Chapter 2

THE TRAVEL AGENCY SYSTEM TODAY

Congress directed the Commission to assess whether the financial condition of travel agents is declining. There is no doubt that the answer is yes. Indeed, the agencies' financial condition has deteriorated to such an extent that some agencies are consolidating, and others are being forced out of business altogether. By June 2002, there were 31 percent fewer agencies and 21 percent fewer agency locations than there had been in 1994, the year before the first commission reductions.[1]

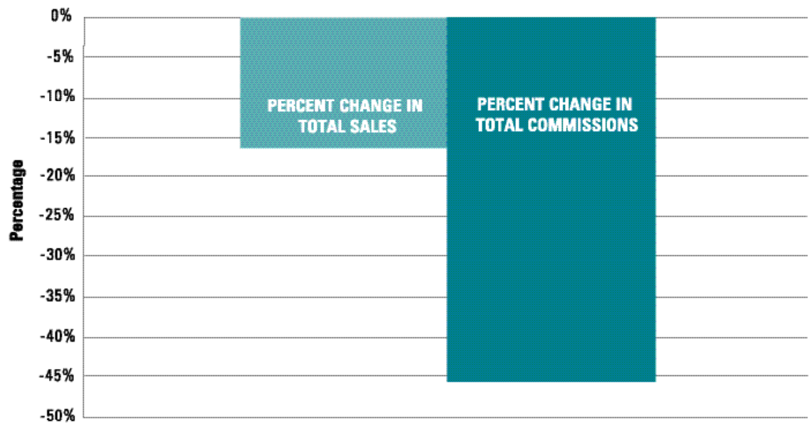
BY JUNE 2002, THERE WERE 31% FEWER AGENCIES AND 21% FEWER AGENCY LOCATIONS THAN THERE WERE IN 1994, THE YEAR BEFORE THE FIRST COMMISSION REDUCTIONS.

Since there is a lack of good industry data on actual profitability of agencies, the Commission has had to infer a decline in agent profits from the decrease in the number of agencies. If agents had continued to be as profitable as they were in the mid-1990s, there would be no reason to expect the precipitous decline in the number of industry participants. The accelerated decline during 2001-2002, when economic conditions have been particularly bad and domestic base commissions have been eliminated entirely, leads to an inescapable conclusion: the travel agency industry is in distress.

The number of agencies peaked in 1994, at 23,937. In 1995, airlines implemented the first in a series of commission reductions. Thereafter, the industry experienced a gradual decline through 2000. By year-end 2001, an accelerated decline reduced the number of agencies to 18,425.[2]

The agents' share of sales eventually declined, too, but the reduction occurred later and at a different rate. Total sales kept growing during the late 1990s, to a peak of $83.5 billion in 2000. But 12 months later, by year end 2001, total agency sales had plummeted more than 16 percent to $69.9 billion.[3] By year end 2001, base commissions per agency location were sinking to 1988 levels.[4] The downward trend in both agencies and sales continued into 2002. In the first six months, the number of agencies had dropped 10.6 percent to 16,470. Airline sales through ARC were 17.0 percent lower in the first eight months of 2002 compared with the same 2001 period and domestic airline sales decreased even more, by 23 percent.

Decline in Agent Sales and Commissions Between Second Quarter 2001 and 2002



Note: Data includes online agencies

Source: Airlines Reporting Corporation

During that same period, there were 1,988 voluntary deletions, or closings of agency offices, up 32 percent from the same period in 2001.[5]

Several factors contributed to this decline in the financial fortunes of the agents:

- Airlines have cut commissions
- The Internet has impacted how people purchase travel
- The economy has had an adverse impact on travel agencies
- Airlines are attempting to bypass travel agents

A. Airlines Have Cut Commissions

By the early 1990s, travel agent base commission levels had settled at 10 percent of the ticket value, more than 40 percent higher than they had been prior to deregulation of commissions.[6] Agents deduct these commissions before remitting ticket revenue to the ARC Area Settlement Plan. At the same time, airlines paid separate, override commissions to agencies that met carrier-established targets for market share or growth. However, it must be remembered that many smaller agencies did not receive overrides. These incentives were reserved for the larger agents that airlines hoped could increase their share of traffic in a particular market.[7]

