

Statement of Daniel M. Kasper**LECG****Cambridge, MA****Introduction**

I have been asked by Orbitz to assess and provide comments in this proceeding on a range of economic, competition, and public policy issues that have been raised with regard to electronic distribution of air transportation generally, and with respect to Orbitz in particular. I am currently Managing Director of the Cambridge, MA office of LECG, a firm that specializes in financial and economic analysis. For more than twenty years, my professional activities – as a consultant, as an expert witness on airline matters, as an academic, as an official at the Civil Aeronautics Board, and as a Member of the U.S. National Airline Commission in 1993 -- have been focused on competition, public policy, and economics of the airline industry.

My initial comments review the role and competitive significance of e-commerce both in the U.S. economy generally and in airline industry in particular. They then assess the economic and competitive implications of the services contemplated by Orbitz and close with a review of the probable effects on competition and economic efficiency of alternative public policy/regulatory responses to the emergence of Orbitz and other new entrants in the air travel distribution business.

The Role and Competitive Significance of E-Commerce in the Economy

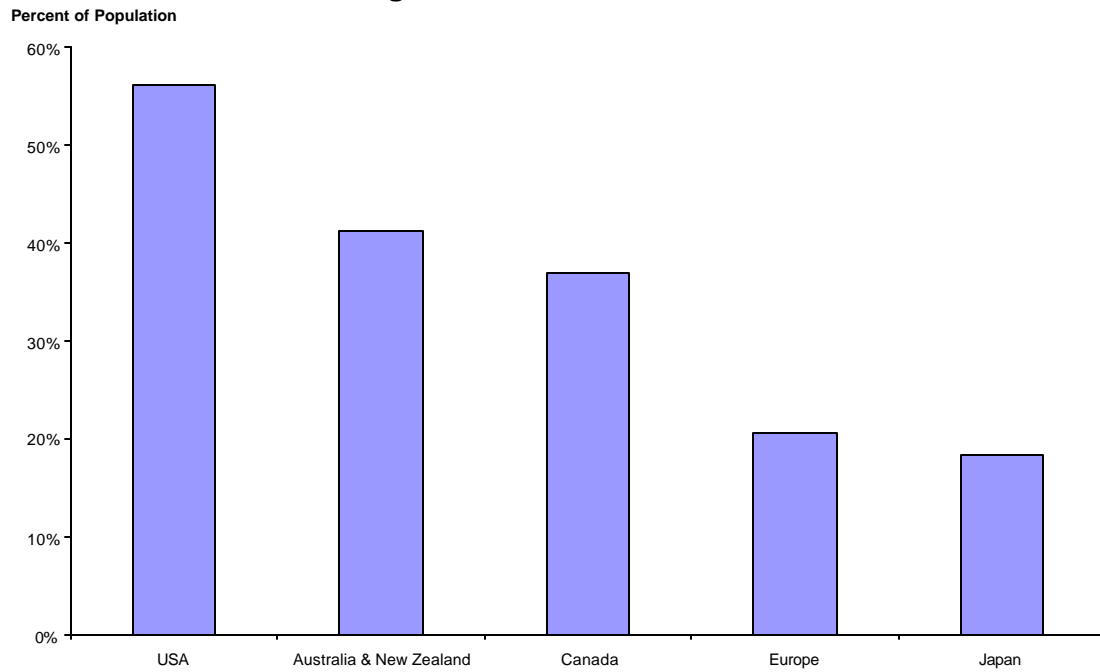
The advent of Electronic Commerce (or e-commerce) has had a profound effect on business and the economy worldwide. Fueled by the wide availability of increasingly inexpensive computing power and the proliferation of the Internet in general, e-commerce has drastically improved consumer welfare, reduced market frictions, lowered purchasing, marketing and distribution costs, and in many cases, has been responsible for allowing new markets to evolve. E-commerce has forced traditional firms to become more competitive, reduce prices and increase service offerings. Moreover, as new ways of accessing the Internet emerge and both businesses and consumers grow more confident of the security and privacy of the Internet, the impact of e-commerce will only increase.

E-Commerce Will Account for Half A Trillion Dollars in Economic Activity in the United States This Year

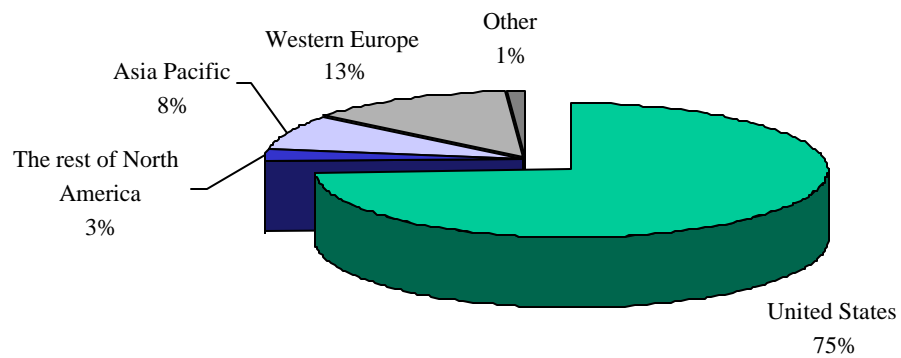
For the year ending July 2000, e-commerce will account for half a trillion dollars of economic activity in the United States alone.¹ The willingness of U.S. firms and consumers to embrace new technology in general – and the Internet in particular – has made it the global leader in e-commerce. As demonstrated by Figure 1 below, Internet penetration in the U.S. is substantially higher than in other developed countries. Consequently, as shown in Figure 2, even though the U.S. economy accounts for only 23% of the world's output, it accounts for nearly 75% of all e-commerce.²

¹ Source: Forrester Research.

