Global Travel Distribution Trends

Tensions and complexities in the current global distribution environment

White Paper

Overview

Over the past seven years, the ongoing push by airlines around the world to reduce costs has been moving inexorably along the distribution chain. Having achieved savings on a number of fronts, major carriers are zeroing in on costs associated with the sale and differentiation of their products.

After a concerted and highly successful effort to reduce labor expenses, airlines have moved forward quickly on other cost-control fronts: they have made a science of controlling capacity; they are using more efficient aircraft; they are eliminating unprofitable routes; and they are investing in more profitable long-haul routes with less low-cost carrier competition.

From the corporate client's point of view, however, airline cost controls are no longer a spectator sport. The carriers' drive to reduce costs and revolutionize pricing affects everyone downstream in the chain, ultimately ending with the consumer or corporate client. This gives rise to the question of who is ultimately responsible for the distribution costs associated with airline seats, hotel rooms, etc. A significant percentage of major network airlines appear at least moderately satisfied with their achievements in reducing domestic or "in country" costs with regard to global distribution system (GDS) fees and agency commissions or incentives. For example, the move to zero commissions has swept across, in whole or in part, North America, Europe and Asia.

However, major airlines continue to struggle with high "out of country" distribution costs for international travel, and feel that GDS fees and credit card merchant fees are approximately 40 percent to 50 percent higher than necessary.

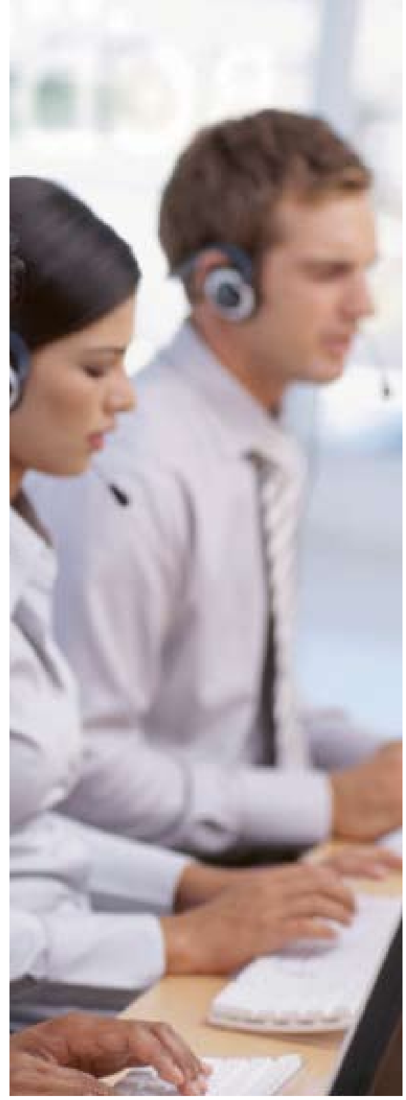
Airlines have also expressed concern that GDSs unfairly display "bundled pricing" on airfares that include most amenities (baggage, meals, seat assignments, upgrades, etc.) against "unbundled" pricing for low-cost carrier fares. Encouraged by successes at Air Canada, more traditional carriers are considering similar pricing options that add to or subtract from base fares.

Following the lead of the low-cost carriers against whom they compete, traditional airlines have seized upon the Internet's inherent capacity to facilitate direct contact with their end-users. Carriers' full-service Web sites now handle between 20 percent to 30 percent (for major carriers) and 70 percent (for low-cost carriers) of their total transactions. In addition to reducing distribution costs, exploitation of this channel allows airlines to feel that they truly "own the relationship" with direct consumers.

However, "ownership" of their highest-yield customers – managed and lightly-managed business travelers – remains a point of concern for major airlines, who see the GDSs and travel management companies (TMCs) as competitors on this front.