In February, 1995, the airlines began to implement what became a series of commission reductions that continued into 2002. The first action capped domestic base payments at $50. The $50 cap meant that agents would continue to earn the standard commission, but only for tickets with a value up to $500. Tickets with higher values produced the same $50 commission, sharply reducing the agent's income from such sales.[8]

Most agents were unprepared for the alteration to a pay structure unchanged for 15 years. Our hearings demonstrated that agents were continually frustrated as airlines made major changes to their businesses with no advance notice.[9] However, agents did not respond in the marketplace to alter airline actions. Delta was the first carrier to announce the new commission level, but did not suffer any loss of travel agent business. TWA initially followed Delta, but then restored its original commission levels after settling an antitrust case;[10] sales did not increase, and several months later, TWA resumed the commission cap.

The agents' failure to make a significant impact on market share, coupled with cost pressures on the airlines, provided the incentive for carriers to continue cutting commissions. An unrelenting series of reductions followed:

September, 1997	—	Domestic base commissions cut from 10% to 8%
November, 1998	—	International commissions capped at $100
October, 1999	—	Domestic base commissions cut to 5%
August, 2001	—	Domestic cap reduced from $50 to $20 roundtrip
March, 2002	—	Domestic commissions cut to zero[11]

Throughout the process, airlines continued to pay incentive commissions to high-volume leisure and corporate agents. In fact, the Commission understands that overrides have increased since base commissions were cut to zero. Unfortunately, unless they are members of travel agency consortia, smaller agencies are less likely to receive override commissions.[12]

To offset the loss of commissions, agents had to develop new sources of income. The most readily available was service, or transaction, fees. Agents also turned to sales of other, non-airline products to supplement income.[13] That strategy required more development time, however, and fees remained the primary tool. According to ASTA, fewer than 2.8

percent of agents were charging such fees before 1995.[14] By 2002, it was projected that 95 percent of agencies would be imposing service fees on some or most airline transactions.[15]

Witnesses told the Commission that, for leisure agents, any fee increases are too small to compensate for the loss of base commissions. Smaller agents are reluctant to test the waters and risk losing clients by boosting charges. If that reluctance continues, more agents will fail to cover their costs and will be forced out of industry. A consultant to the Commission found relatively little demand elasticity for service fees up to $25, but feared that fees of $40 for leisure travel tickets would meet substantial resistance.[16]

Service fees also put agents at a disadvantage. When airlines sell directly to passengers, whether offline or online, they do not add a separate fee to cover their own distribution costs, as many agents feel they should.[17] Therefore, an airline-direct fare for the same seat for the same journey is lower than a comparable ticket offered by an agent charging a fee. That provides an incentive for the customer to deal directly with the airline, and reduces the agents' share of the distribution pie.

To remedy this, some agents want air fares to be offered on a net, or "wholesale," basis irrespective of the distribution channel.[18] Then each channel could add a fee to cover its services. Some agents suggested that airlines be required to list fares with two numbers: net fare and distribution fee. Agents believe displaying this information would make them more competitive. However, several witnesses said that requiring airlines to do this would be an unwanted step back toward fare regulation.

B. The Internet Has Impacted How People Purchase Travel

The Internet has brought fundamental change to the economy and to how commerce is conducted. Many businesses use the Internet as a way to bypass product and service intermediaries to deal directly with consumers. The airline industry is no exception. In fact, it is a leader in the degree to which it is aggressively using e-commerce.

Airlines had offered information on their own web sites in 1995, and a year later began offering passengers online booking. At first, their booking site development was slower than that of the leading online travel agents, Expedia and Travelocity.

Individual airlines recognized that they could reduce distribution costs by combining their already well-established national networks and brand awareness with direct Internet sales. Travelers responded, knowing they could obtain direct access to information and handle their own bookings.[19]

To encourage people to book online, airlines offered numerous incentives. They attracted customers to their sites with exclusive web fares, undercutting the prices offered via CRSs and travel agents.[20] They offered mileage bonuses to already-existing frequent fliers, and signing bonuses for travelers joining their loyalty programs. They sent their frequent fliers weekly e-mails, offering special fares not available through travel agencies.[21] They broadened the range of online services and information, and made their sites more user-friendly by reducing the number of keystrokes necessary to search and book.

