

# Policy Analysis

No. 441

June 6, 2002

## ***Online Travel Services The Antitrust Assault on Orbitz—and on Consumers***

**by James V. DeLong**

### **Executive Summary**

Orbitz, which sells airline tickets to travelers over the Internet, is owned by 5 major airlines and affiliated with 30 more. Its charter requires it to display flight and fare information in an unbiased manner, sorted only by price, number of stops, length of trip, and other basic criteria.

Despite the fact that Orbitz has plenty of competition, other players in the industry have trotted out antitrust arguments to try to keep it from operating or cripple it with regulations. The intensity of the assault should set off alarms, because it is simply the latest example of antitrust being used to suppress competition rather than to promote it.

Orbitz was created because the founding airlines have a strong interest in fostering sources of comprehensive, unbiased information on schedules, fares, and seat availability. Improved information will decrease airline operating costs and promote their interest in filling as many seats as possible.

Orbitz is also introducing new software for booking reservations. This will introduce competition and reduce fees in a part of the industry that now derives market power from government regulation. It will also restructure the industry to reflect the new economic realities of the Internet.

The antitrust attack on Orbitz is highly technical and is directed at provisions of the charter that require the participating airlines to provide Orbitz with all fares that they make publicly available, which is alleged to create excessive power over ticket selling. Another cause of antitrust concern is that Orbitz might in some fashion enable airlines to coordinate, and raise, their fares.

Neither charge is valid. The charter provisions that are drawing fire are necessary to the creation of an unbiased information source. The real motivation of most opponents is their vested interest in the status quo.

The seriousness with which the attack is being taken by the government, the press, and the public illustrates a general failing of contemporary antitrust regulation. Antitrust enjoys an excellent image, primarily because of the belief that it protects consumers. But in practice, the energy behind antitrust policy often comes from firms that are threatened by new arrangements. Pressure from such firms is skewing antitrust policy into a series of efforts to suppress innovation for the benefit of industry incumbents and to the detriment of consumers.

---

*James V. DeLong is a senior fellow with the Competitive Enterprise Institute's Project on Technology and Innovation.*

**Despite the plethora of competition, the antitrust wasps are buzzing fiercely and have gotten the ear of the government.**

## **Introduction**

Orbitz, which started operations on June 1, 2001, sells airline tickets over the Internet. It is owned by 5 major carriers and supported to a lesser degree by 30 more “charter associates.” Its charter requires it to display information in an unbiased manner, sorted only by price, number of stops, length of trip, or other basic criteria. It is bound to avoid favoritism that is based on the identity of the carrier, advertising on Orbitz, sponsorship, or any other factor not related to price or quality of service.<sup>1</sup> The five owners have almost 80 percent of the domestic airline travel market, and the associates account for “a majority of the remaining 20 percent.”<sup>2</sup>

Orbitz has many competitors, both online and off. There are more than 33,000 travel agencies, ranging from one-person shops to giant American Express, and 270 of them are online. Seventy percent of tickets are sold by conventional travel agents. The market share of online services is about 7 percent (of which the airlines themselves have more than half), and analysts expect that the Internet’s share of sales in 2003 will be only 11 percent.<sup>3</sup>

Despite the plethora of competition, the antitrust wasps are buzzing fiercely and have gotten the ear of the government. Before Orbitz was allowed to begin operations it had to obtain the blessing of the Department of Transportation (DOT).<sup>4</sup> It succeeded, despite questioning by more than 20 state attorneys general and the opposition of a host of industry incumbents.

The opponents, undaunted by this initial failure, succeeded in having a statement inserted into a congressional conference report in November 2001 directing DOT to reexamine the issue.<sup>5</sup> In March 2002, DOT sent a letter requesting yet more information from Orbitz and its sponsors, seeking “to determine whether the terms of participation in Orbitz are unreasonably restricting competition in the airline and airline distribution businesses.”<sup>6</sup>

For anyone who values competition and cheap travel, the persistence of this antitrust interest should set off alarms. A high level of

antitrust energy often means that industry incumbents are worried because an innovator is about to eliminate inefficiencies from which the incumbents make money.

On analysis, this is the case with Orbitz. Ostensibly, the protesters fear some vague “anti-competitive” harm because Orbitz is supported by the carriers. In fact, industry incumbents fear the loss of existing opportunities to profit from inefficiency, bad information, and pricing power based on government regulation. But the constantly reiterated purpose of the antitrust laws is to encourage, not prevent, this type of harm.<sup>7</sup> Orbitz’s opponents are, in fact, trying to use the antitrust laws as a barrier to changes that will benefit consumers. The high decibel level of the squawking indicates that these potential benefits are large.

## **The Airline Industry**

The airline industry has a number of special characteristics:

*Low Variable Costs.* Establishing an airline is difficult and expensive. But once it is operating, adding more flights costs little; 80 to 90 percent of total costs are fixed in advance of individual flights.<sup>8</sup> And once a flight is scheduled, the marginal cost of filling a seat that would otherwise go empty produces additional revenue at a cost of almost zero—the fuel used by a 200-pound passenger/luggage combination on a flight of 2,370 miles is about 7.5 gallons, which costs less than \$10.<sup>9</sup> So the marginal cost of carrying the additional passenger is less than \$10 in fuel plus a few dollars for food and drink.

*Expiration.* A seat cannot be stockpiled. Once the flight leaves, its value goes to zero. Airlines live and die by small changes in their percentages of seats filled.

*Cooperation/Competition.* The United States has 429 airports with regularly scheduled commercial operations, which creates 91,806 possible origin-destination pairs. When one adds in connecting flights through intermediate airports, the number of possible trips that can be taken mounts to the billions.

