The Impact on Travel Agents

Three factors fueled travel agent revenues: (1) increased air travel, (2) increased share of tickets written, and (3) higher commission rates. Although there is no consistent data on travel agent profitability, it can be safely assumed that it increased substantially after deregulation. Indeed, because there were no impediments to establishing new agencies or expanding existing ones, the number of travel agent locations increased considerably.

Year	Number of Agency Locations
1980	17,339
1985	27,193
1990	32,077
1995	33,593

Source: ARC[25]

Agency growth flattened out in the early 1990s as the airline industry suffered financial hardship. But agencies resumed their growth after the 1990-92 recession. By 1996, the number of retail agent locations reached its peak of 33,715.[26]

In a deregulated environment, agency services were useful to both business and leisure travelers. As the needs of the two segments diverged, agencies began specializing in one segment or the other. Throughout the 1980s, agents increased their penetration of the corporate travel market. Corporations used their services not only to handle the booking transaction but also to obtain special fares from carriers and provide reports on employee travel that enabled companies to monitor travel expense.[27] The increasing complexity of fares, and the constant changes of routes and carriers, enhanced the value of agents to both the corporate and leisure markets.[28]

The combination of higher commissions and deeper penetration resulted in a substantial increase in the proportion of airline revenue that went to travel agents.

COMMISSIONS AS A PERCENTAGE OF PASSENGER REVENUE[29]

Year	Percent of Revenues
1979	5.0%
1984	7.8
1989	9.5
1994	9.3

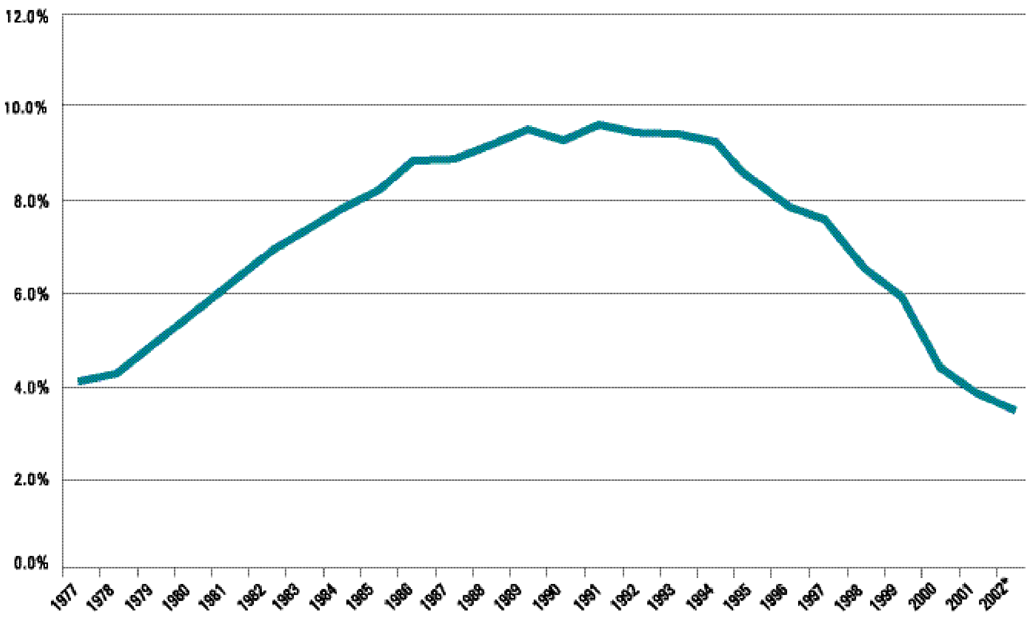
Source: DOT Domestic Form 41 – Major airlines

THE INCREASING COMPLEXITY OF FARES, AND THE CONSTANT CHANGES OF ROUTES AND CARRIERS, MADE AGENTS MORE VALUABLE IN BOTH THE CORPORATE AND LEISURE MARKETS.

By the mid-1990s, the major airlines began to experience new economic pressures. Major carriers suffered from a combination of higher costs and lower yields, the result of increased competition from one another and from low-cost airlines. They were competing with carriers that had much lower costs and could operate profitably at lower prices. They incurred substantial distribution costs that the low-cost carriers avoided.[30] They felt captive to high booking fees and commission expenses, as well as travel agents' control of 85 percent of industry revenue.[31] With the development of technology, they sought new ways to solve these problems.

Their solutions – commission cuts, direct sales over the Internet, electronic ticketing, disinvestment in some CRSs, and other actions to reduce the influence of traditional travel agencies – transferred much of the problem of distribution costs from the airline to the agency. Now the travel agents are suffering.

U.S. Major Airlines Domestic Service Travel Agent Commission Payments as a Percentage of Passenger Revenues (1977 - 2002*)



* Year 2002 includes only one quarter of data.
Source: DOT Form 41