CARRIERS ARE NOW OBTAINING A SUBSTANTIAL PART OF THEIR REVENUE FROM INTERNET SALES, EITHER FROM THEIR WEBSITES, OR THOSE OF ONLINE TRAVEL AGENCIES.

As a result, online bookings increased. So did the depth of data airlines were able to collect about customers. Such information gives the collector an invaluable marketing advantage in boosting direct relationships with consumers. Airlines wanted to recapture that advantage from agents who, using their CRSs, were the primary data collectors.[22] The low cost of Internet marketing also enabled airlines to contact consumers more frequently and less expensively than through the mail.[23]

Now, all major carriers have powerful web sites where passengers can make reservations, review their frequent flyer accounts and confirm the on-time status of flights. These sites have become the airlines' most effective tool to encourage direct dealings with their customers.

Carriers are now obtaining a substantial part of their revenue from Internet sales, either from their web sites or those of online travel agencies. For example, Delta testified that it sold $1.1 billion worth of tickets on its own web site in 2001, a 45 percent increase over the prior year. Delta.com sales in 2002 are 30 percent higher than in 2001, amounting to 12 percent of all Delta tickets.[24] Sabre testified that approximately 15 percent of all airline tickets are sold through the Internet.[25] Of these, 57 percent are sold directly by airline web sites, and 43 percent through online agencies.[26]

The low-cost carriers, with whom the majors must compete, are leading the parade to the Internet and will continue to do so. While Southwest's web site produces 46 percent of passenger revenue, travel agents account for only 20 percent.[27] AirTran's online revenue is estimated to be half its total. Two-year-old JetBlue, which painted its web site address on the fuselage of its aircraft fleet, reports that during the first half of the year, its web site generated 63 percent of total revenues, traditional agents ten percent.

In parallel with airline web site development, online travel agencies — including Sabre's Travelocity, Microsoft's Expedia (now owned by USA Networks) and smaller firms — were investing large sums to create their Internet presence. In their early years, the two big online agencies catered almost exclusively to leisure travelers. Their high-profile, expensive marketing campaigns, combined with airline efforts, pushed the idea that the lowest air fares available were on the Internet—and only on the Internet.

One essential element in the development of the Internet as a medium for the sale of air transportation was the advent in 1995 of electronic ticketing. Passengers could now board the airplane without obtaining a paper ticket. Without this innovation, the Internet transaction would be much more cumbersome: tickets would have to be mailed to consumers, or issued to them at airports. Passengers would have had to book flights far enough ahead to have paper tickets delivered, or arrive at the airport earlier in order to process the paper transaction. The growth of Internet ticket sales would have been far less rapid and saved the consumer less money.

Since 1995, a number of online booking and fare search sites have appeared. Almost unlimited information on any possible destination has sparked even more interest in travel. As a result, travel is the most successful commercial sector on the Internet. Two-thirds of all adults have access to the Internet; 66 percent use it to get travel information, and 42 percent actually buy or make a reservation for travel.[28]

As the Internet's "easier-cheaper" reputation grows, distribution channel shares are changing markedly. One of the Commission's consultants calculated that airline sales of leisure and unmanaged[29] travel sales amounted to 56.3 percent of total sales in 2001 and, based on trends, estimated the changes in channel shares by 2004.[30] By that time, over half of all such air sales will be online.[31]

Leisure and Unmanaged Air Sales

	2001	2004
Travel Agents		
Traditional	49.6%	32.1%
Online	12.8	21.5
Airlines		
Web site	18.0	34.7
Call Center	19.6	11.7

Note: Online travel agency sales includes online sales by traditional travel agencies. While this figure was minimal in 2001, it could be up to 5% of online travel agency sales in 2004.
Airline web site sales also include sales made by travel agencies on airline web sites.

