AN ANALYSIS OF DISTRIBUTION COSTS ORBITZ vs. SABRE-BASED GDS TRAVEL AGENCY

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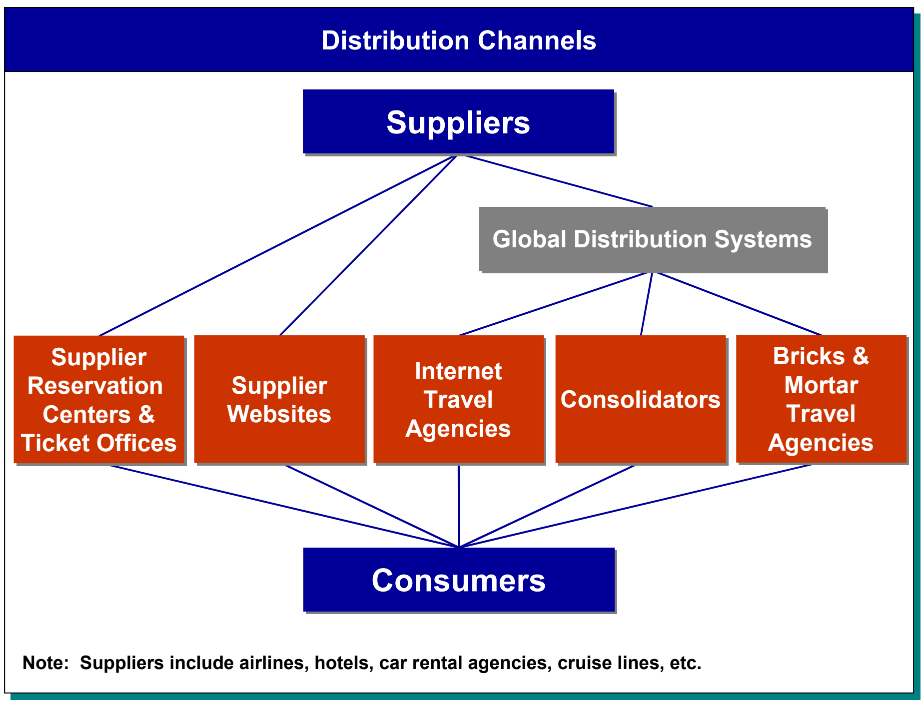
BACKGROUND

Over the past five or so years, there has been increasingly intense pressure on air carriers to lower costs, in general. That pressure became particularly evident when, in 2001, the combination of a recession, "dot.com" bubble burst, and the events of 9/11 pushed the U.S. air carrier industry into a severe financial crisis. The situation today can best be described by the fact that the U.S. industry will generate roughly $27 billion in losses in the three years, 2001-2003. Equally important, the industry debt to capital ratio has risen to about 93%, a clearly untenable position. In this context, we have seen US Airways, United Airlines, and Hawaiian Airlines file Chapter 11 bankruptcy. American Airlines has indicated that it will file Chapter 11 absent concession agreements from all of its unions. US Airways emerged from Chapter 11 reorganization at the end of March 2003. Several carriers, including Vanguard and National Airlines, have been forced into liquidation. The U.S. industry could be faced with further bankruptcies, depending on the length of the recovery from the Iraq conflict, the impact of SARS, and the effect of the general softness in the U.S. and world economies. In response to 9/11, the government provided roughly $5 billion in impact assistance, and a further $10 billion in government guaranteed loan availability to those carriers that qualified. In April 2003, the U.S. government approved an additional $2.3 billion in direct assistance to cover the costs of security being incurred by the airlines.

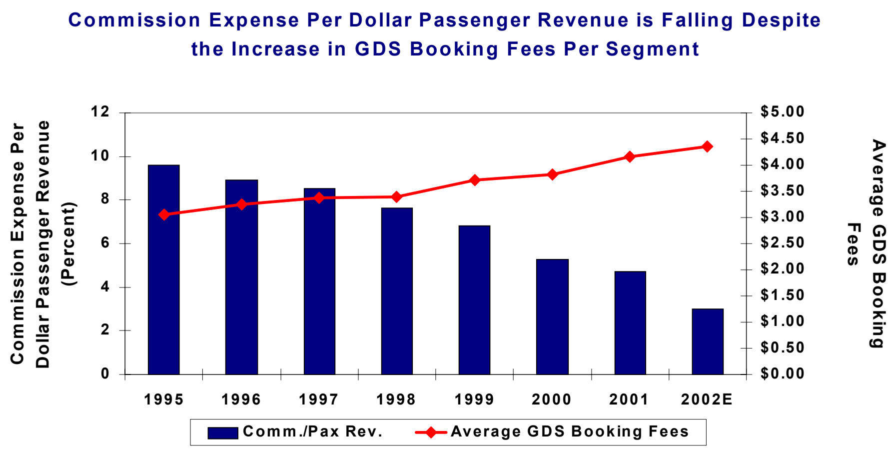
In the context of the economic environment of the late 1990s and into 2003, U.S. network carriers, in particular, have focused on all aspects of their cost structures. One major functional cost category that has concerned airlines for a number of years is the cost of “distribution.” That is, beginning with the first contact between the consumer and his or her booking agent, through the ticketing, airport check-in, and back-office accounting process, costs had become substantial. In the late 1990s and early 2000s, these costs could represent 20% to 25% of an air carrier’s cost structure. Consequently, it became an area of grave concern.