The airlines' success in eliminating commissions and in targeting incentive plans to increase market share has given them sufficient leverage with TMCs to feel they can work with the TMCs in building a three-way relationship with corporate clients. However, airlines are also convinced that they will always need to create leverage over the GDSs through the exploration of relationships with alternative content aggregators such as ITA, G2

Currently there are approximately 270 airlines worldwide whose inventory is not available through Global Distribution Systems



SwitchWorks (G2) and Farelogix, and the creation of distribution players themselves, such as Orbitz and Opodo.

The airlines' struggle to reduce costs, linked to renovating inefficient processes and structures and brought into sharp relief by competition with low-cost carriers, has led to wave after wave of complex and confusing negotiations between the carriers and the GDSs. Multinational corporations and global travel management companies, driven by a need for full access to content and policy compliance, have been asked to pay a premium in some markets (i.e., the United States, the UK and Ireland) in order to use the GDS channel to access full content from the major global airlines.

This white paper explores the tensions and complexities that animate the current global distribution environment. We address most major aspects of travel distribution costs, including:

- GDS fees
- Agency incentives
- Alternative content aggregators, or ACAs
- Merchant fees (credit card companies)

We also address unbundled pricing and other ways of merchandising the attributes of airline inventory, exploring the consequences of traditional GDS' current inability to exploit these methods via the familiar, text-based "green screens" used by travel agencies around the world.

Our approach

To gain insight into the trends surrounding global travel distribution, a questionnaire was drafted and administered via personal interviews with subject matter experts and key players from across the travel industry. These interviews included discussions with members from the groups shown in the table opposite.

These questions have been reproduced, together with key excerpts from individual answers. Each question is accompanied by a conclusion that summarizes the discussion and highlights its impact.

Discussion group	Number of interviews
Major airlines	8
Low-cost airlines	2
Hotels	4
GDSs	3
Travel management executives	6

Do you think the GDS is the most viable technology for travel distribution for the major airlines today?

Nearly all of the subject matter experts agreed that the major GDSs (Sabre/Abacus, Amadeus, Galileo, Worldspan, etc.) are currently the most viable distribution technology for managed travel today, largely due to "comfort, the presence of incumbent partners, and efficiency." Additionally, the GDSs are seen as necessary for "global reach" and for "most profitable long-haul routes." The GDSs' firmly established global footprint also makes "the cost of participation in the marketplace very expensive for new entrants."

However, some key disadvantages and limitations are evident, as interviewees expressed their concerns that the GDSs are:

- "The most viable technology for large global network airlines but not low-cost carriers."
- "The most viable technology, but not the most preferred."
- "The most viable technology for managed travel, but airline Web sites are the most viable for unmanaged business travel and leisure travel."

Conclusion

The GDSs are firmly entrenched – and needed – as the primary distribution channel for airlines and primary content source for TMCs and corporate clients. The global travel management companies and online booking tool providers rely on the GDSs, creating either active or passive segments for each corporate booking. It will take much longer than the airlines would like for ACAs to replicate the GDS functionality that dominates the travel distribution system today. GDSs continue to be the most efficient channel in providing end-to-end solutions.

GDSs are the preferred outsourcing partners for IT hosting and Web site development for over 100 airlines worldwide

Only 15 percent of all managed travel transactions are booked outside the GDS today

Do you think the GDS will be the most viable technology for travel distribution for major airlines three to five years from now?

We received mixed anwers as to whether or not the current GDS providers would remain dominant distribution players on a long-term basis. Our experts stated that the GDSs will remain viable:

- "If they do not stand still. They need to invest in developing Web services and open systems architecture while phasing out legacy 1960's technology."
- "If they support the way in which we want to market and differentiate our airline products and attributes."
- "If they meet our price points, which – though finally reasonable in our domestic ('in country') markets – remain 40 percent to 50 percent too high in our international markets."
- "Because of their economies of scale, and because the global airlines have outsourced so much of their IT and Web site development to the GDS systems (eg. hosting, booking engines, etc.)."