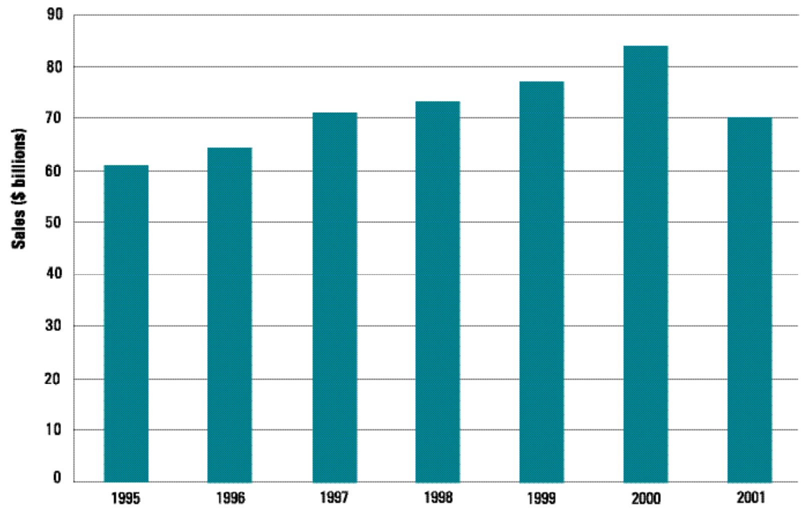
Source: PhoCusWright Inc.

These figures point to three conclusions: the Internet increasingly will become the distribution channel of choice for airlines, whether through their own sites or online agents; airlines prefer and are pushing sales on their own sites, and traditional agents will lose sales — not only to airline sites but also to online agencies.

C. The Economy Has Had an Adverse Impact on Travel Agencies

Another factor adversely affecting travel agents has been the poor economy of the last two years. During the 1990s, even as carriers cut commissions, travel agent sales continued to grow with the buoyant economy, and reached a peak of $83.5 billion in 2000.

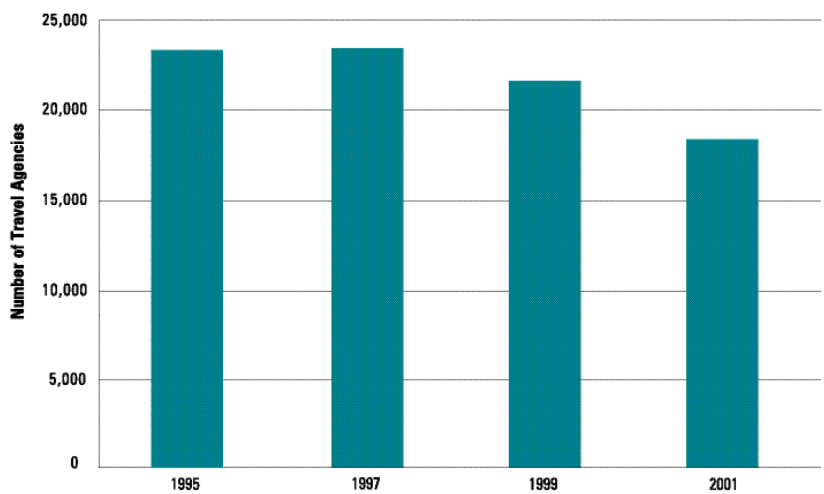
Annual Travel Agent Sales of Air Transportation (1995 - 2001)



Source: Airlines Reporting Corporation

But because of commission cuts, agents' total commission pay peaked earlier, at $6.64 billion, in 1997.[32] The number of agencies declined gradually from 1995, the date of the first commission cuts, to 1998, but then moved steadily downward.

Number of Travel Agencies (1995 - 2001)



Source: Airlines Reporting Corporation

Complete details on the travel agent industry since 1995, including breakdowns of travel agent sales by small agencies, are included in Appendix G.

By 2001, the recession was in full swing. Travel decreased and passengers became increasingly price-sensitive. The September 11th terrorist attacks were particularly devastating to air travel, making an already weak travel market worse. In the immediate aftermath of 9/11, concern over the safety of travel was a major factor. That eased eventually, only to be replaced by concern over the increased inconvenience of travel caused by new security measures. Short-haul trips, which involved a greater percentage of time spent going to and from and waiting at the airport, were the most affected. As a result, agency sales plummeted dramatically.

