The travel business

The ineluctable middlemen

Everyone else in the travel business makes money off airlines. The carriers are trying to fight back

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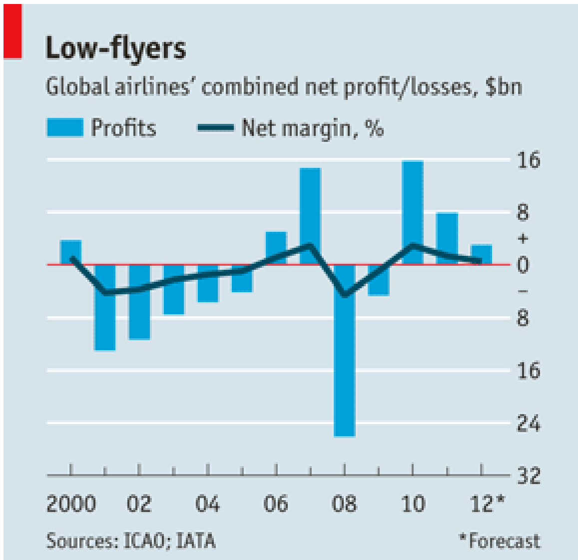
AIRLINES are wonderful generators of profit—for everyone except themselves. Even in good times their margins are as thin as a boarding pass, and in recent years they have more often lost money (see chart). Averaged over the past four decades, the net profit margin of the world's airlines, taken together, has been a measly 0.1%. By contrast, other bits of the travel business that depend on the airlines—such as aircraft-makers, travel agents, airports, caterers and maintenance firms—have done very nicely.



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Some of the tastiest margins in the travel business are enjoyed by the "global distribution systems" (GDSs), a fancy name for computerised-reservations services. These were originally created by several of the largest airlines to distribute their flights through travel agencies but have since become independent firms. Most flights booked through a physical or online travel agent go through a GDS, which charges the airline a fee of about $12 per round trip, passing a few dollars of that to the travel agent. According to Take Travel Forward, an airlines' lobby group, the world's carriers pay $7 billion in GDS fees a year—more than double their expected net profits this year of $3 billion.

The airlines' chronic unprofitability is partly the result of a wave of competition—especially from new low-cost carriers—unleashed by the steady deregulation of aviation since the 1970s. But it is also due to two moves by the airlines, from the 1990s onwards, that in retrospect were strategic errors. One was to stop paying direct commissions to travel agents. The other was to set the reservation systems free to become (as the airlines see it) profit-gobbling monsters that devour their parents.

At the dawn of the internet age, airlines assumed that the middlemen who came between them and their passengers were headed for extinction. Travellers would eventually buy tickets either from the airlines' own websites or from price-comparison engines which hooked up directly to the airlines' computers over the web. So why pay commissions to agents? And why continue to own reservation systems, especially since regulators had stopped them from fiddling with travel agents' GDS screens to place their own flights at the top? So Lufthansa, Air France and Iberia sold most of their shares in Amadeus (the largest GDS); American Airlines sold Sabre; British Airways and KLM sold out of Galileo; and so on.

However, the loss of direct commission from airlines made travel agents more beholden to the GDSs, which not only slip them a share of fees but also provide their back-office computing. Many online travel agencies have come to resemble physical ones, signing up with a GDS which provides a reservations system and other computing power while handing them a commission (ultimately paid by the airlines) on every booking. Despite airlines' efforts to make travellers bypass agents and come to their own websites, less than half of flights are booked this way.

Some airlines have thrown in the towel and let a GDS take over the running of all their in-house systems for handling passengers—in some cases, even their websites. Bookings on BA.com, for example, are handled by Amadeus. Some low-cost carriers, such as easyJet, which had at first refused to use GDSs have relented. This is because they want to reach high-value business flyers, who often make bookings through corporate travel agents—which, in turn, use a GDS to compile their itineraries.

Although there are some big emerging travel markets, such as Brazil and India, where the GDSs' grip is weaker, in others they have been successful in signing up new agents and airlines. China's government is nurturing a state-owned version, TravelSky. The middlemen the airlines wanted to do away with remain comfortably entrenched.