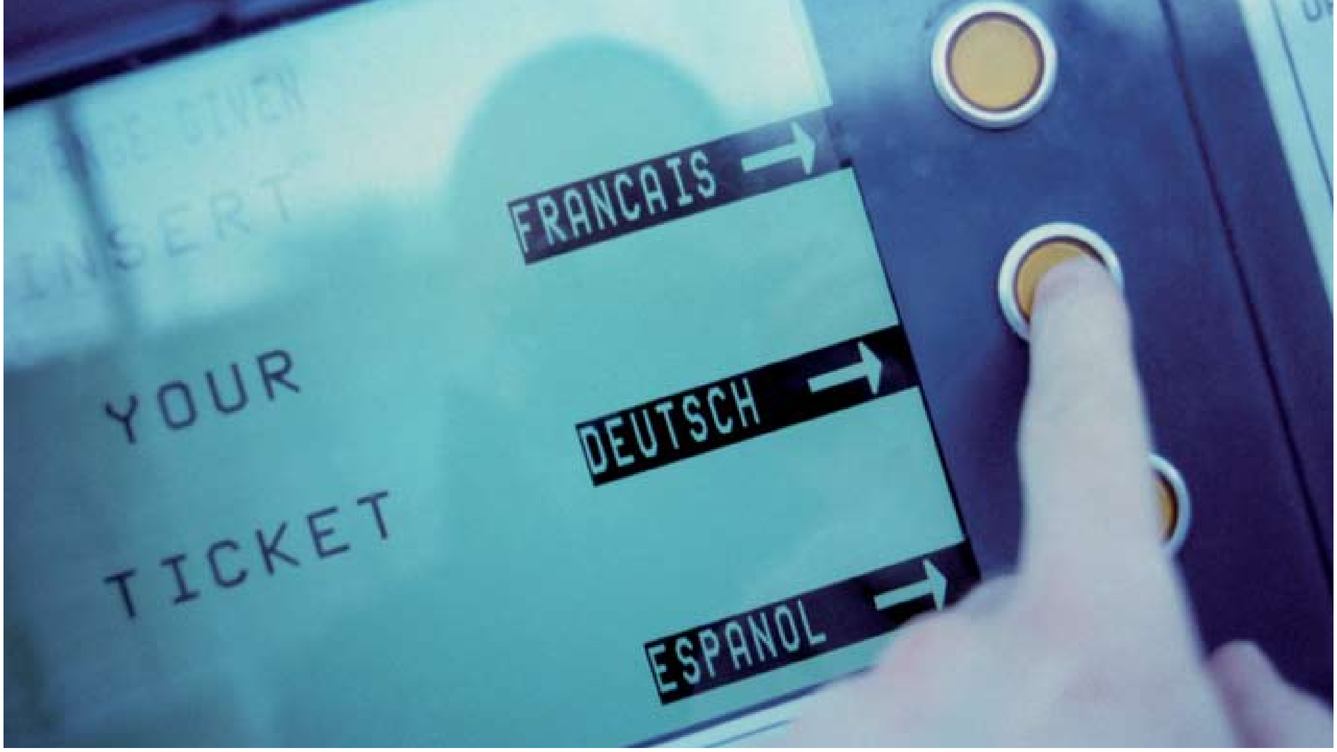
However, key players also noted that airline Web sites will grow, ACAs will take some market share and new independent channels and technology will emerge, such as search engines combining with booking tools. Some wondered about the impact of as-yet unimagined technology developments: "New applications and conveniences are always emerging – look at Apple's iPhone. There will be a similar revolution with mobile devices for the 'road warrior.'"

Conclusion

The GDSs must adapt more quickly or lose market share over the next three to five years. They must embrace new business models in all global markets and reinvent themselves as emerging technology leaders. They will maintain market share only if airline partnerships include 100 percent full content and if the airlines are signed to long-term contracts. However, given their current focus on reducing costs, it seems inevitable that airlines, on their side, will continue to explore lower-cost channel options to help diversify their channel mix, in an effort to create more competition and leverage lower costs.

How much is the GDS costing your airline in each major region of the world?

U.S. network airlines are pleased with their new GDS rates for travel originating in the United States.



British Airways has had similar success with full-content contracts for reduced rates in their home markets of the UK and Ireland.