² Sources: Forrester Research, CIA World Factbook,
(<http://www.odci.gov/cia/publications/factbook/index.html>)

Figure 1: Internet Penetration

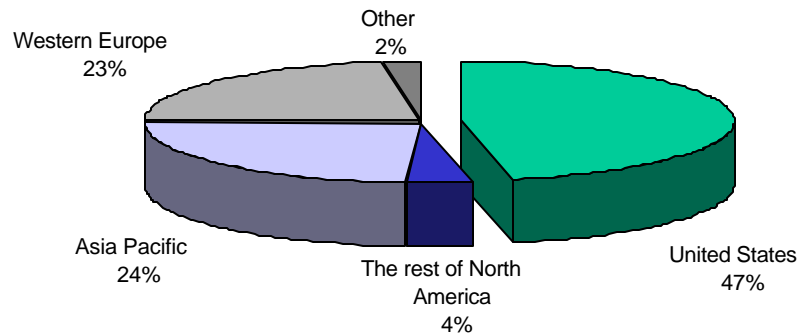
Source: <http://www.netsizer.com>

Figure 2: Total E-commerce Sales, 2000

Source: "Global eCommerce Approaches Hypergrowth", Forrester, April 18, 2000

Furthermore, despite the fact that e-commerce is growing faster in other areas of the world, analysts predict the U.S. will still account for nearly half of all global e-commerce in the year 2004.

Figure 3: Total E-commerce Sales, 2004



Source: "Global eCommerce Approaches Hypergrowth", Forrester, April 18, 2000

"Hands off" Regulatory Policy has Been Instrumental in the Success of E-commerce in the U.S

Realizing the potential for enormous growth in both productivity and output from the Internet and E-commerce, the U.S. regulatory bodies decided at an early stage to adopt a "wait and see" approach as opposed to pre-emptive regulation. For example, in 1997, the White House issued "A Framework for Global Electronic Commerce" which supported a non-regulatory, market orientated approach to electronic commerce.

For electronic commerce to flourish, the private sector must continue to lead... Accordingly, governments should encourage self-regulation wherever appropriate and support the efforts of private sector organizations to develop mechanisms to facilitate the successful operation of the Internet... Unnecessary regulation of commercial activities will distort development of the electronic marketplace by decreasing the supply and raising the cost of products and

services for consumers the world over... Business models must evolve rapidly to keep pace with the break-neck speed of change in the technology; government attempts to regulate are likely to be outmoded by the time they are finally enacted, especially to the extent such regulations are technology-specific. Accordingly, governments should refrain from imposing new and unnecessary regulations, bureaucratic procedures, or taxes and tariffs on commercial activities that take place via the Internet.³

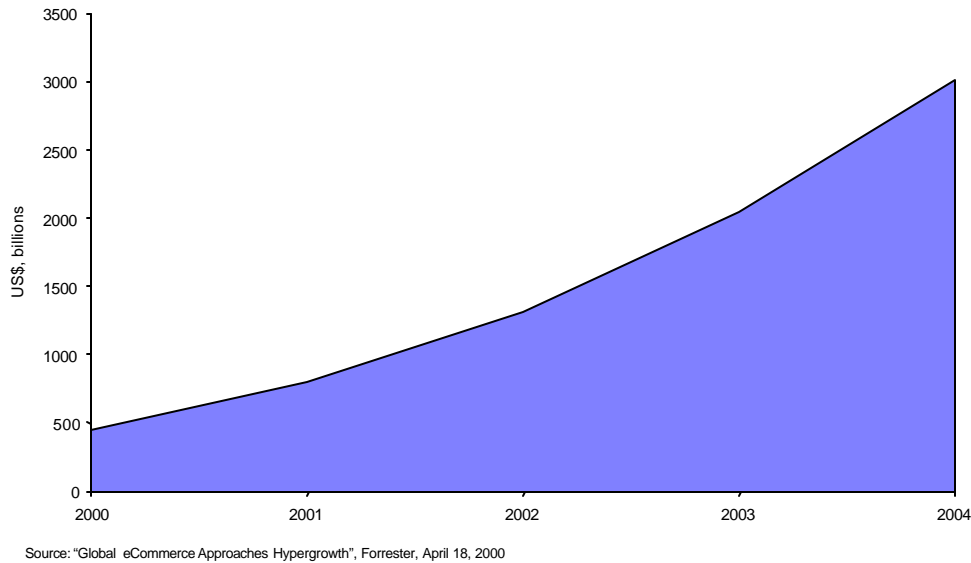
These early decisions have clearly paid huge dividends to consumers, firms and indeed the economy as a whole. Firms have benefited from increased productivity and lower costs, consumers have benefited from lower prices and a greater selection of goods and services, and the economy generally has benefited from increased employment and output, while prices have remained in check.

Business to Business E-commerce Accounts for the Overwhelming Majority of all E-Commerce

E-commerce has traditionally been separated into two main categories: Business to Business (B-to-B) and Business to Consumer (B-to-C). B-to-B e-commerce is broadly defined as sales of goods and services between firms, transacted over the Internet. B-to-B e-commerce is by far the largest segment of the Internet economy, accounting for 92% of all electronic commerce worldwide and \$450 billion of economic activity in the U.S. last year. Indeed, as shown by the following graph, B-to-B e-commerce is predicted to grow at a compound annual rate of 61% and by 2004 will account for 25% of national GDP.⁴

³ "Framework for Global Electronic Commerce." The White House, July 1, 1997.

⁴ Source: "Global eCommerce Approaches Hypergrowth", Forrester, April 18, 2000

Figure 4: U.S. B-to-B E-commerce

The success of e-commerce generally – and B-to-B e-commerce in particular – stems from its ability to make markets more efficient in an economic sense. B-to-B e-commerce has been successful in creating more efficient markets by reducing market risks caused by informational asymmetries and by adding more liquidity to markets. Added liquidity is a result of an electronic market's ability to aggregate buyers and sellers at a very low cost, especially when they are spread out across a large geographic area. A more liquid market tends to drive prices closer to costs, which in turn forces sellers and producers to become more efficient. For example, a firm's procurement department can use B-to-B exchanges to instantaneously receive and compare price quotes from hundreds or even thousands of potential suppliers. E-commerce marketplaces also have the ability to diffuse information more efficiently. Reducing asymmetric information in markets plays an important role in making them more efficient since it reduces the chance of market failure (i.e., the classic "lemons" problem) by reducing risk. For example, B-

to-B exchanges often provide escrow and quality verification services in addition to dispersing information regarding buyer and seller reputations. Finally, transaction costs for both buyers and sellers are typically very low when conducted via e-commerce, which adds liquidity to markets and makes them more efficient.