One of the major components of the cost of distribution was travel agency commissions, which reached a peak of almost 12% of passenger revenue in 1994. Another substantial cost component to the airlines, and thus ultimately to the consumer, are Global Distribution System (GDS) booking fees. These fees arise whenever a consumer buys an airline ticket through a travel agency, tour operator, wholesaler, or internet-based agency. The booking by the consumer, unless made directly with the supplier, e.g., air carrier, hotel or car rental company, is made by the intermediary agent on one of four major GDSs: Sabre, Galileo, Amadeus, and Worldspan.



The actual transaction reserves the seat and creates the ticket. This is accomplished by large legacy computer systems owned by the GDSs. The travel agency or other intermediary has made the sale, but the cost of the sale is billed to the supplier, in this instance the airline, hotel, car rental company, etc. In numerous studies of the cost structure of GDS booking fees over the past few years, we have found that while other distribution costs have been declining, either in an absolute sense or as a percent of revenue generated, booking fee costs have been increasing. In a **ga²** study published in July 2002, "The Economics of Travel Distribution In an Internet Driven Environment," we found that between 1990 and 2000, GDS booking fees had escalated by roughly 7% per annum. With the introduction of the Internet and the increased availability of

Commission Expense Per Dollar Passenger Revenue for U.S. Major Carriers and GDS Booking Fee Trend 1995 – 2002E



Source: U.S. Department of Transportation Form 41, Airline Proprietary Data

online travel distribution through vehicles such as Orbitz, Priceline, Expedia, and others, the rate of increase in GDS booking fees began to subside. Clearly, this was a response to competitive pressures, although the GDSs still maintain measurable pricing power. Between 1995 and 2001, booking fees increased by 4.5% per annum, reaching an estimated annual average level of $4.36 per segment in 2002 (which equates to $12.20 per ticket, based on an average 2.8 segments per ticket).

Earnings during this time period were substantial for the GDSs. On the other hand, U.S. and world air carriers struggled to reach 5% profit margins during the late 1990s and fell to "zero" by 2001. In a New York Times article, Even as the Big Airlines Struggle, A Computer Booking System Prospers, dated February 10, 2003, the President of Sabre is asserted by the author to have observed that Sabre's fees are worth every penny. However, the article's author also observes,

"…the airlines have used their considerable lobbying power, persuading the Department of Transportation to propose eliminating some of the rules that help Sabre and its three rivals—Galileo, Worldspan and Amadeus—keep their fees up." This raises the question, among others, "Why would the airlines use their leverage to change the rules if the booking fees were truly "worth every penny?" The airlines, among others, must believe the current regulations are supporting higher CRS costs than a deregulated, competitive market would achieve.

METHODOLOGY

This analysis of the cost of booking a transaction through a travel agency via Sabre or a typical GDS, compared to the costs and fees of a booking online through Orbitz, required that comparability of costs between the channels be defined and established at the outset.

As a starting point, we determined to use only those cost categories that were reasonably available, subject to definition, and where the source of information and data was credible and recognizable.

There are, as noted, numerous costs incurred by airlines related to the booking and ticketing of passengers, including those that are measurable and quantifiable. Others, while determinable through airlines' internal accounting systems, are unavailable to those outside the airline, e.g., back office accounting.

Thus, we are dealing here with the cost categories that we can define and measure with a high degree of reliability, including:

1. GDS booking fees charged to airlines
2. Rebates, volume, or offset discounts to GDS booking fees
3. Sales Commissions paid by air carriers to travel agencies
4. Service fees charged by "Brick & Mortar" agencies and by Orbitz, the online agency

The sources of these data sets include confidential and aggregated surveys of booking fees charged to airlines; sales commissions paid to travel agencies and ticket values, as reported by airlines to the U.S. Department of Transportation; the "2002 U.S. Travel Industry Survey" published by Travel Weekly Magazine; and Orbitz service fees, volume discounts to carriers, and transaction charges to carriers and consumers as supplied to us by Orbitz.