About 5,000 flights are scheduled each day. Given this complexity, most airlines adopt the hub-and-spoke mode of operating because of its benefits in keeping passengers on the airline that originated the flight, maximizing aircraft and crew utilization, and providing maintenance efficiently.<sup>10</sup> A hub city for one airline is a spoke for others, which creates multiple ways to travel between any particular city pair and necessitates a high degree of interaction among airlines. The whole industry is one giant network within which firms must both cooperate and compete.

*Frequent Fliers.* People who take more than 10 trips per year account for 8 percent of all passengers but 40 percent of all trips.<sup>11</sup> To an airline, these customers are gold.

*Government Involvement.* Federal airmail contracts helped found the airline industry. Safety regulation, air traffic control, and accident investigation are federal government functions. The Antitrust Division of the U. S. Department of Justice keeps watch for “anti-competitive” mergers and pricing practices. State and local governments are responsible for airport construction and operation. From 1938 to 1978 the Civil Aeronautics Board controlled routes and fares. The Department of Transportation has regulatory power to prevent “unfair” practices, which it uses to regulate the airline reservation business.

These characteristics dictate basic industry strategies as follows.

*Product differentiation and price discrimination.* Airlines want to sell as many seats as possible for full price, but as flight times draw near they *must* try to fill the otherwise empty seats for whatever they can get. The result is the complex structure of advance reservations and Saturday night stays, efforts to distinguish business and personal travelers, advance purchases, nonrefundability, negotiated discounts, last-minute bargains, and blind auctions where the bidder does not know the airline on which he will fly. Over 90 percent of all tickets sold by U.S. airlines are discounted, and the discounts average two-thirds off of the full fare.<sup>12</sup> The calculation of how many seats to offer at what price in order to achieve the maximum return from

each flight is called “yield management,” and it depends heavily on extensive information about travelers’ preferences and reactions to prices and on sophisticated computer programs.

*Some Degree of Secrecy.* The difference between the average fares that an airline must receive if it is to stay in business and the low fare that it should rationally take if necessary to fill an otherwise empty seat creates a sticky problem. Logically, if an airplane that is ready to leave the gate in Chicago heading for San Francisco has an empty seat and a passenger offers the airline in the neighborhood of \$25 for a ticket (enough to cover the marginal cost of fuel and food), the airline would profit by taking the deal. But an airline cannot have people flying on \$25 tickets without poisoning its relationship with higher-paying passengers, so it is reluctant to offer such bargains openly. On the other hand, it can offer bargains if the product can be differentiated in some way and if the true price is not made public, so airlines will sell steeply discounted tickets to travel agents who offer packages that combine air fares, accommodations, and other services, or to consolidators who buy blocks of tickets and sell them independently. The term used in the trade is “opaque fares.”

*Dependence on Intermediaries.* Airlines reward intermediaries, such as travel agents, who can deliver customers, especially repeat customers. Because just a few seats per flight can make the difference between hefty profits and crushing losses, any intermediary capable of delivering customers enjoys substantial bargaining power in dealing with airlines.

*Dependence on Computers.* Highly sophisticated systems are needed to keep track of equipment, schedules, seat availability, fares, and individual bookings for a considerable period into the future. Airlines were early and heavy investors in mainframe technology back in the 1970s, funding much pioneering work in databases.<sup>13</sup> Without the computer, the current structure of deregulation combined with multiple and shifting fares would be impossible.

**Orbitz’s opponents are trying to use the antitrust laws as a barrier to changes that will benefit consumers.**

**The airlines want to reduce marketing costs, restructure relations with travel agents to reflect the new reality of the Internet world, and undermine the power of the CRSs.**

## **Selling Tickets**

As befits the complexity of the industry, the system for making reservations and selling tickets is convoluted. It includes five major players: airlines, computer reservation systems (CRSs), conventional travel agents, the Department of Transportation, and the new Internet information and reservation services. It also includes others with specialized roles: the Airline Tariff Publishing Company, which is a computerized central clearinghouse for fare information, and the Official Airline Guide, which performs the same function for schedules. Firms called “consolidators” serve as marketers for blocks of tickets. Priceline and other sites distribute cut-rate tickets through auctions. The Antitrust Division of the Department of Justice polices competition in the industry, creating an overlap with the functions of the DOT. And all of these entities interact with the operational side of the airline companies.

### **Airlines**

The airlines sell tickets at counters, by telephone, and through websites. Individual airlines also maintain the computer databases on flights, fares, and reservations that provide the raw material for searches by other participants.

Marketing and ticket distribution constitute up to 20 percent of an airline’s total expenses. The costs of booking a ticket vary greatly depending on the medium by which the reservation is made. In 1999, America West estimated its average costs for various methods of distribution as follows:<sup>14</sup>

- Conventional travel agent—\$23
- Online travel agent—\$20
- Airline reservation agent—\$13
- Airline website—\$6

Obviously, airlines prefer to sell tickets through their own channels, but given the importance of boosting load factors, no channel can be ignored.

### **Computer Reservation Systems**

Computer reservation systems, which are not well known to the public, are operated by independent companies that provide travel agents with information about flights and seat availability and book reservations. These companies were started by airlines during the 1970s and soon fell under DOT regulations designed to prevent any airline from using a captive CRS to obtain a competitive advantage.<sup>15</sup> (To a large extent, the airlines have divested their ownership; remaining airline stakes are in the 10 percent to 15 percent range.) Any reservation not made by an airline itself goes through a CRS.

CRSs charge the airlines, not the agents, a booking fee of around \$3.50 per flight segment, and the average round trip has four segments. CRSs have steadily raised their prices in real terms even as the cost of computing in every other area of national life has fallen drastically. The fee per segment was \$1.00 in 1984. If fees had kept pace with inflation, the segment fee would be about \$1.70, half its current cost. If the price had dropped comparably to other computer costs, it would be in the pennies.