Business to Consumer E-commerce

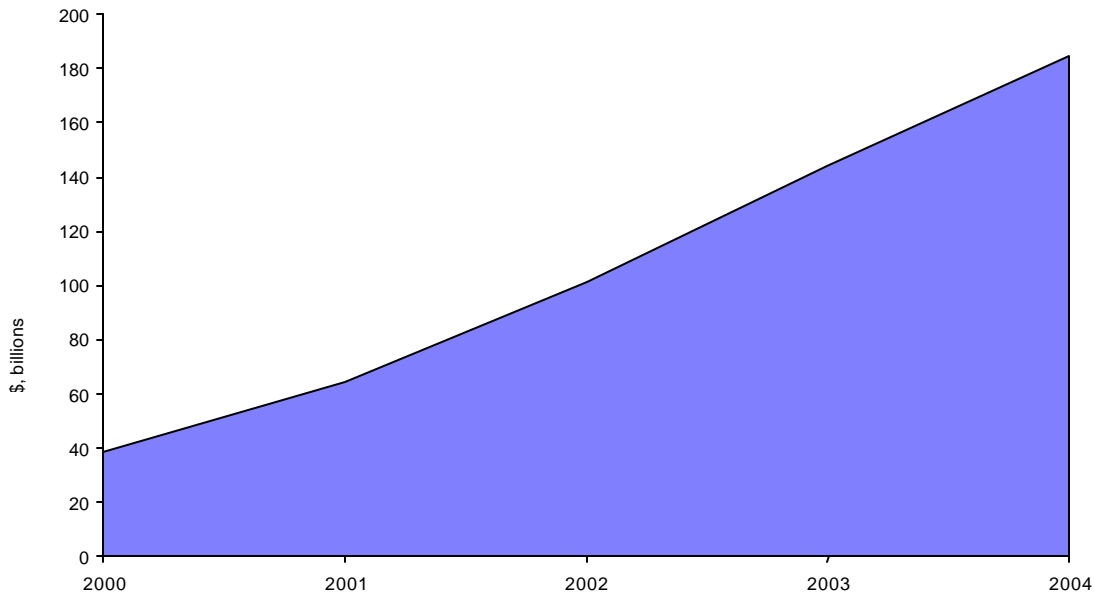
B-to-C e-commerce is defined as sales between firms and consumers transacted over the Internet, for example, someone buying a book from Amazon.com. B-to-C e-commerce sales were \$18.8 billion in the first half of 2000, or 1.2% of all retail sales.⁵ The following table shows the main B-to-C categories of goods and services:

Table 1: U.S. B-to-C Spending by Category July 2000	
Airline tickets	17%
Books, music and videos	10%
Hotel reservations	10%
Computer hardware and software	13%
Consumer electronics	6%
Apparel and Footware	5%
Car rental	5%
Toys/Videogames and sporting goods	5%
Office supplies	4%
Food/beverages	3%
Health and beauty	3%
Furniture, home décor	3%
Jewelry	2%
Tools, hardware, garden supplies	2%
Appliances	2%
Flowers	1%
Other	9%
Source: NR/FR Forrester Research	

⁵ Sources: Forrester Research and the Bureau of Labor Statistics.

B-to-C e-commerce in the United States is expected to grow at compound annual rate of 48% and will reach \$184.5 billion by 2004, accounting for 4.3% of all retail sales.⁶

Figure 5: U.S. B-to-C E-commerce



Source: "Global eCommerce Approaches Hypergrowth", Forrester, April 18, 2000

The evolution of B-to-C e-commerce has benefited consumers in a number of ways. First, since price information can be updated and consolidated almost instantaneously from sellers throughout the country (and indeed the world) – vigorous price competition can be realized if such information is provided in an unbiased fashion. When consolidated and displayed fairly, this product and price information has the effect of driving prices toward the sellers' costs. Secondly, e-commerce allows consumers to purchase goods and services from outside their geographic area giving them a much wider choice of products and services. Thirdly, consumers often benefit from the lower distribution costs

⁶ Sources: Forrester Research and the Bureau of Labor Statistics.

of transacting online in the form of lower prices or other value added features and services. For example, airlines typically offer additional frequent flyer miles or percentage discounts to consumers who purchase tickets via their own websites. Finally, e-commerce has afforded consumers the ability to allocate their time more efficiently, since it allows them to purchase goods and services when it is most convenient for them.

Consumer to Consumer E-commerce

A third, less frequently cited form of electronic commerce is Consumer to Consumer (C-to-C). Examples of C-to-C e-commerce include Internet hosted auctions conducted by companies such as E-bay or U-bid, where individuals may buy and sell personal belongings. Although at first glance, one might think that the volume of goods being sold by such methods is small, E-bay alone has conducted over 60 million auctions since 1995 and in the second quarter of 2000 conducted auctions valued at over \$1.3 billion.⁷ Added security features, such as the ability of individuals to accept credit card payments, have helped to fuel the rapid growth of this type of e-commerce.