	2000	**2001**	
	(in billions)		Decrease
Total Air Sales	$83.5	69.9	16%
Agency Commissions	4.8	3.6	25%

Source: ARC

Airline traffic declined for the first several months of 2002, as did average fares. For the first eight months of the year, domestic fares decreased 11.6 percent, and international fares 4.8 percent, compared with the same period in 2001. Passenger enplanements for the same 2002 period were 11.1 percent below the comparable period of 2001.[33] Unavoidably, such substantial reductions have had an adverse impact on travel agents.[34] The number of ARC agencies declined from 18,425 in 2001 to 16,470 in the first half of 2002.[35] There is reason to believe — in light of all the factors discussed in this report, and regardless of the future performance of the economy — that the number of travel agencies will continue to decline.

D. Airlines Are Attempting To Bypass Travel Agents

Travel agents have also been confronted by a strategy of many major airlines of diverting business away from agents and dealing directly with the passenger. The industry calls this disintermediation, but we find "bypass" a simpler term. The benefits to airlines of bypassing agents are twofold – reduced distribution costs and increased control over passengers.

While the airlines publicly acknowledge only one reason for bypass — cost reduction — the control issue is equally, if not more, important. For generations, airlines have tried to encourage the sort of passenger loyalty that would inhibit their customers from using an alternative carrier. Airline clubs and frequent flyer programs were some of the mechanisms developed to meet this goal. But travel agents have always been impediments to such relationships because they could offer the passenger independent advice about schedules and fares, undermining an airline's ability to bind consumers to a particular carrier.

THE INTERNET BECAME THE AIRLINES' VEHICLE FOR BREAKING THE AGENTS' HEGEMONY OVER THE DISTRIBUTION OF INFORMATION AND SALES OF AIR TRAVEL.

The Internet became the airlines' vehicle for breaking the agents' hegemony over the distribution of information and sales of air travel. If carriers could attract passengers to web sites they controlled, they would achieve their long-term goal of dealing directly with consumers and deterring them from comparison shopping.

The Commission does not suggest that there is anything unfair or anticompetitive about the bypass strategy. So long as it is not adopted in collusion with other carriers, and is not an abuse of market power,[36] direct dealing with the consumer is a normal marketing strategy utilized in any number of industries. Therefore, the Commission believes no effective regulatory actions can or should be taken against such normal competitive policies.

The airline bypass strategy has had two major elements – development of each carrier's own web site, and creation of a jointly owned online agency that would compete with Expedia and Travelocity, the two largest on-line agencies.

Airline web sites – As noted above, airlines lagged behind the major online agencies in building their online presence, though now they actually sell more online travel through their own sites than through online agents. Sale of travel over their web sites has not only reduced CRS booking fee and commission costs; it has also attracted passengers who previously might have used travel agents. The discovery of the sometimes sizable differences between promotional web site fares and fares offered through travel agents has attracted many people who at least shop, if not always book online. Agent witnesses complained that these differences often amount to hundreds of dollars, and that passengers who find such differences are lost to the agency for future purchases.[37]

Agents testified that these differences in fares, plus the fees they are charging to compensate for lost commissions, put them at a competitive disadvantage. They also recognize the right of airlines to deal directly with consumers, and have not proposed any regulatory intervention to restrict such sales.

Orbitz – Orbitz is an online agency owned by the five largest U.S. carriers: American, Continental, Delta, Northwest and United. Orbitz has another 37 airline partners who do not hold equity, but who have signed the same marketing agreements as the owners. Together, the 42 airlines are called charter associates. The company began taking reservations in June 2001 amid a cloud of controversy that continues to this day.[38]

The Orbitz contracts include two controversial clauses that agents claim prevent them from gaining access to airline web fares. The so-called most-favored-nation (MFN) clause requires charter associates to provide Orbitz with any fares posted on their own or third-party web sites.[39] The second clause requires participants to provide Orbitz with marketing support, including advertising and publicity, in relation to their sales on the site. This support may take the form of exclusive web fares.[40] The clauses do not specifically preclude carriers from giving web fares to Orbitz' competitors. However, agents contend they have that effect because the agreement gives Orbitz the right to match any web deals its owners may offer to other agencies.