Four major CRSs exist—Sabre, Worldspan, Amadeus, and Galileo. A travel agency need belong to only one, because every airline accepts reservations from all four. If an airline owns a stake in any CRS, it is compelled by DOT regulation to participate in all. If it does not, it still deals with all CRSs because each has control over a bloc of travel agents.

Competition among CRSs takes the form of signing up as many travel agencies as possible. Signing bonuses are common and can be substantial.<sup>16</sup> However, the industry practice is to sign travel agents to long-term contracts, so at this point the shares of the major CRSs are quite stable and the industry seems to be static. New entry is not practical for a number of reasons, especially existing long-term contracts, the nature of the technology used, and the inhibitions imposed by DOT regulations.

The CRSs are sophisticated about the structure of their industry and have no incentive to compete by lowering booking fees. That

would gain them no new travel agency clients. (On the contrary, it would lessen their ability to give rebates.) In fact, the airlines are held captive by a combination of regulatory requirements and fear of losing vital bookings.

### Travel Agents

Agents perform multiple, complicated, and sometimes conflicting functions. They are, at different times and to differing degrees:

1. Neutral intermediaries who sell tickets for any airline for which a passenger wants a ticket.
2. Agents working on behalf of travelers locating the lowest fares or best flights according to the travelers' criteria.
3. Entrepreneurs who steer passengers toward whichever airline rewards them most handsomely, even if that airline is higher in price or less convenient for the traveler. (This is not usually known to the travelers.)<sup>17</sup>
4. Packagers of travel and other services (e.g., airline, hotel, rental car, tours) that can be sold to travelers as a bundle.

Deregulation and the consequent increase in complexity of the fare structure created an important niche for travel agents as suppliers of information and a bonanza for the agents themselves. In 1977, travel agents were responsible for 38 percent of bookings, and commissions were between 4 and 5 percent. After deregulation, agents' share of the bookings rose to 85 percent by the early 1990s, and commissions rose to a peak of 11 percent.<sup>18</sup>

In 1993, airlines spent \$7.6 billion on base commissions, which is well over 10 times the average profit of \$634 million that the whole industry earns in an average year.<sup>19</sup>

Commissions can be levied directly on the price of a ticket sold ("base") or they can take the form of "overrides"—incentive payments for meeting overall sales quotas, or other special payments from the industry. The existence of such rewards promotes steering, of course.<sup>20</sup> A 1998 survey found that 52 percent of domestic travel agencies received

overrides in 1997, and 69 percent of those indicated that they sometimes book a specific airline as a result. GAO says that travel agencies estimate that the customer defers to the agent about 25 percent of the time, and that overrides are often a "tie-breaker."<sup>21</sup>

Agents are also given rebates by the CRSs; these are usually linked to the volume of bookings generated. It is estimated that rebates to a large travel agency amount to about one-third of the booking fees generated by that agency for the CRS. Travel agents who deal with businesses may share the commissions and CRS rebates with their clients. Some agents are captives of companies, established to recapture those payments for their owners.

As the Internet developed, the information functions performed by agents became less valuable, and the airlines began pressuring for cuts. By 2000, base commissions had fallen to \$4.3 billion as a result of the dollar level caps imposed by airlines on commissions for domestic flights.

In response, an increasing number of agents began collecting fees directly from travelers. By 1999, about 40 percent did so.

In March 2002, Delta announced that it was cutting base commissions to zero, while retaining overrides of an undisclosed nature. Within a week the rest of the six biggest airlines followed suit—American, United, Continental, Northwest, and U.S. Airways. "Without commission revenues," said the *Wall Street Journal*, "travel agents are expected to increase fees they charge to book travelers. . . . That, in turn, could lead more consumers to buy their tickets online, which benefits the airlines."<sup>22</sup>

### Government

The Department of Transportation regulates the airlines. In the 1970s and thereafter, as individual airlines invested in CRS systems, two types of complaints were voiced by airlines and travel agents: (1) an airline-owned CRS would slant the display of possible flights to favor those of its owner, to the disadvantage of other airlines, and (2) existing travel agents would be affected negatively.

**Orbitz expects to become profitable in late 2002, relying totally on commissions and fees and not on subsidies from the airlines.**

**Travel agents find it increasingly difficult to convince airlines to pay for their services.**

DOT, acting at the behest of industry incumbents, issued rules in 1984 and 1992 designed to protect against bias in the display of information by the CRSs, and to protect travel agents.<sup>23</sup>

Achieving those purposes had ancillary effects, however. The airlines were prevented from using investment in computer systems as a tool to change the structure of the ticket-selling industry. Continuing investment in CRSs was also discouraged because the rules ensured that carriers that chose not to invest would not be disadvantaged. DOT and many industry participants assume, or pretend, that the rules embody reasonable requirements. No one criticizes the rules because no one wants to irk the regulator. In truth, the rules are a recipe for sclerosis and inefficiency, protecting incumbents and ensuring that CRSs will maintain substantial market power over airlines.

The current rules expired in March 1997, but they have been extended annually while DOT reviews them to decide if substantive changes are needed. They will now expire on March 31, 2003.<sup>24</sup>

### **The Internet**

The first sale of a ticket online was by Alaska Airlines in 1995. Since then, the Internet has burgeoned. Every airline has a website for selling tickets. Some 270 broader online services exist, plus uncounted websites run by existing travel agencies. The most important services are:

- Travelocity, owned by Sabre, which is the largest CRS. Sabre also has the largest business travel management service (GetThere) and is a major supplier of data processing services to the airline industry, including some of the airlines that are sponsoring Orbitz.
- Expedia, which was started by Microsoft and is now owned by USA Networks, recently overtook Travelocity as the biggest online site.
- Orbitz, created by a consortium of airlines.