New and Faster Ways of Accessing the Internet Will Increase the Role of E-Commerce

The overwhelming majority of transactions conducted over the Internet are performed through personal computers or terminals (known as thin clients) connected either via traditional dial-up services, through an institutional (corporate) local area network (LAN) or via various broadband methods such as digital subscriber lines (DSL) or cable modem. Traditional dial-up methods of accessing the Internet are notoriously slow, which has undoubtedly hampered the growth of B-to-C e-commerce. As broadband access to the

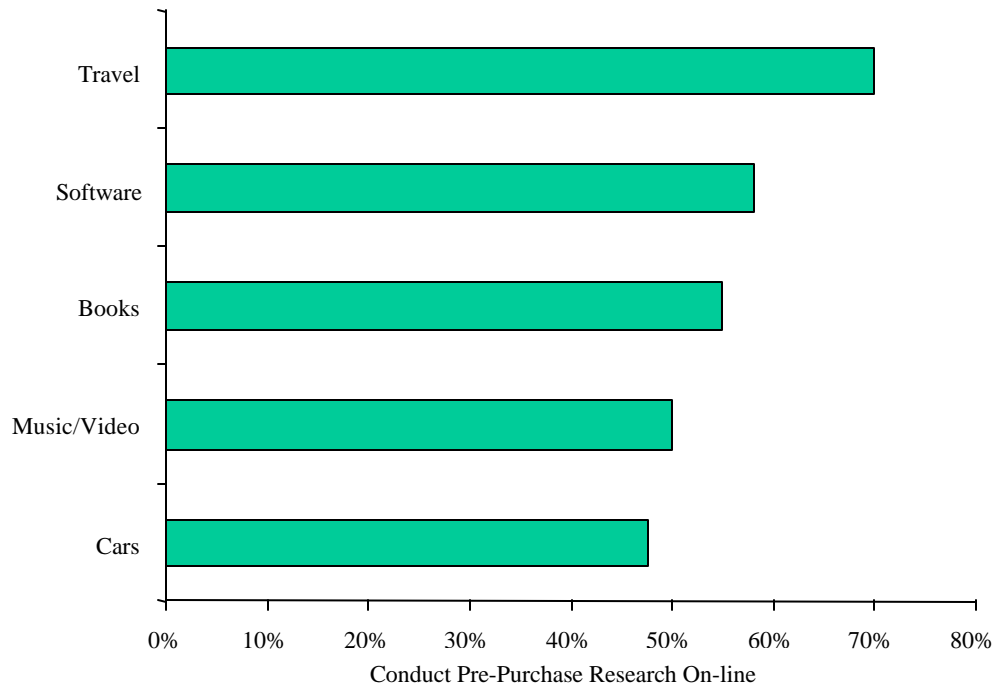
Internet becomes more affordable and widely available, merchants will be able to provide richer content regarding items they wish to sell, and hence, reduce the gap between the “virtual” and “actual” shopping experience. Furthermore, emerging technologies such as wireless access to the Internet will continue to fuel additional sources of growth for e-commerce.

The Role and Competitive Significance of E-commerce in the Aviation Industry

As noted in Table 1 above, airline tickets account for the largest segment of B-to-C e-commerce. Not only do consumers spend more on airline travel than any other category, they spend more time researching travel than any other topic, as shown by the following figure.

⁷ Source: <http://pages.ebay.com/community/aboutebay/overview/benchmarks.html>.

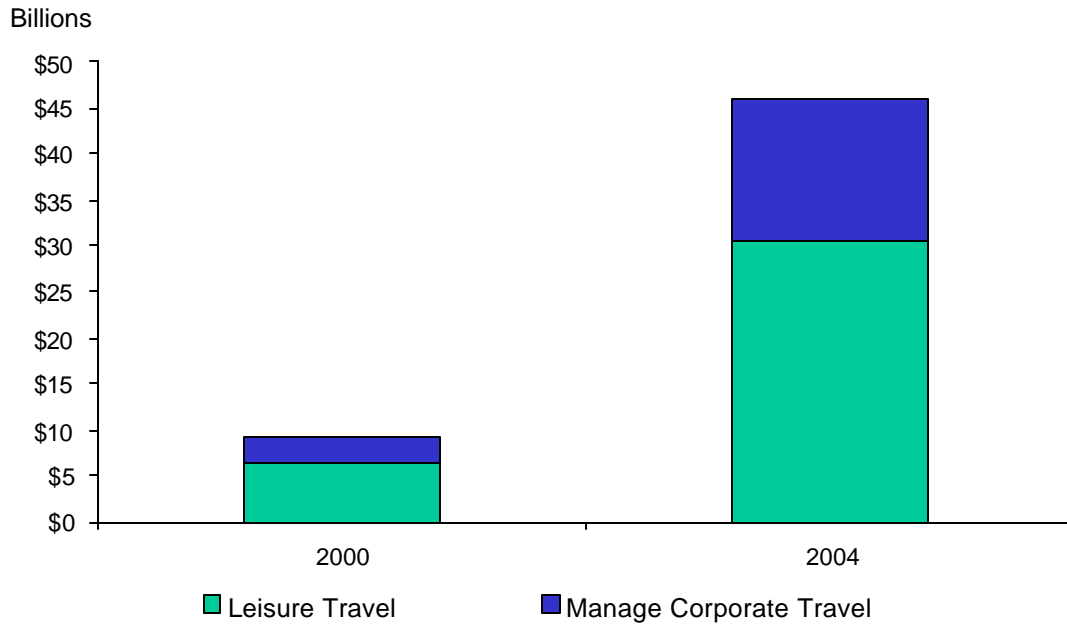
Figure 6: More Internet Users Research Travel On-Line than Any Other Product



Source: Jupiter Communications

In addition to the \$6.4 billion of travel services purchased online by consumers in 2000, businesses will procure \$2.8 billion of travel services online in 2000 and this amount is expected to grow to \$15.7 billion by 2004.⁸

⁸ Source: "Sabre Buys a \$757 Million Lifeline: GetThere," The Forrester Brief, Forrester Research, September 8, 2000.

Figure 7: Online Travel Purchases

Note: 2000 leisure travel is a Forrester estimate for 1999.

Source: Forrester research

It is no coincidence that air services constitute one of the largest segments of the Internet economy. The informational demands required to sell airline services are enormous. Indeed, it is estimated that any given trip purchased by a consumer must be selected from a set of over 1 billion possible itineraries. Combined with the perishable nature of airline services, these informational requirements have often resulted in market inefficiencies – for example, the inability to coordinate potential passengers and airlines to create a market for distressed inventory (excess seats which are still available shortly before the day of a scheduled flight’s departure).

