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European Commission
Directorate-General for Energy and Transport
Office DM24 5/98
B-1049 Brussels
Belgium

Re: Consultation paper on the possible revision of Regulation 2299/89 on a Code of Conduct for computerised reservation systems

To the Directorate-General for Energy and Transport:

Thank you for providing American Airlines with the opportunity to provide comments on issues related to the Commission's Regulation 2299/89 – the Code of Conduct for computerised reservation systems. As The Brattle Group and Norton Rose have noted:

> The short-term objective [of the Code of Conduct] was to prohibit directly the use of market power by airline-owned CRSs to restrict competition. The longer term objective was to dissipate CRS market power itself.[1]

While airline ownership of CRSs is no longer a significant issue, there is still a need for targeted regulations designed to prevent CRSs from abusing their market power. For example, the Code of Conduct should be updated to prohibit or restrict the use of parity clauses, worldwide participation requirements, and fare bias in CRS displays. At the same time, allowing CRSs to discount their product by eliminating the non-discrimination rule would help create competition. Our response to the consultation paper's ("Paper") specific questions to stakeholders follows:

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[1] The Brattle Group and Norton Rose, *Study to Assess the Potential Impact of Proposed Amendments to Council Regulation 2299/89 with Regard to Computerized Reservation Systems*, October 2003, p. iv.

Q1. In light of the described market developments, is there still a need for the sector-specific competition rules imposed by the Code of Conduct? Or should the Code of Conduct be revised or abolished?

A. The Growth Of Alternate Distribution Sources Has Not Changed The Dependence Of Network Carriers On CRSs

The developments described in the Paper have not changed the fundamental fact that CRSs have a significant level of market power over airlines. This CRS market power was created over the course of many years, and it will not simply disappear after just a few years of new technologies and new entrants. The fundamentals of CRS market power remain no less intact today than they did when the Commission last examined the industry:

- Travel agencies face heavy pressure to use a single CRS – and not to switch – because of long-term agreements with large termination penalties, CRS exclusivity provisions and incentive payments from the CRS that often exceed the subscription price;

- Airlines face heavy pressure to participate in each major CRS, as the loss of revenue associated with pulling out of a CRS will typically exceed any potential booking cost savings; and

- Travel agencies purchase CRS services generally without incurring a net payment obligation, and airlines incur the payment obligation without being able to promote one CRS over another.

1. Travel Agencies Typically Use Only One CRS – And Switching Is Extremely Difficult

In most cases, a travel agency will only use one CRS, and it is a major undertaking for an agency to change the CRS that it uses. This is because using more than one CRS is typically inefficient, and the switching costs of making such a change are extremely high. While this is partly a natural phenomenon given the increased training and back-office technology costs associated with using more than one system, CRSs have taken steps to further reduce the incentive for travel agencies to use more than one CRS, or to change providers. For example, CRSs typically impose long term and sometimes exclusive contracts with tiered incentive programs, termination damages and technology/training dependence. Making a switch even more difficult is the fact that CRSs have acquired the providers of back-office systems to the

agencies, as well as booking tools used by corporate accounts. These purchases of downstream service providers are designed to further increase travel agencies' costs of switching, In fact, CRSs have taken steps to insulate themselves from competition by artificially interfering the ability of other CRSs and new distribution technology providers to integrate with the back-office and booking tool products they have acquired.[2]

2. Airlines Face Pressure To Participate In All CRSs

While the airline industry suffers through cycles in which devastating losses are suffered, the CRS industry continues to be what Sabre has called "a cash cow."[3] CRSs are able to impose price increase after price increase because they have never had to compete for participation from network carriers. As The Brattle Group and Norton Rose have noted:

> CRSs quickly gained leverage over airlines at large; because most travel agencies subscribed to only one of the reservation systems, airlines had to participate in every CRS in order to reach all of their potential customers.[4]

While network carriers such as American have made some progress in shifting a percentage of their bookings (primarily leisure) to lower cost distribution channels (such as AA.com), the fact remains that travel agents are still an essential element of the distribution process. American relies heavily on travel agents because it sells a complex network of services, and the travel agencies provide value to American's customers. For example, American's large corporate accounts rely almost exclusively on travel agencies. Moreover, in some regions – like Spain, Turkey, Argentina and Brazil – one or two CRSs control the entire distribution market, and then tie that dominance to other regions in a single contract in order to further leverage their market power.

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[2] For example, some third party providers of these systems have noted that Sabre's back-office technology "works only with Sabre." Sabre could use this to "lock up smaller and midsized [travel management companies]." *The Beat – a travel business newsletter*, April 24, 2007.