The online agencies provide information

to customers about flights and allow the customers to book their own flights. For the most part, online agencies obtain information and book seats through the same channels as ordinary travel agents: the OAG for schedules, the ATPCO for fares, and the CRSs for seat availability and specific bookings. However, Orbitz and Expedia have each developed software more powerful than that used by the CRSs to search out seat availability information and present consumers with more options. They still use CRSs to book seats. Orbitz, and possibly other online services, are working on "direct connect" computer programs to make their own bookings, bypassing the existing CRSs. Orbitz's system is scheduled to go into operation in May 2002.<sup>25</sup>

Online agencies make money, like ordinary travel agents, from commissions paid by airlines and from rebates from CRSs. They, too, are moving in the direction of charging consumers, and Orbitz now charges a fee of \$5.00 per booking. Online agencies also run advertising, and the extent to which advertising purchases induce them to slant their information is a matter of acrid controversy. Orbitz's charter forbids this. Both Expedia and Travelocity deny that it happens.

## **Airline Motives for Creating Orbitz**

The airlines, individually and as a group, have three strong reasons for creating a source of broad and unbiased information about fares and seat availability, and, ultimately, an alternative channel for booking seats. They want to reduce marketing costs, restructure relations with travel agents to reflect the new reality of the Internet world, and undermine the power of the CRSs.

### **Reduce Marketing Costs**

Each airline wants to reduce marketing costs so that it can cut fares and energize demand. Of course, each would like to reduce its own costs while keeping those of its competitors high, but, given the extent to which

the airlines are intertwined, this is not possible. If they play King of the Hill, they will drag each other down and increase costs for all. To reduce costs, however, members of a network must cooperate.

The need for cooperation has always existed—imagine making travel arrangements if airlines refused to pool information on schedules and fares and forced every passenger to seek information from each individual airline instead of consulting the airline guide or a travel agent. Establishing a system of broad, unbiased online information for consumers (i.e., creating Orbitz)—is the logical extension of the preexisting system of reporting information to the OAG and ATPCO.

A logical question is why the airlines decided to create Orbitz instead of waiting for market incentives to induce third parties to create unbiased services.

The answer lies in a combination of impatience and uncertainty. Impatience because it could take time for such services to develop, and the gains to the airlines from the existence of unbiased information are so great that they cannot afford to wait. Uncertainty because it is not absolutely certain that an unbiased online service would be economically viable.

The potential problem is that online services provide travelers with significant information for which they may not get paid—travelers can research online, then book from a travel agent or from the airline itself. The sites get far more browsers than buyers,<sup>26</sup> and, while the percentage of buyers will rise as customers grow familiar with the service, significant incentives will continue to operate to the detriment of online sites.

If a travel agent does not charge the traveler a service fee, then there is an obvious incentive for the traveler to use an online agency to obtain information and then book the reservations through a travel agent. This costs the customer nothing and saves a little time, and the use of an intermediary can provide trouble-shooting services if plans go awry. Also, a savvy buyer, such as a business, can negotiate with the agent for a share of commissions and CRS rebates. Any agent who does not tell his

customers: “Do your search through Orbitz, then book through me and we will share the commission,” is missing a business opportunity. Even when a fee is charged, the traveler may receive services that exceed the value of the fee, subsidized by the agent’s commissions from the airlines.

The online services are responding by establishing services for customers that mirror those provided by travel agents, such as alerts about schedule changes, reminders, and help lines. They are betting that automated services can, in the long run, be more effective and cheaper.

Also, the problem of foregoing payment for services may be short lived. As market forces bring commission payments into alignment with actual value added to the transaction, the online services will be in a good position, providing the best information at the lowest cost. Even in the short run, Orbitz and Expedia are optimistic. Orbitz expects to become profitable in late 2002, relying totally on commissions and fees and not on subsidies from the airlines. Expedia, which relies not just on commissions but on packaging travel services and selling seats and rooms on consignment, made a profit in the last quarter of 2001.<sup>27</sup>

Nonetheless, a rational airline should be concerned that short-term financial pressures might lead any online service to bias its displays and auction its viewers to whoever bids the most for that bias.<sup>28</sup> The creation of a service such as Orbitz, which has non-bias guaranteed by its charter, is a logical way to ensure that temptation is resisted, not only by Orbitz but by other Internet companies as well.

### **Recast Relations with Travel Agents to Reflect the Reality of the Internet World**

A second airline interest is to recast relationships with travel agents to reflect their current functions and the value they add to transactions.

The combination of deregulation and the initial stages of the computer revolution resulted in a complex and shifting fare structure. This gave travel agents a vital role in col-

**Through Orbitz, the airlines are helping to fund a new generation of reservation-making technology that will end the DOT-created CRS pricing power.**

**If unilateral action is “anti-competitive” and joint action is also “anti-competitive,” exactly what can the industry do that would be “pro-competitive”?**

lecting information for consumers about fares and routes. Now that this function can be performed more effectively and efficiently by computers, travel agents find it increasingly difficult to convince airlines to pay for their services. Before the airlines eliminated them in March 2002, base commissions had fallen steadily since 1995, to about 5 percent. They were also capped in dollar terms.<sup>29</sup>

Not surprisingly, travel agents would like to maintain high commission levels, because they could use computers to search cheaply and then pocket the money. But high commissions no longer reflect the economic value of the function.

In another role, travel agents steered customers to whichever airline bid the most, often unbeknownst to the passengers. The airlines were well aware of this, but they could not afford to alienate agents and so they acquiesced. Today, they need not play this game—if unbiased information is available, passengers will catch on quickly, and the power of the agents to steer passengers will decline precipitously. If agents can no longer deliver passengers, and airlines no longer must pay them for steering, the airlines can put the savings back into reductions in price and improvements in service, to the benefit of travelers and the airlines themselves. Airlines want to hasten this restructuring. Hence, they support a service that provides the broad and unbiased information necessary to let the market work.