From its initial announcement in November, 1999, Orbitz and its owners have said that it had two missions.[41] One was to drive down CRS costs. The other mission was to provide competition to online agents Expedia and Travelocity, which had attained a dominant position in third-party Internet sales. Both agencies had the potential to supplant traditional travel agents as intermediaries controlling the flow of information from airlines to consumers, particularly because each had the financial strength of major corporations behind them. Airline participants in Orbitz did not want the Internet to establish online agencies as powerful intermediaries in travel distribution.

Online competitors, traditional travel agents, and CRSs have filed voluminous testimony critical of Orbitz and its airline owners. They complain that airlines have adopted a policy of sharing their low web fares only with the online agency that they own, and that this gives

Orbitz an unfair competitive advantage.[42] For their part, several travel agent witnesses cited numerous instances where they had quoted clients a CRS fare, only to lose the sale because the customer had found a fare as much as hundreds of dollars less on the Internet.[43]

Orbitz' critics propose various regulatory solutions to eliminate this advantage: require airlines to provide web fares to all agencies if they give them to any; eliminate certain contract clauses that require or encourage carriers to provide all their web fares to Orbitz; some would even require airlines to divest their ownership of Orbitz.[44]

Orbitz and CRS booking fees - Orbitz and its airline owners argue that airlines choose to provide web fares to Orbitz because other methods of distribution would require airlines to pay both exorbitant booking fees, averaging almost $11 per ticket and, until recently, agency commissions.

However, critics argue that the cost reduction from avoidance of booking fees does not justify what can be a far wider differential between web fares and those offered through CRSs. If the fares were based on cost differences, the difference should be equal to the amount of the booking fee. Therefore, they conclude, the fares must be designed for another purpose -- to divert traffic from traditional agencies.[45] The Commission agrees that the difference between web fares and other prices cannot be justified solely on the basis of booking fees, and that the fare differentials serve the strategic goal of bypassing travel agents.

Airlines do incur costs when they receive an Orbitz reservation. Orbitz charges a transaction fee of $6.44 per transaction — and a carrier also pays the Worldspan CRS booking fee of approximately $3.89 per segment.[46] Then Worldspan rebates to Orbitz, and Orbitz rebates to airlines perhaps a third of the booking fee. Thus, at present, the cost of a Worldspan/Orbitz booking may be approximately $13.00, more than $2.00 above the cost of booking through a CRS. Of course, some bookings through a CRS may result in the payment of override commissions.

However, airlines project that the cost differential between Orbitz and CRSs will change, since the agreement between Orbitz and the carriers gradually reduces the Orbitz transaction fee over the next several years. Moreover, Orbitz has developed software to link its site directly with airline inventory and thereby avoid booking fees altogether. “Supplier Link” has already been announced for American, and other carriers will be added in the future. Since Orbitz will charge $4.00 per ticket for this technology, the total cost may be lower than CRS booking fees, but not by much.

The debate over the relationship of air fares to CRS costs overlooks the broader issue of how airlines price tickets. In the short term, air fares are not based on cost but rather on demand. Since airlines want to attract passengers to the web, fare differentials are designed to stimulate increases in traffic to the web, not to reflect cost differences. Airlines undoubtedly want to avoid booking fees, but the determining factor in establishing the price of a web ticket is whether it will generate incremental revenue for the carrier. In the long run, the carrier bypass strategy may force CRS vendors to reduce fees. In the meantime, it has a negative impact on the ability of traditional agents to compete and to serve their customers.

Orbitz and online agencies - Orbitz' second mission was to provide competition for online agents Expedia and Travelocity, and it has done so in dramatic fashion. Within a few months of its launch, Orbitz' share of travel volume, mostly through airline bookings, had vaulted it to third among online travel agencies.[47]

Expedia, Travelocity and other witnesses complained that the most-favored-nation and marketing clauses in the Orbitz contracts are unfair and cause them harm in the marketplace. They allege that the most-favored-nation clause precludes Orbitz participants from offering exclusive deals to other agents,[48] which reduces the likelihood they can underprice Orbitz. Moreover, the marketing agreement makes it illogical for Orbitz charter associates to spend money on advertising and publicity for Orbitz while simultaneously giving the same fares to its competitors. However, the Commission also was told that Orbitz rivals are making marketing agreements with airlines, though at a level that one called "subeconomic" transaction rates. This has been confirmed by the DOT report on Orbitz, and, as noted below, a recent Consumer Reports newsletter found that its rivals are fully competitive with Orbitz.[49]

Agent Costs -- Agents complain, too, that the airlines are even increasing their cost to use the distribution system, and that this places increased economic pressure on small agencies. Some of these costs, imposed by airlines through the Airlines Reporting Corp., may seem insignificant to outside observers. But a $1,000 cost increase is a major one for agencies that are very small businesses. Agents interpret some of these increases as a deliberate attempt by carriers to make their operations more costly, or more difficult.