CURRENT FINDINGS

In one of many efforts to rationalize its fee structure, Sabre has developed a comparative analysis of booking fees for a round trip ticket generated by a travel agency on a GDS and a consumer direct booking on Orbitz. That study, "AIRLINE DISTRIBUTION COSTS PER TICKET", published by Sabre and until recently found on its website, stated that the booking fee and related commission and transactions costs of a ticket booked through a travel agent between November 2002 and June 2003 are estimated at $9.98, while the same booking on Orbitz would cost the airline $13.32.

Sabre, in its analysis of costs to airlines of a GDS booking through travel agencies on Sabre versus online, failed to include or mis-stated certain costs related to GDS and Orbitz bookings, including:

- No recognition of the travel agent commissions being paid by airlines. While these payments are now often characterized as "incentives" or "overrides," they are still commission payments to travel agencies.
- Overstatement of transaction fees paid by airlines to Orbitz.
- No recognition of the historical and expected booking fee escalation.

- No recognition of "Supplier Link," which allows bookings to take place through Orbitz, directly to the supplier, thus eliminating any booking fee by a GDS.
- Failure to recognize the differences in fees charged to the passenger by a travel agency, compared to the fees charged to the passenger by Orbitz.

A. <u>BOOKING FEE COST TO AIRLINES</u>

When these factors are fully recognized, the current round trip ticket distribution cost comparison is:

Orbitz-Average of all airlines	**$16.43**
-Charter Associates only	**$16.22**
-Supplier Link	**$9.58**
vs.	
Sabre Travel Agency	**$26.20**

Orbitz cost lower than Sabre Travel Agency:

Orbitz Average of all airlines	**37.3%**
Orbitz Charter Associates only	**38.1%**
Orbitz Supplier Link	**63.4%**

The detailed costs, by year, may be found in Attachment A.

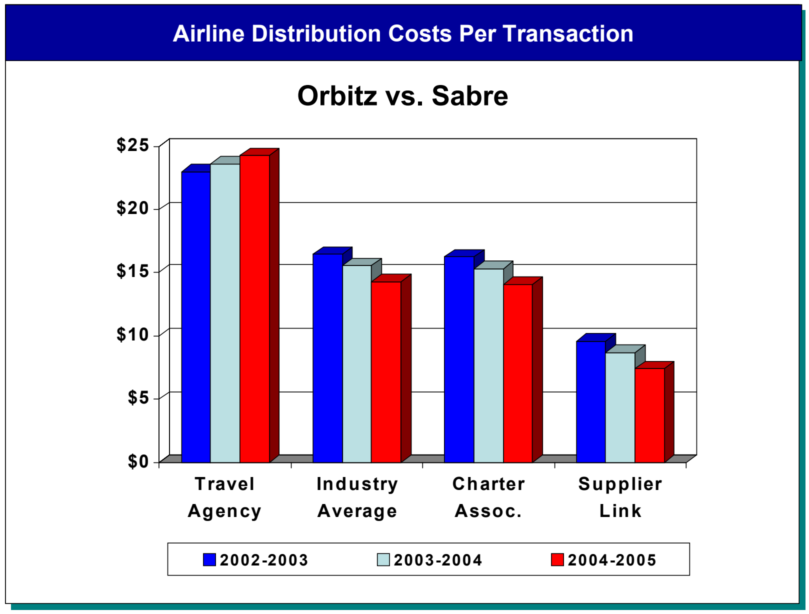
Airline Distribution Costs Per Transaction - Summary

Orbitz vs. Sabre (June 2002 – May 2005)

		ORBITZ			Percent Orbitz Total Cost Is Less Than Travel Agency:		
Cost Category	Travel Agency	Industry Average	Charter Assoc.	Supplier Link	Industry Average	Charter Assoc.	Supplier Link
Total Distribution Cost ('02-'03)	$26.20	$16.43	$16.22	$9.58	-37.3%	-38.1%	-63.4%
Total Distribution Cost ('03-'04)	$26.82	$15.52	$15.31	$8.67	-42.1%	-42.9%	-67.7%
Total Distribution Cost ('04-'05)	$27.46	$14.25	$14.04	$7.40	-48.1%	-48.9%	-73.1%