Airlines also want to retain their ability to reward travel agents who do perform important economic functions, primarily putting together travel packages and marketing them to customers who might not otherwise travel, or who might otherwise travel on some other airline. The Orbitz charter specifically reserves the airlines’ right to make special fare deals as long as they are not offered publicly. Packages and bulk sales are allowed.

In the long term, the best solution for consumers would be for airlines to pay no commissions, and for travel agents to be paid by the travelers. If consumers paid directly for services received, the market for information,

reservations, packages, and other aspects of travel would work smoothly. A lack of commissions would also indicate that information had improved and that middlemen no longer had the capacity to steer business in return for rebates.

Delta, when it eliminated base commissions (though it plans to “continue to pay individually negotiated incentive commissions to select agents”), explained the move:<sup>30</sup>

Technology has fundamentally changed airline ticket distribution practices. The rapid growth of electronic ticketing and the Internet allows customers to shop for, buy and receive Delta tickets, on their own terms. The cost of distribution through electronic channels is much lower than traditional means. . . . Travel agents remain an important part of Delta’s sales network. They are successfully adapting to the new competitive environment. . . . Some customers clearly prefer to arrange travel through a travel agent because of the unique expertise they provide. The elimination of published base commissions at Delta removes one of the last vestiges of a commission program developed in a regulated environment.

Other airlines followed, and the *Wall Street Journal’s* “Middle Seat” columnist interpreted the trend as “good news for consumers—mostly.” He reasoned that the move will strengthen the airlines financial position, which is good for consumers in the long run, and that it will reduce the travel agents’ “divided loyalties”—the split between the customers and the airlines that pays them.<sup>31</sup> But he sees the overrides as presenting a continuing problem of divided loyalties. This is certainly true—but it is a problem that can be solved if travelers demand disclosure.

### **Create Competition in Booking Reservations and Reduce the Pricing Power of the CRSs**

The third motive for creating Orbitz was



that the airlines were weary of what they regard as the excessive charges of the CRSs—\$14 and up in booking fees for the average round trip was seen as piracy, way out of line with costs and, thus, with the prices that would prevail in a freely competitive market.

The DOT rules are to blame for the situation. Starting in the 1980, DOT was anxious to avoid giving any airline an advantage as a reward for making investments in computerization and CRSs and reduced the incentive for new firms to enter the market and invest in such systems. And by forcing each airline to participate in all CRSs, it ensured that CRSs would have little incentive to compete with each other on either price or quality.<sup>32</sup> The result is a system that, in the words of William Hannigan, president of Sabre, the largest CRS, provides a “legal ability to print money.”<sup>33</sup>

Through Orbitz, the airlines are helping to fund a new generation of reservation-making technology that will end the DOT-created CRS pricing power. This alone is worth the cost to the airlines of setting up Orbitz, which was around \$150 million. Booking fees are 2.7 percent of the cost of the average ticket, a total of \$2 billion per year. The arithmetic shows that a reduction in booking fees of only 4 percent would repay the airlines’ costs for Orbitz in a year.

In reality, the reductions will be much more than that. When Orbitz’s reservation system comes online, its price for a booking will be \$4 per ticket, versus the current CRS price of about \$14 for a four-segment round trip ticket.

Furthermore, much of the new technology is not proprietary to Orbitz. The basic search engine was developed by ITA Software, a company founded by a group of MIT alumni, and is available to all comers, including other travel agents and airlines.<sup>34</sup>

There is considerable irony in the current attacks charging that Orbitz must be “anti-competitive” because it is a product of joint action by the airlines. Thirty years ago, when individual airlines attempted to obtain competitive advantage by acting unilaterally to create CRSs, the government imposed rules to forestall them, arguing that any unilateral

advantage would be anti-competitive. Now, in the context of Orbitz, it is argued that joint action is anti-competitive. If unilateral action is “anti-competitive” and joint action is also “anti-competitive,” exactly what can the industry do that would be “pro-competitive”?

### **The Orbitz Business Plan**

Orbitz’s business plan reflects the purposes outlined above.<sup>35</sup> It is based on: (1) a promise to display fares in an unbiased manner, ranked solely by cost and number of stops, and not slanted to favor the offerings of any supplier or sponsor, (2) superior software that will find more flight options than are now available from other services, (3) sharing with participating airlines any CRS fee refunds received by Orbitz, and (4) a capacity to connect directly to airline host systems, bypassing the existing CRSs and introducing competition into the business of booking seats.

The plan also includes provisions to make Orbitz a broader business, to include (1) a “hand-holding” service to inform customers of the status of their plans and (2) a provider of travel packages that integrate airline reservations with other services, such as hotels.

Finally, Orbitz’s charter has several features designed to solve the “prisoner’s dilemma” that arises in any deal between firms that are in a mixed cooperative-competitive relationship, especially firms belonging to a network as intricately intertwined as that of the airlines. Each airline’s “druthers” would be to reduce its own distribution costs while those of its competitors remain high. Thus, from the standpoint of any individual airline, the best solution would be for a site such as Orbitz to contain all the fares offered by the airline’s competitors, but for the airline itself to reserve special low fares that it revealed only on its own website.

Obviously, if each airline tried this, the whole system would fall apart. Each airline would save out its lowest fares for its own website, or for some other favorite location, and there would be no source of comprehensive information.

**How does an industry achieve the benefits of reasonable cooperation without running afoul of the antitrust authorities?**

**A more logical explanation for Southwest's concern is that Orbitz will reduce other airlines' distribution costs, thus enabling them to reduce fares and cutting Southwest's cost advantage.**

Therefore, if good information is to exist, each participant must bind itself to provide Orbitz with its lowest fares. That is why the Orbitz charter contains, and must contain, a "most-favored-nation" clause whereby each participant makes available to Orbitz all fares that are made available to the general public. (This category does not include fares that reflect corporate or government discounts, special fares for meetings or groups, and consolidator fares. Also, if a competitor offers special terms favorable to the airline, and Orbitz refuses to provide comparable terms, the airline is free to proceed with the special deal. Airlines can also provide "opaque fares" to other agents because they are made available as part of special travel packages or through blind auctions, and are thus not "publicly available.")