Some Background on Airline Ticket Distribution

As airline travel grew more popular during the 1960's, so did the complexity and amount of data required in order to provide airline services. To keep track of all the information required, airlines set up internal reservation systems which tracked their seat availability and linked each seat sold to a passenger record. In 1962 American Airlines, with the help of IBM, was the first airline to develop a computerized reservation system (CRS), known as SABRE. However, it was not until 1976 that a CRS could be used to book tickets on one of numerous participating airlines. As CRSs became more powerful, they grew to become the predominant means by which airline tickets are booked, and today account for nearly 80% of all airline ticket bookings⁹.

Airline Distribution Costs

Today, airline distribution costs account for as much as 20% of an airline's operating expenses.¹⁰ The single largest distribution cost is a travel agent's commission, currently about 5% of a ticket's price.¹¹ Other distribution costs include ticket processing fees – costs related to the currency which traditional airline tickets are printed on – in addition to credit card and CRS booking fees. CRS booking fees are paid based on the number of segments on a given itinerary. Thus, based on a \$3.54 CRS booking fee per segment, an advance purchase roundtrip ticket involving a connection in both directions costing \$300

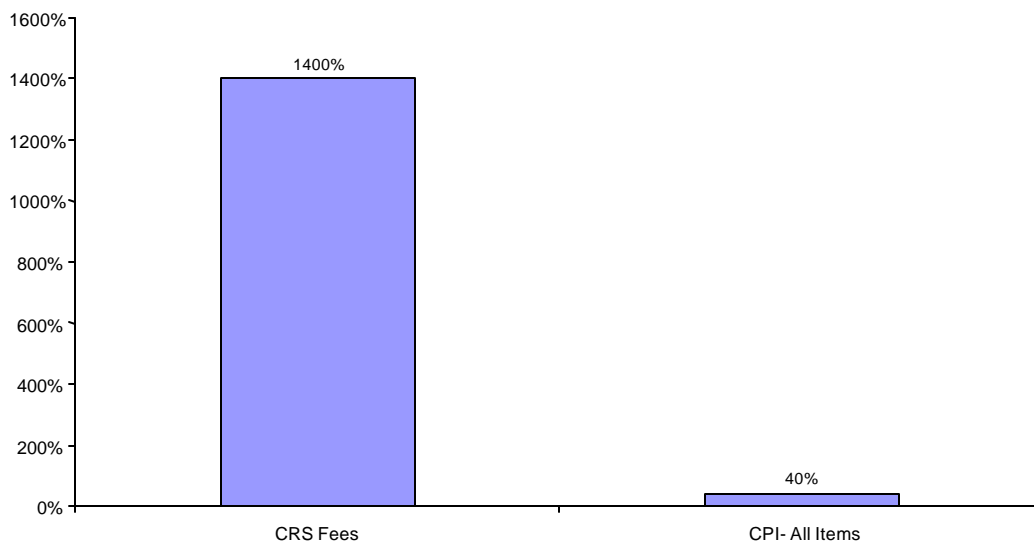
⁹ "Airlines: Reshaping the Industry's Business Model", Merrill Lynch, April 8, 1999.

¹⁰ "Airlines: Reshaping the Industry's Business Model", Merrill Lynch, April 8, 1999.

¹¹ Base travel agent commissions i.e., without overrides. Commissions are also subject to caps, currently averaging around \$50 for domestic roundtrip tickets and \$100 for international roundtrip tickets. Source: "Northwest Airlines and KLM Announce Changes to Commission Structure", October 11, 1999, www.nwa.com and "United Airlines Cuts Travel Agent Commissions", October 7, 1999, www.webtravelnews.com.

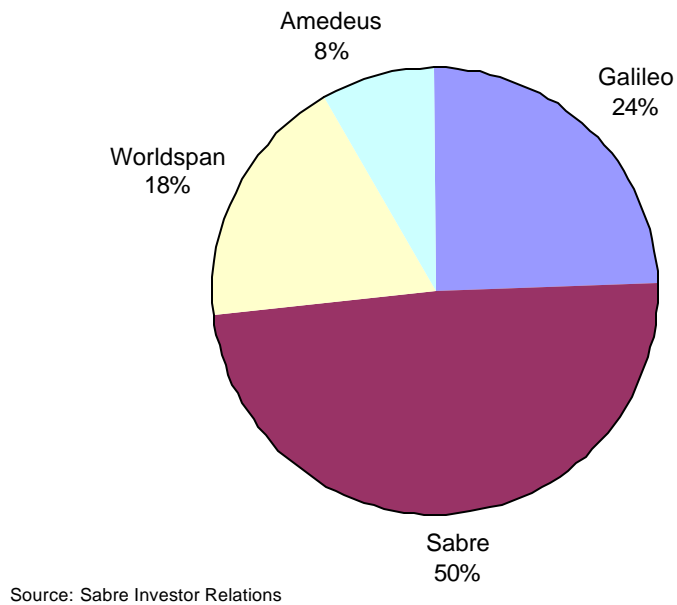
would generate \$14.16 in CRS fees, or 4.72% of the ticket's cost.¹² It is noteworthy that, notwithstanding a steep and secular decline in the cost of computing power, CRS booking fees have consistently increased as the market for CRS services has become increasingly concentrated.¹³

**Figure 8: Growth in CRS Fees vs. the CPI
1983-1999**



Source: Bureau of Labor Statistics and Testimony of Jeffery G. Katz before the U.S. Senate Committee on Commerce, Science and Transportation, July 20, 2000

¹² Kenneth Mead testified that the CRS booking fee per segment is \$3.54. "Internet Sales of Airline Tickets", Statement of the Honorable Kenneth M. Mead, July 20, 2000, CR-2000-111