[3] Saul Hansell, *Even as the Big Airlines Struggle, Computer Booking System Prospers,* N.Y. TIMES, February 9, 2003.

[4] The Brattle Group and Norton Rose, *Study to Assess the Potential Impact of Proposed Amendments to Council Regulation 2299/89 with Regard to Computerized Reservation Systems*, October 2003, p. iv.

For example, although American did consider pulling out of one or more CRSs in 2006 during often contentious negotiations over booking fees and other issues, we realized that to do so would create significant difficulties. When we considered the anticompetitive contracts that the CRSs often had with agencies and the general difficulties that agencies would have in switching, we chose a different path. Eventually, American concluded that not dealing with each major CRS would be extremely disruptive to the travel agency community, and at the same time would place American's revenue at risk – two consequences that we do not take lightly. As such, American and other network carriers will remain subject to CRS market power absent a fundamental change in the way the market operates.

3. Travel Agencies Do Not Bear The Burden Of High CRS Booking Fees – Rather, They Share In The Profits

Moreover, CRS incentive payments create a perverse incentive for travel agencies to select the *highest* cost distribution channel, as the agencies share in the monopoly rents that CRSs are able to extract from airlines. For example, if a CRS increases booking fees by € 1.00, it is not the travel agency that bears the cost – it is the airline. Yet the airline cannot simply stop using the high-cost CRS, despite being in a market where costs are rising uncontrollably, because to do so would mean a risking a disproportionate amount of worldwide revenue. Even assuming that the travel agency could readily change CRSs, the CRS could effectively bid airline costs up even higher by increasing the inducement paid to the agency and then raising airline booking fees. In short, travel agencies choose a CRS not based on how cost-effective it is to the airline, but on how much revenue it will generate for the agency. Such a system has inevitably led to unreasonably high booking fees.

In most markets, these supracompetitive prices would attract new entry, which would then drive the price down to a more reasonable level. Unfortunately, the fact that CRSs can buy loyalty from travel agencies by raising booking fees creates a significant barrier to entry. For example, if existing CRSs charged € 5.00 per booking, kicking back € 2.00 to the travel agency, a GNE might try to enter the market at a price of € 3.00 per booking. However, travel agencies have no incentive to switch to a GNE that could not afford to offer the € 2.00 incentive payment. Thus, the GNE could only gain traction in the industry by setting its price *higher* than those of the incumbents, so that it could pay an even *higher* incentive to the travel agency to encourage a switch. The other financial alternative to support the growth of new entrants would be for the airline to bear the burden of paying a financial incentive to an agency using a new entrant. However, CRSs would likely try to abuse their parity clauses to prohibit this sort of competition. The market failure caused by the fact that travel agencies purchase CRS services without incurring a payment obligation comes at airlines' and consumers' expense, as higher booking fees translate into higher fares and reduced services.

B. Deregulation Has Helped Airlines Reduce Their Booking Fees In The United States By Allowing Them To Make Agencies Responsible For The Cost Of The Distribution Channel They Choose

With American's full-content CRS deals expiring in 2006, we were set for the first long-term negotiations with the CRSs since the deregulation in the United States. American, along with other airlines, began to implement a new distribution model in which high booking fees would either be reduced or shared by travel agencies. As a part of these negotiations, American made it clear to the CRSs – particularly Amadeus – that it would require booking fees to come down from their inflated levels. If booking fees did not come down, American would impose a fee on travel agencies which chose to use CRSs that continued to charge unreasonable booking fees.

This program – known as the Source Premium Policy – makes travel agencies choosing to issue tickets through sources that impose high booking fees carry some of the burden of those fees. Specifically, a travel agency contributes a $3.50 "source premium" to partly offset the booking fee that the CRS collects from American. In order to avoid the source premium, the travel agency would be required to issue tickets using CRSs or other distribution sources that did not charge unreasonable booking fees. In response to American's new program, Galileo, Sabre and Worldspan each announced new programs for their travel agencies that gave the agency a lower booking fee in exchange for full content and an agreement not to collect a source premium from agencies that "opt in." This program has created an incentive for travel agencies to subscribe to lower-cost distribution sources, and has helped make the market more competitive.[5]

However, despite seeing the three other major CRSs create opt-in programs for their travel agencies, Amadeus stubbornly tried to hold the line by filing a lawsuit seeking an injunction ordering American not to impose cost recovery charges on travel agencies that insisted on using Amadeus despite its unreasonably high booking fees. In an effort to justify its position, Amadeus pointed to parity clauses – part of the PCA adhesion contracts imposed during the regulated era when CRS market power was at its peak.[6] Fortunately, the Court rejected Amadeus' attempt to use injunctive relief to insulate it from the need to compete and provide its product at a competitive price. While the case has moved to arbitration, American and Amadeus