### **Opposition to Orbitz**

The antitrust objections to Orbitz take two forms.

The first is that Orbitz will affect the market for *air travel* by inhibiting discounting and allowing carriers to coordinate their fares. The second is that Orbitz will dominate the market for *air travel reservations*, to the detriment of other travel agents.

Both arguments rest on requirements in the Orbitz charter. The "most-favored-nation" clause is the principal target, but another charter provision that provokes attack requires the participating carriers to spend money to promote Orbitz and allows them to fulfill this obligation by providing some cheap fares exclusively to Orbitz.

Neither the "fare coordination" nor the "reservations" argument is persuasive, despite the considerable ink that has been spilled on them.

The "fare coordination" argument is close to incomprehensible. Airlines already have excellent information about fares, published in the same sources (ATPCO and OAG) from which Orbitz gets its information. So the argument depends on a logic that holds that secret discounts exist and that these are crucial to the functioning of a competitive mar-

ket even though no one knows about them. One can spin a defense of this logic, but not easily or convincingly. The defense is particularly difficult in the context of the airline industry, with its numerous alternatives for traveling between any two given places and its constantly shifting prices.

The concern about a monopoly of the reservations business is equally far fetched. To understand this conclusion, one can conduct extensive analysis of the possible impact of the "most-favored-nation" and promotional provisions of the Orbitz charter. Or one can take a shortcut by recognizing the fact that the provisions will not give Orbitz undue market power because such a result would be contrary to the interests of the founding airlines, especially the charter associates, who are not stupid.

The airlines want to reduce their distribution costs. As a part of this, they must ensure that there is competition among outside distributors; the airlines do not want to give any organization the power to jack up the price of airline tickets. The rational charter associate will wish all online information companies, not just Orbitz, a long and prosperous existence. It will encourage them all, and foster competition that reduces their charges to the bone.<sup>36</sup>

Even the five Orbitz owners should be promoting competition, not an Orbitz monopoly. The financial benefits to them from reducing booking fees and distribution costs are generally enormous, dwarfing any possible profits that Orbitz might earn.

In general, the problem confronting Orbitz is an old one, since it affects every trade association and standard-setting organization: How does an industry achieve the benefits of reasonable cooperation without running afoul of the antitrust authorities?

The Internet and the possibility of efficiency-enhancing industrywide e-commerce initiatives present this old problem in a new form, and in 2000 the antitrust authorities issued two guiding documents.<sup>37</sup> Orbitz's charter provisions track these documents quite closely.<sup>38</sup>

The real explanation of the antitrust assault lies in the interests of the organizations that are leading the attack. Primarily, they fear the greater efficiency that will accompany better information in the market.

Travel agents enjoy collecting high commissions for performing low-cost computerized searches. Some of them also like the possibility of auctioning ignorant passengers to the highest-bidding airline. Not all agents engage in this practice, of course, and all of them now know that the existence of the Internet numbers its days. But suppressing Orbitz would allow the practice to continue for a bit longer.

The CRSs obviously want to keep collecting their tolls, and they are among the most influential of the Orbitz opponents. They have a strong interest in not having people understand their true motive, that of blocking competition that would erode their existing market power, so they tend to stay behind the scenes.

Existing online travel services would like to suppress a well-financed competitor. However, they cannot argue to the antitrust authorities that they do not want competition, so they must find alternative arguments.

The two largest online services, Travelocity and Expedia, have quite different interests. Travelocity, as part of the Sabre group, must defend not only its own interests but those of its parent CRS. Orbitz sees Sabre/Travelocity as an important force in the current fight:

Having purchased its major competitors, locked up the major portals [e.g., AOL, Yahoo], and extended its tentacles into all areas of e-commerce, Travelocity, in particular (and Expedia to a lesser degree), is sitting all but unchallenged on top of a distribution sector that is expected to quadruple over the next four years.<sup>39</sup>

Expedia may see itself as capable of performing the function of providing unbiased information, and thus filling the same niche

as Orbitz. And it has another reason to feel aggrieved by the entry of Orbitz: The current industry structure of commissions and booking fees creates a price umbrella for a lower-cost service such as Expedia that might let it earn excellent profits. The company certainly has no reason to welcome the entry of a similarly efficient competitor, especially one with deep-pocket funding. However, Expedia has now become part of the USA Networks group, so it is embedded in a network of its own, with access to substantial outside funding.<sup>40</sup>

Southwest is the leading airline opponent of Orbitz. Southwest operates on a business model different from that of other airlines, relying on point-to-point rather than hub-and-spoke configuration, specializing in low-cost operations, focusing on medium length trips, and handling its own ticket sales.

It is branded as the low-cost airline and sees little benefit from participating in Orbitz or any other online service. Until recently, Southwest had an arrangement with Travelocity, but it objected when Orbitz published fares that Southwest sent to the OAG, and eventually stopped reporting them to deny access by Orbitz. This step cut off Travelocity as well.

The ostensible basis of Southwest's objection to Orbitz is that it would allow the major airlines to conspire to raise their fares.<sup>41</sup> Even if this charge were true, it would make no sense for Southwest to mind. If other carriers raised their fares, the competitive position of Southwest would improve. A more logical explanation for Southwest's concern is that Orbitz will reduce other airlines' distribution costs, thus enabling them to reduce fares and cutting Southwest's cost advantage. CRS fees are especially important in this calculation; Southwest refuses to pay them, which is why travelers must book directly through Southwest. This gives it an out-of-the-gate cost advantage of \$3.50 per segment.