In recent years the main hope for restoring airline profitability has been ancillaries: all those extra charges for meals, checked bags, less-cramped seats and the like. The trouble is, carriers grumble, the GDSs' computer systems have struggled to cope with them, which makes it hard to flog such extras to passengers who book through agents. Like other airline chiefs, Qatar Airways' boss, Akbar Al Baker, complains of GDSs' slowness in updating their systems to cope with all these options, but he admits that they cannot do without the GDSs because they provide such a big share of their reservations.

American Airlines, Air Canada and a few other carriers have tried to do so, by setting up a "direct connect" service, by which travel agents (physical or online) can bypass the GDSs and hook up to the airline's internal system to book both the basic flight and extras. To get any traction with this, the carriers are having to revert to paying agents commission—though less than they pay the GDSs. So far agents have mostly stuck with the GDSs: rebuilding their IT systems to make direct connections to airlines is expensive, and their contracts with GDSs may make it costly too.

The search is on

Hoping to solve these problems, the airlines' international association, IATA, is working on a grandly titled "new distribution capability". One of its main elements will be a common technical standard for direct-connect services. The GDSs could make use of such services, so as to sell the airlines' full range of extras as well as just flights. But perhaps of more interest to the airlines is that it would become easier for travel agents to build computer systems that deal directly with airlines. It would also become easier for search engines to scour the web for flights, assemble a list of options for travellers, then let them click through to the website of their chosen airline to complete the booking—again without a GDS's involvement.

Such a service is already offered by Google (which has bought ITA, an airline-software firm, and Frommer's, a guidebook publisher, as part of its push into the travel business). The airlines hope that common technical standards will also encourage the creation of lots of innovative new travel-search firms. Adam Wood, an analyst at Morgan Stanley, is sceptical: it would be hugely expensive for any new entrant to replicate the existing GDSs' heavy spending on technology: the need for such investment makes flight distribution a business that naturally tends towards an oligopoly, he reckons.

IATA hopes to have its new technical standards agreed by the end of the year—though as a rule, getting airlines to agree on such things is tricky. Then there would be the problem of implementation; the industry, like every other, has seen ambitious IT projects fail disastrously. Suppose that IATA does persuade hundreds of airlines to agree on the new technical standards, and successfully build computer systems that run on them. Even then, admits Gary Doernhoefer, an IATA official, the GDSs' grip on the industry may not change much without regulatory action to unpick their cosy agreements with travel agents.

Regulators are indeed looking into the issue. An investigation into the GDSs by America's Department of Justice is quietly ticking over, and the European Commission is reviewing its code of conduct for them. Meanwhile, two of America's big carriers have taken GDSs to court over the tactics they use to maintain their hold over travel agents. American Airlines' case against Sabre is due to begin in a Texas state court in October. AA has also filed suits in federal courts against Sabre and Travelport (which owns Galileo and Worldspan and part-owns Orbitz, an online travel agency), as has US Airways against Sabre.

The GDSs, meanwhile, are lobbying America's Department of Transportation to force airlines to include "core" extras (such as bag fees and check-in charges) in the fares they quote to the GDSs, to make for fairer comparisons with carriers that offer all-inclusive fares. Cory Garner, a senior executive at AA, says that in principle his airline is more than happy to provide such information, but its main worry is that the lobbying will prompt the government to lay down overly prescriptive rules on how it is provided. IATA and other airline associations fear a worse outcome:

that they may be banned from offering any exclusive fares or promotions to agents which book directly rather than through a GDS. The department is expected to announce any rule changes in November.

Both sides can claim to be the consumer's champion. The airlines argue that the cost of the middlemen adds to the price of tickets (though the superficial evidence suggests that it is airline shareholders who suffer). They say they want to reform the distribution system to offer flyers a wider choice and a more individually tailored service. The GDSs argue that they provide travellers, through their agents, with impartial comparisons of all available flights, allowing them to get the best value.

Svend Leirvaag, an executive at Amadeus, argues that it's a pity the airlines fixate so much on GDS fees, which at around 2% of their revenues are much less than the money the industry could save by fighting such things as ever-increasing travel taxes and the unfair subsidies that prop up some state-owned carriers. The airlines are lobbying for these things too, but they would still like to cut the cost of the middlemen.