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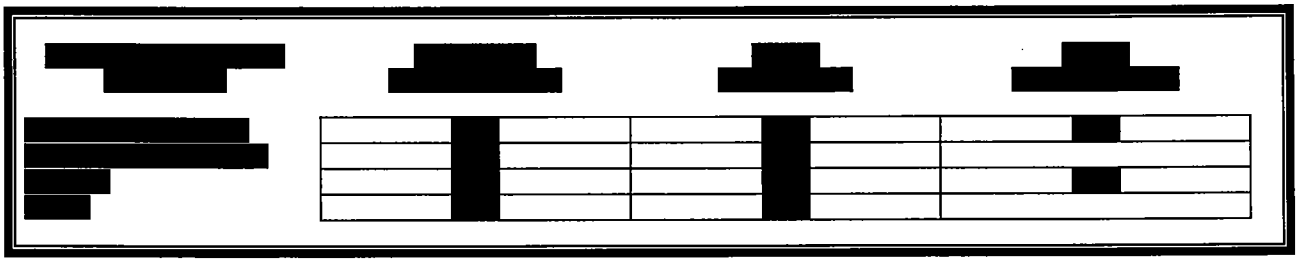
[5] It should be noted that American did not reach an agreement with Sabre until a month after its prior full content amendment had expired and on the day that American would have started levying charges on Sabre's agencies. Many agencies were deeply concerned during this interim period and told us that they wanted to switch CRSs, but could not do so because Sabre would not offer them relief from the termination provisions of their contracts.

[6] Amadeus is not alone in this anticompetitive interpretation of parity clauses.

have reached a temporary agreement which significantly reduces its booking fees – but only for bookings in the United States as a part of Amadeus' recently introduced opt-in program. Amadeus' refusal to allow American to adequately address the excessively high booking fees for points of sale outside the United States is one of the primary stumbling blocks to reaching a long-term agreement.

C. CRS Booking Fees Are Still Excessive Outside The United States

Of course, the negotiations described above would have been difficult if not impossible for bookings in the European Union, as the Code of Conduct prohibits price discrimination by CRSs. Ironically, the protections against discrimination that were intended to protect smaller carriers from larger ones (most of which had an ownership interest in a CRS) are now being used to justify a refusal to provide discounts to *anyone*. Amadeus has specifically cited the Code of Conduct each time American has sought to reduce its booking fees in Europe.[7] As a result, those booking fees continue to rise each year, with no respite in sight. [redacted]



CRSs are providing an identical service to American around the world, there is no legitimate justification for the disparity between booking fees in the United States, and booking fees in Europe. Outside of costs, American is largely indifferent as to which GDS is providing service in a particular market due to the lack of technological differentiation by the GDSs. The fact that CRSs vie for agency subscribers in those particular markets by bidding up the airlines'

[7] American suspects that the CRSs do engage in discounting through both zone pricing schemes as well as opaque forms of value transfer that shield the agreements from the light of day and the Code of Conduct.

[redacted]

cost is an inefficient use of our money. Unfortunately, airlines have little alternative but to pay, as not doing so would put revenue at risk worldwide. Clearly, the CRSs continue to wield market power. [redacted] This is certainly not what the Commission had in mind when requiring pricing parity in the CRS industry.

D. The Commission Should Move Toward Deregulation – But Prohibit Or Restrict Inherently Anticompetitive Tools Used By CRSs Such As Parity Clauses, Worldwide Participation, And Fare Bias

1. Parity Clauses

Parity clauses – by themselves – give the CRS industry market power over airlines. For example, the GDSs have traditionally tried to limit a carrier's ability to work directly with an agency to pay that agency incentives as a potential mechanism for fertilizing the growth of lower cost distribution channels. As the U.S. Department of Transportation has noted:

> [A] participating airline should have some ability if practicable to persuade travel agencies to use a system or similar electronic service that provides better service or charges lower fees. Insofar as Sabre's contract would bar this, it would keep an airline from taking steps to reduce its CRS expenses. It would also be directly contrary to our conclusion in the parity clause rulemaking that airlines should normally be free to choose the quantity and quality of service bought from their suppliers.[10]

Enforcement of parity clauses creates a barrier to entry for GNEs, which ultimately leads to higher prices for consumers and less innovation in distribution in the end. CRSs have abused parity clauses in an effort to prevent the introduction of rationality into the market place. For example, Amadeus argued that the parity clause in its PCA with American and Northwest prohibited the airlines from imposing cost recovery charges on agencies which did not opt-in to a lower-cost distribution model. All parity clauses – whether dealing with fares, charges, incentives or otherwise – should be banned.