Most European and U.S. airlines are skeptical about the possibility of negotiating better deals in (non-home-market) mainland Europe, Latin America, or Asia Pacific, where, according to the airlines, current GDS rates are almost twice as high as in-country rates.

Comments from subject matter experts include:

- "The GDS cost in North America for U.S. network airlines is approximately $7.50 a ticket and going down over the next four to six years."
- "The GDS cost is in the $12 to $15 range for U.S. airlines' tickets with a European point of sale, and such costs are going higher because of the Euro's strength against the dollar and less control over 'PNR churning,' fictitious names, and agency accreditation."
- "The GDS cost is in the $16 to $17 range for major airlines in Latin America."
- "European airlines are concerned that although they get in-country price breaks based on Amadeus' value-based pricing model [introduced in 2004], they are not getting the breaks that U.S. airlines are getting for U.S. point-of-sale routes, nor per-ticket reductions in their home country."
- "Several Latin American airlines have pulled their content from the GDS and are using inefficient direct channels of distribution (e.g., GOL in Brazil)."
- "Asia-Pacific airlines have a fragmented region with both global and local GDS systems. They are working on achieving 100 percent e-ticket use by May 2008, have cut commissions to zero and are exploring other distribution cost reductions. They are therefore more willing to pay for the GDSs' reach for now."

Conclusion

The new full-content GDS deals signed by U.S. airlines, and the resulting opt-in programs that went into effect on Sept. 1, 2006, have established reasonable rates for travel originating in the United States and long-term contracts for both parties. The U.S. network airlines and British Airways, who have followed suit with similar programs in the UK and Ireland, are now demanding similar 40 percent to 50 percent savings in international markets through lobbying with the European Union and other aggressive plans.

It is highly likely that the dominant airline in a given domestic market (i.e., Air Canada in Canada and Lufthansa in Germany) will be able to leverage similar deals. Major network airlines, however, cannot afford to lose market share by witholding content in international markets where they will continue to pay a premium for the GDSs' reach. With increased competition as a result of the Open Skies agreement between the United States and the European Union, airlines will be eager to keep all distribution channels available in order to maintain the premium fares they currently command.

Do you think the alternative players in distribution technology (such as direct connection providers G2 and Farelogix) will become a viable option in the next two or three years?

Most thought leaders in travel distribution believe that airline support of ACAs (G2, ITA, Farelogix) and airline sites such as Orbitz (North America) and Opodo (Europe) gave carriers the leverage needed to negotiate full-content deals with GDSs for sizeable discounts.

Most airlines, hotels, car rental, rail, ferry and other suppliers booked through the GDS by travel agencies are studying this precedent. Some of the non-airline suppliers are seeing their own GDS costs increasing by more than 10 percent annually, in contrast to the airlines' fee reductions. Contagious dissatisfaction with this state of affairs could cause more content disruption or even more support for ACAs.

- "Farelogix has evolved as an excellent content aggregator and multi-GDS tool."
- "G2 has changed their business model to become an agent desktop, point-of-sale tool with somewhat limited functionality direct connections."
- "The mega-agencies seem to all be developing their own desktop/point-of-sale tools that can aggregate content from multiple GDS, ACAs and direct connections where an airline has a robust Application Protocol Interface (API)."

The picture is not entirely rosy for the airlines and the ACAs, however, as some carriers are concerned that they are already losing the leverage gained in their 2006 negotiations with the GDSs.

- "If the ACAs become a real threat to the GDS companies, they usually get acquired by the GDS with a premium profit. Look at what Sabre paid for GetThere/ITN. G2 is now owned by the same private equity firm that owns Sabre."
- "Airlines continue to outsource IT, hosting, Web sites and more to GDS companies and are giving very little to ACAs, even though ITA is building Air Canada's new API and agent portal."

Conclusion

It seems that new entrants have largely underestimated the complexity of airline content, TMC processes and the entire travel distribution system. Their biggest issues have become the lack of any standardization with airline IT infrastructure and the degree to which airlines outsource their IT needs to GDS companies. However, the new entrants may yet play a role as content aggregators and enablers of direct channels for airlines. As one airline executive put it, they will "supplement GDS content and help keep some leverage on GDS pricing."