The rest of the opponents consist of the usual ragtag band of pseudo "public interest" and "consumer" groups that somehow wind up on the anti-consumer side of every

**The rest of the opponents consist of the usual ragtag band of pseudo "public interest" and "consumer" groups that somehow wind up on the anti-consumer side of every antitrust dispute.**

antitrust or other regulatory dispute.

None of the protesting groups can demonstrate that they will suffer the type of harm that the antitrust laws are designed (at least in theory) to prevent. Indeed, quite the reverse is true. Each will suffer the type of harm that the antitrust laws are supposed to encourage—they will lose market power that is based on inefficiency, friction, and government regulation.

## Conclusion

Antitrust enjoys excellent press, primarily because of the frequent assertion that it protects consumers. But theory is not reality, and in practice the energy behind antitrust policy rarely comes from consumers, who are a disorganized and inattentive lot, seldom aware that they have a stake in some obscure legal battle. The energy comes from business firms threatened by new arrangements. Their pressure skews antitrust policy into a series of efforts to pervert the law to suppress innovation and so benefit industry incumbents, to the detriment of consumers.

As Professors William J. Baumol and Janusz A. Ordover wrote in 1985:

There is a specter that haunts our antitrust institutions. Its threat is that, far from serving as the bulwark of competition, these institutions will become the most powerful instrument in the hands of those who wish to subvert it. More than that, it threatens to draw great quantities of resources into the struggle to prevent effective competition, thereby more than offsetting the contributions to economic efficiency promised by antitrust activities.<sup>42</sup>

The assault on Orbitz is proving that their concern was well justified. It is also part of a larger assault on e-commerce being conducted by middlemen who fear erosion of monopoly market power.<sup>43</sup> It is important to the future of the Internet, e-commerce, and

antitrust doctrine that it be repelled.

## Notes

1. Information on Orbitz's structure can be found at [www.orbitz.com](http://www.orbitz.com). For a discussion of its relationship with its founding members, see an article by Orbitz general counsel Gary Doernhoefer, "Orbitz Revisited: The Orbitz Perspective," *The Transportation Antitrust Update*, American Bar Association, Winter 2002, p. 23.

2. William F. Adkinson Jr. and Thomas M. Lenard, *Revise Orbitz's Flight Plan: Serious Competitive Risks Outweigh Questionable Benefits* (Washington: Progress and Freedom Foundation, June 2001), p. 3.

3. Kenneth Mead, inspector general, Department of Transportation, "Internet Sales of Airline Tickets," Statement before the Senate Committee on Commerce, Science, and Transportation, Report no. CR-2000-111, July 20, 2000, [www.senate.gov/~commerce/hearings/0720mea.pdf](http://www.senate.gov/~commerce/hearings/0720mea.pdf).

4. DOT, Office of the Secretary, Letter to Jeffrey G. Katz, president, Orbitz, April 13, 2001, available from author's files.

5. U.S. House of Representatives, "Conference Report [To accompany H.R. 2299]," 107th Congress, 1st sess., Rept. 107-308, November 30, 2001, p. 47, <http://thomas.loc.gov/cgi-bin/cpquery>.

6. "Government Investigation of Online Travel Company Orbitz Moves Forward," March 19, 2002, [www.siliconvalley.com/mld/siliconvalley/news/editorial/2894079.htm](http://www.siliconvalley.com/mld/siliconvalley/news/editorial/2894079.htm).

7. See *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477, 488 (1977): "[R]espondents complain that by acquiring the failing centers petitioner preserved competition, thereby depriving respondents of the benefits of increased concentration. The damages respondents obtained are designed to provide them with the profits they would have realized had competition been reduced. The antitrust laws, however, were enacted for 'the protection of competition not competitors' [citation omitted]. It is inimical to the purposes of these laws to award damages for the type of injury claimed here."

8. General Accounting Office, *Aviation Competition*, GAO-01-832, July 2001, p. 22.

9. See Boeing Company, Product Technical Specs, 717. A fully loaded 717 weighs 121,000 pounds, including a fuel weight of 29,500 pounds (3,933 gallons) and has a range of 2,370 statute miles. Thus, by simple arithmetic, each gallon transports

27 pounds, and it takes 7.4 gallons to transport 200 pounds, [www.boeing.com/commercial/717/717technical.html](http://www.boeing.com/commercial/717/717technical.html). The 717 carries 106 passengers, so the average expenditure of fuel per passenger is 37 gallons, counting the weight of the plane as well as the passenger.

10. However, Southwest Airlines and some others have made a very successful business by specializing in low-cost fares and point-to-point routes instead of hub-and-spoke.

11. Air Transport Association, "Airline Economics," in *The Airline Handbook—Online Version*, Chap. 4, [www.air-transport.org/public/publications/display1.asp?nid=964](http://www.air-transport.org/public/publications/display1.asp?nid=964).

12. *Ibid.*

13. Global Aviation Associates, "The History and Outlook for Travel Distribution in the PC-Based Internet Environment," February 2001. Report prepared for Orbitz.

14. Merrill Lynch, "e-Commerce: Virtually Here: Airlines," April 8, 1999, p. 3, [www.e-commerce.research.ml.com/30209817.PDF](http://www.e-commerce.research.ml.com/30209817.PDF). Cited in General Accounting Office, "Domestic Aviation: Effects of Changes in How Airline Tickets Are Sold," GAO/RCED-99-221 (July 1999), p. 17.

15. See Fred Smith, "The Case for Reforming the Antitrust Regulations (If Repeal Is Not an Option)," *Harvard Journal of Law and Public Policy* 23, no. 1 (Fall 1999): 25.