During the Commission's hearings, agents cited several examples of practices designed to impose costs on agents. Among these are increased costs for training and paper tickets, imposition of arbitrary debit memos, and refusal to accommodate service fee charges on ticket stock.

THE COMMISSION HEARD IMPASSIONED COMPLAINTS ABOUT AGENTS' FRUSTRATION RELATED TO AIRLINE DEBIT MEMOS.

Training costs entailed in filling new, ARC-required staff positions are one issue. In 1999, ARC initiated the Certified ARC Specialist (CAS) program. At new agencies and at agencies experiencing a 30 percent ownership change, at least one person must take the CAS examination. The CAS training course costs from $275 to $395 and the examination costs from $145 to $175. ARC says the program is designed to increase agency efficiency in performing several business functions — including ticketing, refunds, exchanges and settlement — and that it was created in response to concerns expressed by agents about finding experienced personnel.[50]

Agents also cite higher costs for paper tickets, even though fewer are being issued. In a recent month, 69 percent of total travel agency volume was recorded on e-tickets.[51] Still, some passengers will want paper tickets, even if the airlines impose a separate paper ticket fee. And ARC is now requiring better, i.e., more costly, storage equipment for paper tickets than was used previously. Since tickets will increasingly be issued electronically, these paper ticket costs will be incurred for a smaller and smaller proportion of the agents' business.

The Commission heard impassioned complaints about agents' frustration with airline debit memos. Debit memos cover charges airlines impose on travel agents to recover deductions taken by agents, or to cover errors in processing tickets.[52] For example, prior to March, 2002, an agency selling a ticket deducted its commission and remitted the balance; if the ticket was then refunded by the airline, the airline claimed the commission back through a debit memo. Another example: reservations ticketed at the wrong fare, such as one issued at a discount fare for which the passenger does not qualify. The airline may issue a debit memo to reclaim the difference between the ticketed price and the full coach fare, even if the passenger would have qualified for another discount.

Apparently, some airlines have become particularly arbitrary in issuing debit memos, and the time required to respond to them has risen considerably. For example, agents were incensed at American debit memos issued after 9/11. Agents handled refunds for passengers on cancelled flights through the Area Settlement Plan, but American claimed that such refunds should have been forwarded only to its revenue accounting department. Agents responded that American employees had told them to handle the refunds through ARC. For each refund processed through ARC by the agent, American issued a debit memo of $200, even though the passenger was entitled to the refund.[53]

Agents criticize airlines for refusing to help them operate efficiently. For example, they want ARC to provide a place on tickets to record their service fee. That would eliminate the need to process the fare and the fee separately. And, agents say, it would produce a recognizable link on credit cards and other billing statements between the fee the customer pays and the ticket he or she is buying. Agents say they would pay the portion of the credit card charge related to their fee. But the change would require approval by the International Air Transport Association, which requires unanimous consent to changes by its almost 270 member carriers. One airline told ASTA that it would not approve any such change.[54]

During one Commission hearing, an airline proposed that agents should bear the entire cost of a credit card transaction.[55] With base commissions now eliminated, airlines currently receive the entire ticket revenue processed by ARC for domestic air transportation. The credit card fee can amount to two-to-three percent of the entire ticket price. When commissions were paid, this would have been 20-30 percent of the agent's entire revenue. With no commission, it would be patently impossible for the agent to absorb this amount, and unreasonable as well, since the agent is merely acting as an agent for the airline principal.

These cost increases are minor, compared to the other major changes that have impacted agents, but they are burdensome for small businesses. Particularly with respect to debit memos, there is room for improvement in airline procedures that would reduce the burden placed on agencies.