With many of the major U.S. airlines locked in to five- to seven-year full-content agreements, it is unlikely that alternative channels will gain much traction over the next few years. In addition, we have seen some of the low-cost carriers begin to participate, or expand their participation, in the GDS. The need for content aggregation will continue to exist in markets and regions where fragmentation is a significant factor.

The growing focus on technology and multiple infrastructures accentuates the need for industry technology standards to match or resolve the different requirements of airlines and the GDSs

Do you think that the opt-in programs that finally succeeded in the United States when airlines and GDSs worked together, will become a model for continental Europe?

Most of the thought leaders felt that full content/opt-in programs are already working in the UK and Ireland, where they were driven by British Airways. Most airlines felt that the success of such programs in continental Europe would depend on major forces such as Air France-KLM and Lufthansa.

Interviewees' comments included:

- "It will be up to the national airlines to take the lead and then all of the other airlines will fall in behind them."
- "If six or seven major airlines can leverage these deals in North America, it can happen in Europe as well."
- "Until GDS deregulation occurs in Europe, I do not see this happening in Europe."
- "Until Air France, Lufthansa, and Iberia divest ownership in Amadeus, this approach will not be taken in mainland Europe."

Conclusion

Previous attempts to institute opt-in programs in mainland Europe met with no success. However, now that the United States, the UK and Ireland have been able to introduce opt-in programs, it is unlikely that other home market carriers will stand by and not make similar changes. Today, the EU requires content parity among the GDSs; however, airlines have not necessarily provided "full content." Carriers will likely use the full-content leverage to help shift the economic model. Despite the comments of some discussion group members, it seems equally probable that airlines will not wait for a deregulated environment to pursue opt-in programs.

Who should pay GDS fees and associated distribution costs for the airlines and other suppliers: Customers? Agencies? Suppliers?

Most of the key players interviewed felt that GDS fees and other distribution costs should be shared among those who derive the benefits. Almost everyone agreed that the customer ends up paying for GDS costs in the end, whether it is included as part of the cost of the ticket, as an opt-in surcharge or as an increased agency transaction fee.

Key comments included:

- "If airlines were to sell their seats in a wholesale model to travel agencies and not control retail pricing, the agency should have to bear the cost."
- "Whoever makes the choice of choosing the GDS for distribution should pay a premium over a set base fee. In today's market that means that the agency and the corporate customer would pay the premium."

Conclusion

In the view of the airlines, travel agencies and their managed travel customers choose to use the GDS for efficient access to content and for the ability to control preferred supplier usage at the point of sale. As a result, the carriers feel that for corporate customers, GDS fees can be at least partially offset by savings achieved through improved efficiency and processes. They also feel that the agencies should support some technology costs

instead of getting the technology for free.

Airlines differentiate between GDS distribution costs and those associated with distribution via their own Web sites, as the latter is a controllable cost and is also incurred by low-cost carriers. This levels the playing field in a highly competitive environment. Web distribution also allows carriers to differentiate their products and services and to own the customer relationship.

What is your vision for the ideal technology model for the airlines over the next five years?

This open-ended question inspired a wide range of responses. Here are a few of the key comments:

- "The GDSs need to free airlines from the constraints of legacy systems and become enablers of one-to-one marketing."
- "The GDSs need to shift from a fixed customer relationship to a variable relationship with dynamic functionality."
- "GDSs need to focus on their core business of airline information technology. They need to create merchandise classes and inventory systems in order to tailor our airline products and services to targeted customer segments."
- "GDSs need to focus on new architecture and new platforms such as XML and Web services with dynamic inventory and pricing."
- "GDSs need to move to the Web 2.0 and the Travel 2.0 world. It seems that with 50 percent to 60 percent of the world's travel agents still on text based 'green screens,' they have not even made it to a 1.0 graphical world."