2. Worldwide Participation

Most CRSs require airlines to provide worldwide content as a condition of participation. In other words, American could not pull out of a CRS in a particular market where its fees are excessive unless we were prepared to exit that CRS entirely; it generally would not make sense to risk worldwide bookings over CRS pricing in a smaller market. This makes it even more

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[10] 67 Fed. Reg. 69,366, 69,393 (November 15, 2002).

difficult for airlines to consider withdrawal from a CRS as a method of counteracting CRS market power. Airlines should have the right to control where CRSs can distribute content, as this will create a more balanced competitive situation – one in which uncompetitive CRS pricing in a certain region can be combated by pulling content for that region (or any other region to balance out the leverage) without doing so worldwide.

3. Fare Bias

While Question 8 below focuses on display bias, CRSs have tried to use fare bias as a competitive weapon against the airlines. For example, when Northwest imposed a cost recovery fee on travel agencies that used high cost CRSs, Sabre changed Northwest's fares in its displays to add a surcharge in the same amount. It is completely inappropriate for CRSs to change the fares filed by carriers, and serves only to give the CRSs another in a broad arsenal of weapons they can use to maintain and strengthen their market power over airlines. Accordingly, the Code of Conduct should prohibit CRSs from changing the fares filed by airlines.

Q2. Given the described market developments, has the risk of market foreclosure not reduced and are general competition rules (Article 82 of the Treaty in particular) not a sufficient remedy/deterrent against these risks?

American believes that the Commission would be justified in launching an investigation of the CRS industry for violations of Article 82 *even with* the Code of Conduct in effect. Since CRSs are not a substitute for each other on the upstream side of the market, they enjoy a dominant position that is being consistently abused. Booking fees are already excessively high, and CRSs are able to impose price increases at will that bear no relation to their costs. Thus, while Article 82 may well be a remedy and/or deterrent to CRS abuses of market power, the Commission should not repeal the Code of Conduct and wait for those abuses to get even worse than they are today before taking action.

Q3. Would the air transport distribution market – including small and medium-sized companies involved in the market – be ready for the introduction of greater pricing freedom (such as through the removal of the rules of non-discriminatory fees given in article 10)?

The Code of Conduct's ban on discriminatory CRS pricing is a rule that now does more harm than good. Like mandatory participation rules, the ban on discriminatory pricing was crafted at a time when airline and CRS ownership was intertwined, and it sought to address incentives created by airline CRS ownership that no longer exist. For example, some alleged that airline CRS owners would use discriminatory pricing to gain strategic advantage over other carriers that posed a competitive threat. Likewise, concerns existed that major carriers – most of which had stakes in a CRS – could take care of themselves, while smaller, unaffiliated airlines would be the most likely to suffer in a discriminatory pricing environment.

However, these concerns have been largely resolved in recent years. CRSs have independent ownership and now pursue their own best interests, without regard to the interests of their prior owners. Ironically, smaller new entrant airlines often enjoy a *stronger* bargaining position than their larger competitors that once owned the CRSs. The traditional network carriers still distribute most of their tickets through travel agencies and CRSs. Given their customer volumes and worldwide networks, they still have no choice but to participate in every CRS. In contrast, new entrants are less reliant on travel agencies and CRSs. For these carriers, not participating in one or more CRSs is a viable alternative. In addition, since consumers perceive the new entrants as offering lower prices, their content and participation is particularly valuable to the CRSs. For these reasons, many "low cost carriers" are uniquely positioned to obtain the best pricing from the CRSs.

The Code of Conduct's ban on discriminatory pricing no longer protects smaller carriers from the alleged anticompetitive practices of larger carriers that once owned the CRSs. In today's environment, the requirement of uniform pricing only serves to forestall negotiation on CRS prices and to enhance CRS market power. Price negotiation is a hallmark of any competitive market, and market forces will never take hold in the CRS market as long as regulation precludes dynamic pricing. Absent the tie between airline and CRS ownership, the ban on discriminatory pricing is a regulation whose justification and time has passed.

Q4. Given the changes in the market and in the ownership and control structures of the CRS providers, are the specific obligations imposed on parent carriers still needed? Or should these obligations be reviewed or lifted?