16. Global Aviation Associates, p. 58. A CRS may pay \$10,000 to \$15,000 to retain a five-terminal agency, and as much as \$50,000 to induce one to switch. At \$3.54 per segment booking fee, and an average of three segments per trip, a \$50,000 payment is recovered by 3,571 reservations booked. A mid-size travel agency may book over 13,000 tickets per year.

17. See Michelle Higgins, "Now Boarding Your Travel Agent," *Wall Street Journal*, December 14, 2001: "Even though he uses the same corporate travel agent every three months, [a Michigan insurance executive] says he had 'no clue' such perks existed. 'Just like anything... you want to know the ins and outs of who's getting bonuses for what.'"

18. "Orbitz and Travel Agents," [www.orbitz.com/newsroom](http://www.orbitz.com/newsroom).

19. Scott McCartney, "Airlines Move to End Most Commissions Is Good News for Consumers—Mostly," *Wall Street Journal*, March 21, 2002.

20. A. Bradley Mims, deputy assistant secretary of

the Department of Transportation, Statement before the Committee on Commerce, Science, and Transportation (July 20, 2000), p. 4.

21. General Accounting Office, "Domestic Aviation: Effects of Changes in How Airline Tickets Are Sold," GAO/RCED-99-221, July 1999, p. 20.

22. Martha Brannigan and Kortney Stringer, "American and Continental Join Delta in Eliminating Most Commissions," *Wall Street Journal*, March 19, 2002.

23. "Carrier-Owned Computer Reservation Systems," <http://cfr.law.cornell.edu/cfr/cfr.php>.

24. Department of Transportation, NPRM, "Extension of Computer Reservation Systems (CRS) Regulations," *Federal Register* 67(Feb. 15, 2002): 7100, <http://frwebgate1.access.gpo.gov/cgi-bin/waisgate.cgi?WAISdocID=80967731856+1+0+0&WAIAction=retrieve>.

25. Orbitz uses software developed by ITA, which also sells to other airline businesses. Delta recently announced that it is converting its internal operations to ITA's software. See [www.itsoftware.com/news/](http://www.itsoftware.com/news/).

26. At Travelocity, as of July 2001, 9 percent of the visitors made a reservation. This was up from 4 percent the year before. Amon Cohen, "Inside Track," *Financial Times*, July 24, 2001.

27. Eric Hellweg, "It's Not Just Amazon. These Net Businesses Are Also Profitable," *Business 2.0*, Feb. 12, 2001, [www.business2.com/ebusinessdispatch](http://www.business2.com/ebusinessdispatch).

28. A CRS owned by an airline is forbidden to bias its display, but an online site directed at consumers is not within the definition of a CRS.

29. "Orbitz and Travel Agents," [www.orbitz.com/newsroom](http://www.orbitz.com/newsroom).

30. Delta Airlines, press release, "Delta Eliminates 'Base' Commissions for Travel Agents in the United States and Canada," March 14, 2002, [www.delta.com](http://www.delta.com).

31. McCartney, note 19.

32. See, for example, Antitrust Division, Department of Justice, "Comments on Proposed Rule on Computer Reservation Systems," Department of Transportation, Dkt OST-96-1145, Sept. 19, 1996, [www.usdoj.gov/atr/public/comments/crs\\_comm.htm](http://www.usdoj.gov/atr/public/comments/crs_comm.htm). Final ruling can be found in the *Federal Register* 62 (November 5, 1997): 59784.

33. Amon Cohen, "Inside Track," *Financial Times*,

July 24, 2001.

34. See Sarah Milstein, "How to Get There? It Counts the Ways," *New York Times*, April 21, 2002, p. BU 5, [www.itasoftware.com](http://www.itasoftware.com).

35. See [www.orbitz.com](http://www.orbitz.com).

36. See, for example, DOT, "Request for Comments on Computer Reservation System (CRS) Regulations," *Federal Register* 62 (November 7, 1997): 60195; "Supplemental Comments of American Airlines" (September 22, 2000), pp. 8-11.

37. Department of Justice, "Antitrust Guidelines for Collaborations Among Competitors" (April 2000), [www.ftc.gov/os/2000/04/ftcdojguidelines.pdf](http://www.ftc.gov/os/2000/04/ftcdojguidelines.pdf); and Federal Trade Commission, "Entering the 21st Century: Competition Policy in the World of B2B Electronic Marketplaces," (October 2000).

38. See Doernhoefer.

39. DOT, "Comments of Orbitz" (Sept. 22, 2000), p. 27.

40. Jim Hu, "USA Networks to Buy Expedia Stake," C/NET, July 16, 2001, <http://news.com.com/2100-1017-269959.html?legacy=cnet>.

41. DOT, Comments of Southwest Airlines, Inc. (Oct. 31, 2000).

42. "Use of Antitrust to Subvert Competition," *Journal of Law and Economics* 28 (May 1985), reprinted in CEI Antitrust Reform Project, *Antitrust Reader* (1997).

43. Robert D. Atkinson, "The Revenge of the Dis-intermediated", Progressive Policy Institute Policy Paper (Jan. 2001), [www.ppionline.org/documents/disintermediated.pdf](http://www.ppionline.org/documents/disintermediated.pdf).

Published by the Cato Institute, Policy Analysis is a regular series evaluating government policies and offering proposals for reform. Nothing in Policy Analysis should be construed as necessarily reflecting the views of the Cato Institute or as an attempt to aid or hinder the passage of any bill before congress. Contact the Cato Institute for reprint permission. Additional copies of Policy Analysis are \$6.00 each (\$3.00 each for five or more). To order, or for a complete listing of available studies, write the Cato Institute, 1000 Massachusetts Ave., N.W., Washington, D.C. 20001, call toll free 1-800-767-1241 (noon - 9 p.m. eastern time), fax (202) 842-3490, or visit our website at [www.cato.org](http://www.cato.org).