Conclusion

Interestingly, despite all the talk about ACAs and direct distribution, it is clear that for many carriers, the GDS still plays a key role in their ideal vision. But it is a new and improved, sleeker, more dynamic GDS. The global airlines want the convenience and speed of the GDSs on current and future cutting-edge technology platforms. They want the ability to differentiate their various cabin products (e.g., aisle and window seats) through the GDSs, just as they have on their own Web sites.

The growing focus on technology and multiple infrastructures accentuates the need for industry technology standards to match or resolve the different requirements of airlines and the GDSs.

What is your airline's plan to reduce merchant fees paid to charge card and credit card companies? How will you approach corporations who receive a significant charge card rebate and significant traveler perks (such as frequent flyer mileage) and ask them to give up these benefits?

Merchant fees charged by credit card companies (e.g., American Express, Visa, MasterCard, AirPlus, Diners Club) have become one of the airlines' highest distribution costs. These fees range from 2.1 percent to 2.8 percent, or $12 to $15, per ticket. The charge card companies have positioned themselves effectively by getting the airlines their money quickly, taking the accounts receivable risks and buying miles for their own loyalty programs, to make this area a net profit center for most major airlines.

Most of the thought leaders interviewed felt that a reduction in merchant fees would be a complicated challenge, due to a number of factors:

1. Airline affinity cards and the sale of miles to credit card companies are major revenue and profit centers for the airlines.

2. The major multinational corporations receive significant charge card and procurement card rebates on both travel and entertainment (T&E) volume and small business purchases.

3. Frequent travelers receive significant frequent flyer miles in credit card loyalty programs.

Some airline comments reflect their awareness of these challenges: "Our airline will not be aggressive with reducing merchant fees. Since we earn more revenue in our frequent flyer program from selling miles to charge card companies than we pay out, we believe this would be 'a penny wise and a pound foolish' decision." Additionally, airlines recognize that credit card companies play a valuable role in policing fraud: "Credit card companies have some of the largest private 'police forces' in the world as well as an end-to-end system to manage accounts receivable and write-offs effectively."

However, it appears that these hurdles are not going to stop most major airlines from aggressively testing and implementing programs to reduce or eliminate the $12 to $15 merchant fee per airline ticket. As one airline executive observed, "The 'hot light' has now been moved from agency incentives and GDS fees to merchant fees."

In doing so, however, carriers are aware that they face a variety of audiences with different needs, and will treat them accordingly:

- "Our airline will aggressively market new alternatives such as PayPal, Telecheck, BillMeLater, debit cards, our own affinity card and UATP card, Google Wallet, and direct settlement with corporations through electronic funds transfer (ACH)."

- "Our airline is willing to make this benefit very lucrative to corporations even if it means giving back all of our savings. This would help eliminate the major annual increases in these fees as well as reduce some taxation based on the cost of the ticket."

- "Our airline will focus on using consumer payment systems such as PayPal and debit cards only in the leisure market and unmanaged business travel."

- "Our airline feels that we will concentrate on reductions that do not involve multinational corporations and managed business travel. There will be a few corporations such as Wal-Mart that are willing to invest in direct settlement with all of their preferred suppliers for a gain-share incentive."

Conclusion

When it comes to reducing merchant fees, the airlines have a major challenge in front of them: in addition to helping corporations consolidate their travel spend, charge card companies have "locked in" the corporations with rebates and the travelers with loyalty program miles and other perks.

There does seem to be room for the airlines to reduce these fees with inducements in the leisure and unmanaged business travel segments. In the area of managed travel, they could potentially test opt-in programs to provide some leverage to get longer-term, fixed-fee commitments on a per-ticket rather than percentage basis. However, the airlines do not have as much leverage over the charge card companies as they have over the GDSs. Many of the airlines have co-branded partnerships which could potentially limit their ability to promote alternative forms of payment.

In certain markets such as Latin America, cash payments for airline tickets are standard. Such regional customs and business practices are not likely to change any time soon.