Figure 9: U.S. CRS Market Share

The Evolution of Airline E-commerce

Propelled in part by the widespread adoption of computer technology and the Internet by the public and the fact that CRS providers have steadily increased booking fees despite the advances in computer and telecommunications technologies, airlines have increasingly sought to use the Internet and other new technologies to increase the number of channels by which they sell their services, thereby lowering their distribution costs. In November 1995, Alaska Airlines became the first carrier in the U.S. to sell tickets via its own Internet site and today, every major airline operates an Internet site on which

¹³ The dramatic decline in computing costs has been well documented. For example, the cost per million of

passengers can book tickets directly. These new technologies have helped airlines reduce costs and manage the ever increasing amounts of data required to operate large networks. Moreover, in many instances, combinations of new technologies have helped airlines to reduce the market inefficiencies related to the perishable nature of their product. For example, airlines are now able to use the Internet to sell their distressed inventory through their own “last minute” electronic fares. The Internet enables airlines to market their distressed inventory almost without cost through direct e-mail to passengers interested in spontaneous leisure travel. Furthermore, because e-fares avoid travel agency commissions and CRS booking fees, it costs substantially less for an airline to book an electronic ticket via its own website compared to a traditional ticket booked through a travel agent. These economies make it economically feasible for the airline to offer last minute tickets at a price low enough to attract such discretionary travelers. The Internet has also allowed airlines to distribute services through a number of other channels such as Priceline.com, which sold 1.25 million tickets in the first quarter of 2000.¹⁴

Since airlines do not have to pay travel agent commissions, CRS booking or ARC processing fees for tickets booked through their respective websites, they have a clear incentive to sell as many tickets as possible through this channel. Nevertheless, online purchases through airline websites account for only a small proportion of all ticket

instructions per second (MIPS), a standard measure of computer processing efficiency, has fallen from \$480 in 1978 to \$4 in 1995. (www.neweconomyindex.org)

¹⁴ Source: Equity Research, Priceline.com. Prudential Securities, April 24, 2000.

sales.¹⁵ This is because the overwhelming majority of travelers prefer to make plans via a travel agent, either traditional or online. Travel agents not only provide travelers with the ability to search across multiple airlines, they typically save time and provide one-stop shopping for other services such as hotels and rental cars.¹⁶ Unfortunately, the online travel agent services business has become highly concentrated in just a few years. As the following table shows, Travelocity (owned by Sabre) and Expedia (owned by Microsoft) together account for over 60% of all online travel agency bookings.

Table 2: 1999 Online Travel Agency Market Share	
Travelocity/Preview Travel/ITN.net	39%
Expedia/Travelscape	24%
Priceline.com	10%
Cheap Tickets	4%
Others	23%
Source: PhoCusWright	

Despite the fact that online travel agencies embrace many new cost reducing technologies such as electronic ticketing, they still rely on a few CRS systems that are costly, have technological limitations and are hampered by well-known software biases. These biases tend to limit the ability of travel agents (both traditional and online) to find the lowest available fare on a given routing. Consequently, in many cases consumers have not been able to realize the full benefit of vastly improved technology when they book airline tickets online.

¹⁵ For example, in 1999 US Airways and Continental booked 6% and 3.8% of their tickets on their respective websites. Low fare airlines typically book a larger percentage of their tickets via their websites. For example, Southwest alone has sold over \$1 billion of tickets via their website and expects to book 30% of its tickets online this year.

¹⁶ Some airline websites now list flights on competing carriers and offer additional services such as hotel and rental car booking.

Orbitz Will Bring New Technology – and New Competition – to the Distribution of Air Transportation

Orbitz offers the first airline reservation search engine designed to take full advantage of the enormous advances in computing power and software. Thus, whereas the older software used by traditional CRSs eliminates the overwhelming majority of itineraries from consideration before they are checked for prices, Orbitz software compares prices for up to 1 billion different itineraries and then returns the lowest available fares and best itineraries to the user, free of any bias in selection or display. Thus Orbitz fills an important niche for both travelers and travel agents seeking comprehensive and unbiased searches, i.e., without the shortcomings and biases of traditional CRSs.

In addition, Orbitz intends to provide an equally critical service for airlines (and their customers) by helping to lower airline distribution costs. As discussed previously, CRS fees paid by airlines have increased sharply – some 1,400 per cent since 1983¹⁷ -- despite the steep and rapid decline in the cost of computing over that same period. In light of the Department's experience regulating CRSs, these results should come as no surprise to DOT. Indeed, every time the Department has reviewed CRSs, it has concluded that these systems must be subjected to regulation by the Department in order to prevent the abuse of their inherent market power.

In an important sense, then, Orbitz can be understood as simply an organizational vehicle for harnessing the advances in computing and software to reduce distribution costs and to reduce the dominant role currently enjoyed by CRS vendors. It seeks to accomplish this

¹⁷ See Figure 8, *supra*.

reduction in costs by rebating an amount equal to some portion of the booking fees each airline participant paid for bookings through Orbitz – that is, by competing against other CRS-based distribution channels on the basis of price. In addition to directly reducing distribution costs, by creating a new distribution alternative, Orbitz will thus help to break the stranglehold on airline distribution currently enjoyed by the existing CRSs and provide an important new source of competition to the dominant, established on-line agencies.