When the Code of Conduct was adopted in 1989, the ownership and control structure of the CRS industry was much different than it is today. Currently, only Amadeus is under airline ownership – and even that is a relatively diffuse holding split between Air France, Iberia and Lufthansa. Given that fact, the Code of Conduct's specific obligations imposed on parent carriers are no longer necessary, although their continued presence in the Code is largely irrelevant to American. Rather, the Commission should focus the Code of Conduct on reducing or eliminating CRS market power as set forth in our response to Question 1.

Q5. Should airlines remain free to invest in CRS providers and control them or should there be rules that restrict the possibility for airlines or other sectors to control CRSs? Are specific transparency requirements needed for CRS providers that are not publicly listed on a stock exchange?

CRS market power is not eliminated by preventing airlines from owning and controlling them. In fact, CRS market power was *enhanced* when airlines began to divest their interests in CRSs. American does not believe that regulating the ownership and control of an industry leads to inherently pro-competitive results; indeed, it often has the opposite effect. Thus, while the Commission may want to retain the Code's restrictions on parent carriers to ensure that future airline ownership of CRSs does not result in new anti-competitive effects, the focus today should be on addressing the market power wielded by existing CRSs against the airline industry.

Q6. Are the provisions given by article 6 of the Code of Conduct to make the data from Marketing Information Data Tapes (MIDT) available to groups of airlines and subscribers still pertinent in the present market context?

MIDT data certainly has its limitations, particularly with measuring the market shares of new entrant carriers that sell tickets almost exclusively through direct bookings. However, MIDT is still an extremely useful tool for planning purposes. American has invested a great deal of time and effort into refining MIDT data in an effort to adjust the figures to reflect actual market shares – not simply market shares for tickets booked through travel agencies. Given the continued value of MIDT, American believes that the provisions contained in article 6 continue to be important. Allowing CRSs to discriminate against certain carriers in the provision of MIDT is to invite mischief. If MIDT is made available to one carrier, it should continue to be made available to all.

Q7. Should travel agents' identity no longer be revealed in the MIDT?

American believes that the Paper's comments on the use of MIDT data to measure an airline's market share with a particular travel agency are misdirected for two reasons. First, eliminating this data from MIDT would only force airlines and travel agencies to use another source of information to measure and validate agency performance. In fact, many airlines have supplemented MIDT with other products for corporate dealing because of MIDT's inherent limitations. Of course, this product comes at an additional cost, and expanding its application to agency programs would only increase that cost to the airlines. Thus, if the Commission were to remove travel agency identifiers from MIDT data, it would only serve to increase costs for airlines – the underlying agency contracts would continue to exist.

Q8. Are the Code of Conduct's detailed prescriptions with regard to the principal display of a CRS still pertinent in the present market context? Are they still required to ensure a neutral choice? Or can they be simplified or removed? In case stakeholders favour a simplification or removal of these prescriptions, could they – where possible – quantify the reduction in administrative costs that such a regulatory change would induce?

While display bias may certainly still be an issue worth regulating, it is a far less important issue than it was in the past given the shift away from airline ownership of CRSs. Far more important is prohibiting CRSs from biasing an airline's *fares* by adding surcharges designed to undermine an airline's pricing structure, as discussed in our response to Question 1. Consumers deserve transparency from CRSs so that they are able to understand the difference between the fare they are paying airlines and the service charge they are paying travel agencies.

Q9. Would greater pricing freedom with regard to booking fees allow more rail services to be offered on the CRS displays? Do we need additional measures to promote the sale of rail tickets via CRSs?

CRSs currently offer rail services that are marketed by airlines as a part of a codesharing arrangement, and it is obvious that consumers would benefit from additional distribution outlets for more European rail services. However, the solution is not to create a double-standard under which some modes of transport receive beneficial pricing at the expense of others. Rather, the Commission should seek to make booking fees more affordable for *all* travel service providers. If CRS booking fees were to come down from their inflated levels, rail services might find participation in those systems worthwhile if the benefits outweighed the costs. The same is true for new entrant carriers. For example, lower booking fees might even motivate carriers like Ryanair or easyJet to expand their distribution to CRSs. The Commission should take steps to eliminate (or at least reduce) CRS market power – accomplishing that will naturally lead to expanded participation in CRS distribution, which benefits agencies and consumers.

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As always, American appreciates the opportunity to make its views known to the Commission on issues relevant to air transportation in Europe. We are proud to serve the European Union with our transatlantic flights and through our codeshare partners – particularly within the **one**world Alliance. If you have any questions regarding our response, or need further information on this or any other topic, please do not hesitate to let us know.

Very truly yours,

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