In the near future, does your airline plan on using unbundled pricing to market your product and services in a different way (e.g., varied pricing for middle seats vs. aisle seats)? Are the GDSs and the agency community ready to market attributes, or will you use channel-specific marketing, such as unbundled pricing found only on your Web site?

Several major airlines have begun unbundling their pricing in order to merchandise various product attributes such as a premium for an aisle seat and a discount for a center seat. Other product attributes, with the potential for earning additional fees include number of bags, next-cabin upgrade fees, meals, club passes, flexible charges for schedule changes, and many other areas unique to each airline.

Within the GDSs currently, low-cost carriers' lower unbundled fares are being compared at the point of sale to full-service airlines' bundled fares on the same route. Today, the GDSs do not distinguish the "flight package price" and what is included in the fare or not.

Some global airlines have built or are building robust Web sites to merchandise their products more effectively. Air Canada has emerged as one of the market leaders in this area.

Corporate travel managers and travel management companies are fearful of making new travel policy decisions in which unbundled services would be approved for expense report reimbursement. In addition, TMCs and corporations are concerned about the potential costs associated with subsequent decreases in online transactions and touchless rates and increased agent interactions that may be necessitated by labor-intensive "re-bundling."

Here are a few of the key comments on this very hot topic in the industry:

- "Our airline is absolutely committed to the concept of up-selling and merchandising our products and services. We feel that Air Canada and several low-cost carriers have already set a standard for this to become a competitive factor."

- "Our airline is currently doing the math on merchandising our products. However, we will not be the market leader in this area. We already feel that we 'nickel and dime' our customers and we are not going to add to this issue right now."

- "Our airline is very concerned about unbundled pricing because we have such wide fare bands. Every airline doing this today has narrow fare bands. We would have to reduce revenue by coming up with a base fare and pricing each attribute. We are concerned that travelers would not buy every attribute and that is where revenue reduction would happen."

- "This is a much simpler exercise for a low-cost airline or a national airline. We believe that an airline such as Southwest Airlines could benefit financially by charging for advance seat assignments – a service most other airlines already provide. It would be interesting to see if they can still turn their planes around so quickly if they try it."

Conclusion

It appears that unbundled pricing and merchandising will become a standard on airline Web sites and portals with graphical user interfaces, where carriers can up-sell and cross-sell new revenue streams without diluting current yields.

It is clear that the GDSs are working on this functionality; some carriers have even instituted specific delivery timelines in their GDS contracts. Questions remain as to whether the GDSs can achieve the functionality in time to meet the needs of the airlines, and what the impact will be on the transparency of comparison shopping.

Although an unbundled approach to marketing and pricing figures largely in most airlines' long-term strategies, they acknowledge that the evolution will be much slower in the area of managed travel booked through TMCs, online booking tools and the GDSs.

Looking ahead

Over the next several years, we expect airlines to continue focusing on lowering distribution costs on all possible fronts – whether through lower GDS fees or lower merchant fees. Suppliers such as hoteliers and car rental companies are watching developments in this arena closely, to see how they too might benefit.

Suppliers will continue to look for ways to differentiate themselves through merchandising and attribute selling. The industry needs to keep pace with accelerating technology changes and develop flexible platforms that can easily adapt to ever-changing demands of both suppliers and end users.

The full-content agreements that are currently in place between major carriers and GDSs address only a portion of the concerns of corporate clients looking for optimal, efficient access to content. The reality remains that GDSs still do not provide full access to content from suppliers such as rail companies, independent hotels and the majority of low-cost carriers.

In this environment, it is more critical than ever that travel management companies take an active role in providing customers with flexible, seamless access to multiple supplier channels and, on a larger scale, insulating customers from disruptive industry developments.

Customers must ensure that their travel management company can address the distribution-related pains felt by their three core "audiences": travelers, the travel program and the corporate strategy. Companies should ask themselves:

- Can my TMC give my travelers access to a complete range of travel options, with offerings tailored to my travel policy?
- Can my TMC give my travel program full access to content and maximize my supplier agreements and policy compliance?
- Can my TMC give my company complete data security and independence from marketplace conflicts?

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