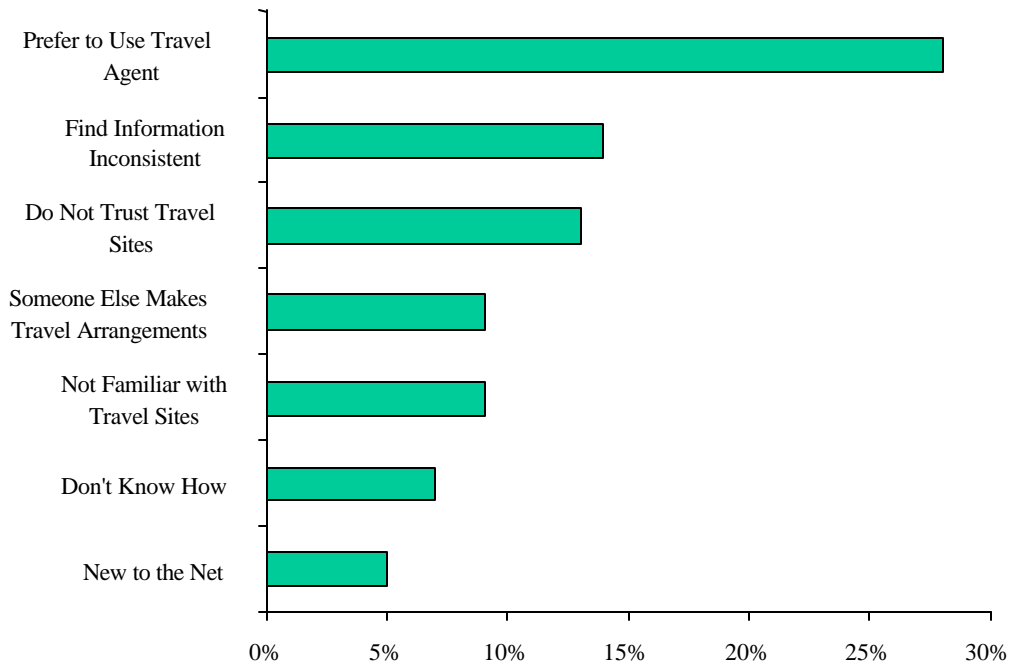
Access to All Public Fares Is Central to Orbitz's Strategy and Success

In order to attract sufficient business from users to become economically viable, however, Orbitz's strategy requires that it offer unbiased access to *all* publicly available fares, including the tiny percentage of fares currently offered by airlines only on their individual websites. In return for providing Orbitz with access to 100% of its publicly available fares rather than the 99.9% of fares it currently makes available to all marketing channels, an airline will get a substantial discount on distribution costs applied to all fares sold by Orbitz. (This discount would amount to approximately 30% of the booking fees a carrier pays on bookings through Orbitz and that would presumably be incurred in booking through Travelocity or Expedia.) In addition, participating airlines have assurances that all displays will be unbiased and that each airline will retain the ownership and control of its own individual booking data, both important competitive concerns particularly for small and new entrant airlines. By making it more likely that an

airline's low fares will be found and displayed, Orbitz's superior search and display capabilities will provide further benefits to both airlines and travelers.

It is therefore not surprising that those who have the most to lose from the success of Orbitz strategy – the entrenched CRS vendors that currently dominate airline distribution and the two dominant on-line agencies – have attacked Orbitz, alleging that Orbitz will permit its major airline owners to dominate distribution by not making all fares available to all distribution channels. Upon careful analysis, however, these concerns turn out to be, at best, considerably premature and substantially overstated. More likely, they are totally lacking in merit.

To begin with, even under its own highly optimistic assumptions, Orbitz will have only a tiny share --approximately 2 percent by 2004 -- of air transportation sales, a business that will continue to be dominated for the foreseeable future by the travel agency/CRS distribution channel.¹⁸ The share of airline distribution handled by travel agencies/CRSs has increased significantly in the two decades following airline deregulation. Today, some 80% of all airline tickets are sold by travel agents who are required, as a practical matter, to utilize a CRS to make the booking. Thus, it is clear that the vast majority of travelers prefer to use the services of a travel agent to book their air travel arrangement, a situation that is unlikely to change substantially for the foreseeable future.

Figure 10: Top Reasons Consumers Don't Purchase Travel On-Line

Source: "Internet Travel", Bear Stearns, April 2000

Moreover, given the volume of inventory that each airline must sell every day, the highly perishable nature of those seats (and their associated revenues) and the fact that most flights depart with some empty seats¹⁹, no airline can afford to withhold any substantial portion of its seat inventory from any significant distribution channel. But some fares – typically for “distressed inventory”, i.e., seats that would otherwise go unsold – are priced so low as to be unprofitable if an airline were required to pay the normal commission, CRS and ARC fees. Therefore, every airline now offers so-called “e-fares”

¹⁸ Federal Register, Vol. 65 No. 142, July 24, 2000, Proposed Rules

¹⁹ The system-wide load factor for U.S. scheduled airlines in 1999 was 71 percent. Air Transport Association of America, <http://www.air-transport.org>.

that are available for purchase only on its own website.²⁰ These fares appear to constitute only 1/10 of 1 percent of all airline fares.²¹

As a result, the distribution of air travel today continues to be dominated by only four providers of computerized reservations services through whose computers the overwhelming majority of airline bookings must pass.²² Since it is typically not in the economic interest of a supplier in any industry to have distribution channels that are dominated by other parties – particularly when those parties are able to exert significant market power -- producers in a wide range of industries have traditionally used their right to control their own products as one means of countering the market power of those that distribute their products. A producer's *ability* to deny distributors access to some of its products can thus be critical to a producer's ability to control or at least seek to influence the cost and quality of its product distribution. In this fundamental respect, airlines are no different than other producers and should not be treated differently. Obviously, this is a decision each airline will make individually. Those who try this course may not succeed, but it is important that they have the opportunity to try.

Recognizing that both travelers and airlines could benefit from a new distribution alternative, Orbitz has developed a strategy that would offer comprehensive search capabilities, totally unbiased displays, and a substantial reduction in the distribution costs airlines would be required to pay. Although the approximately 30 percent discount in

²⁰ A number of airlines also use "blind" website channels, including Priceline and Hotwire, to sell their distressed inventory. Customers using these channels are not told the identity of the airline until after they have purchased their tickets.

CRS booking fees offered by Orbitz is no doubt attractive to airlines, Orbitz nonetheless expects to account for 2 percent, at most, of all airline sales – and less than one sixth of on-line ticket sales – by 2004. Thus, for most airlines, the principal attraction of Orbitz is probably its potential to provide meaningful competition to the entrenched CRS suppliers. If as a result of competition from Orbitz, other distributors (and their respective CRSs) are forced to lower their prices and/or improve their services, the savings to airlines – and ultimately to travelers – will be substantial.

ESTIMATED SAVINGS FROM REDUCED BOOKING FEES²³

30% reduction on booking fees for 2% of sales = \$12.6 million

30% reduction on 20% of sales = \$126 million

30% reduction on 50% of sales = \$315 million

If airlines are required to make all fares available to all distribution channels, however, these savings would almost certainly not be realized. Since airlines would have no way to induce their customers to use their lower cost distributor (i.e., Orbitz), other vendors and their CRS suppliers would not need to offer airlines reductions in booking fees comparable to those offered by Orbitz in order to obtain access to all fares and airlines.

Even proposals that would require airlines to provide all vendors with access to all publicly available fares only if those vendors matched the terms offered by Orbitz are replete with practical and conceptual problems. To begin with, few (if any) existing

²³ Statement of Kenneth Mead, Inspector General, USDOT, “Internet Sales of Airline Tickets”, July 20, 2000

distributors – including Travelocity and Expedia – appear to have the ability currently to provide either the comprehensive search or unbiased display provided by Orbitz. Moreover, the price matching requirement would have to focus specifically on the net cost to airlines in order to ensure, for example, that Travelocity’s CRS owner did not simply raise its booking fees enough to offset any nominal “matching” reductions promised by Travelocity, thereby eliminating the contemplated savings. In addition to involving the Department in rather detailed oversight and regulation of pricing in the distribution of air transportation, the adoption of a matching “solution” would also require the Department to ensure that other vendors fully matched the data protection and non-bias provisions offered by Orbitz. In short, the imposition of an obligation on airlines to make all fares available through all channels subject to a “matching” condition would inevitably require the Department to become involved in detailed economic regulation of the distribution sector.

If the Department were to mandate MFN without requiring other parties to fully match Orbitz’s terms, however, it would perversely affect both Orbitz and consumer welfare. Without the overall distribution cost savings inherent in the Orbitz contracts, it is unlikely that airlines would make their low e-fares available to other distribution channels since the higher cost of using those channels would make these low e-fares uneconomic. Alternatively, airlines would be unlikely to offer these e-fares through Orbitz (or any other 3rd party distribution channel) and consumers would be denied the ability to conveniently compare and then book these on the same site. And if Orbitz is denied

²² Sabre Investor Relations

²³ Source: Sabre and Galileo Investor Relations and 10-K filings

access to the low e-fares that are currently available only on individual airline's websites, it would deprive Orbitz of a key element of its strategy for attracting customers to its site and reduce significantly the likelihood Orbitz will emerge as an effective competitive spur to the incumbent firms that dominate the CRS and electronic ticket distribution sectors²⁴

Even some who could be expected to welcome the advent of effective competition to the existing CRS providers have expressed concerns based on the fact that Orbitz would be owned, at least initially, by several major airlines. I believe these concerns are misplaced. To begin with, it is becoming increasingly common in e-commerce for competitors in an industry to cooperate in the development of common platforms (or channels) for dealing with firms that supply goods and services to that industry.²⁵ More importantly, even before the recent financial difficulties encountered by so-called "dot.com" companies, investing in a new B to C e-commerce venture, particularly one seeking to compete against entrenched incumbents in the highly concentrated CRS and electronic ticket distribution sectors²⁶ was likely to be viewed by investors as, at best, a high risk undertaking. Under more recent financial market conditions, investors are likely to be even more skeptical regarding the prospects for such a venture, particularly where – as here – the dominant incumbent on-line travel agents have entered into contracts giving them exclusive rights to the most heavily used Internet portals.

²⁰ For reasons explained above including, inter alia, the strong incentives faced by airlines to sell their highly perishable seat inventories, the demonstrated consumer preference for using travel agents to book air travel, and the huge share of airline bookings handled by travel agents, airlines will continue to make the vast majority of their fares available through travel agencies as well as other distribution channels.

²⁵ Examples include Chemdex and Convisint

²⁶ I note that these incumbents have entered into exclusive access arrangements with the largest internet portals

Moreover, since the success of Orbitz strategy depends in significant part on obtaining access to all fares – something that requires the cooperation, at a minimum, of most major airlines and since these same airlines would be among the principal beneficiaries of a reduction in distribution costs, it is surely not surprising that, before putting their own capital at risk, potential investors would demand strong evidence of major airline support for Orbitz. The willingness of airlines to invest in Orbitz lends important credence to the existence of significant expected cost savings. In addition, the use of a joint venture such as Orbitz is well established as an efficient and legitimate way to share such risks. Thus, the willingness of major airlines to invest in Orbitz signals to the financial markets the support for Orbitz that is critical to attracting other investors.

If the Department were to adopt regulations that effectively kill the threat of real competition posed to the entrenched suppliers of CRS and electronic distribution services by new entrant on-line ventures, it will have effectively foreclosed the possibility of relying on market forces to discipline the cost and quality of CRS services. What will then be left is a highly-concentrated business whose dominant players enjoy significant market power, insulated from the prospect of effective competition. Under these circumstances, the Department would have to consider seriously the establishment of a considerably more comprehensive regulatory regime than the current CRS rules, one that entailed more substantial regulation of CRS fees and competitive practices.

Since under even its most optimistic of assumptions Orbitz will be only a small player in the airline distribution for many years to come, it would be far more reasonable for the Department to avoid imposing regulations that “strangle the baby in its cradle” and instead let the forces of competition play themselves out under its watchful eye. If, as is likely, the effects of competition from Orbitz and possibly other new e-distributors, prove to be beneficial and efficiency-enhancing, the Department need do nothing further. If as its opponents allege, Orbitz is used for anti-competitive purposes, the Department retains the authority to institute a rule-making or enforcement proceeding at any time. In either case, the Department will have the benefit of actual experience with competition by Orbitz and others rather than basing its decision on speculation about what might or might not happen, and how or when it might happen, in the future.²⁷

²⁷ I note that a study recently released by the International Data Corporation concluded that “Airlines will not dominate online airline ticket sales, despite the planned launch of an airline-owned Web travel venture.” See, “Airlines will not lead Web travel sales, study says”, Reuters, September 18, 2000.