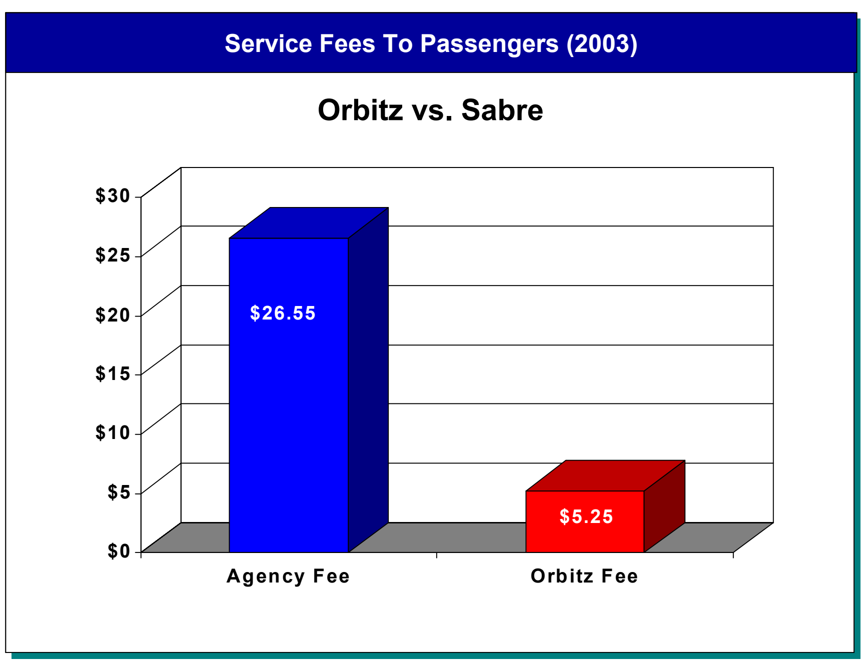
These disparities in distribution costs to airlines actually increase over the years as the transaction fees to Charter Associates of Orbitz decline. Thus, by July 2004, average Charter Associates' transaction costs through Orbitz will be roughly $14.04 per ticket, while these costs would amount to $27.46 through a travel agency. So the travel agency's costs would be $13.42 (or about 96%) higher than a transaction through Orbitz.

These costs also do not include service fees charged by travel agencies, both "brick & mortar" and online, to the passenger.



B. SERVICE FEES TO THE CONSUMER (PASSENGER)

In addition to the costs incurred by airlines, and thus ultimately passed to the passenger in the ticket price, the booking that takes place via a travel agency through a GDS, or online through Orbitz, generates a "service charge" to the passenger.



This charge is generally called a “service fee.” As can be seen from the chart above, the service fee charged by the travel agency, as reported in the “2002 U.S. TRAVEL INDUSTRY SURVEY,” published by Travel Weekly Magazine, “brick & mortar” travel agencies charge passengers $26.55 per ticket issued, on average. Orbitz also imposes a service fee for tickets booked online through its website, but it amounts to only $5.25, on average, or an 80% discount from the fee typically charged by a traditional travel agency.

In summary, the cost of distributing a round trip airline ticket through Orbitz is measurably less costly, under any set of circumstances, than booking that ticket through a Sabre-based or other “brick and mortar” travel agency. The current industry average cost of a booking through Orbitz of $21.68 ($16.43 to the airline and $5.25 to the passenger) compares very favorably with the cost of $52.75 ($26.20 to the airline and $26.55 to the passenger) when the booking and ticketing takes place through a travel agency via a GDS. Moreover, when the transaction takes place through Orbitz on an airline with Supplier Link, the cost is reduced to $14.83 ($9.58 to the airline and $5.25 to the passenger).

On average, the disparity in cost between the two forms of booking will continue to grow as more and more carriers move to Supplier Link and as the GDS booking fees continue to increase in future years, albeit at a somewhat more moderate rate of escalation.

Airline Ticket Distribution Costs Per Transaction

Orbitz vs. Sabre (June 2002 - May 2003)

Cost Category	Travel Agency	Orbitz Industry Average	Orbitz Charter Associates	Orbitz Supplier Link	Percent Orbitz Total Cost Is Less Than Travel Agency: Industry Average	Charter Associates	Supplier Link
GDS Booking Fee[1/]	$15.39	$13.64	$13.64	$4.00	-11.3%	-11.3%	-74.0%
Less: Offset[2/]	$0.00	($2.79)	($3.00)	$0.00			
Net GDS Booking Fee	$15.39	$10.85	$10.64	$4.00	-29.5%	-30.8%	-74.0%
Commission/Transaction Fee[3/]	$10.82	$5.58	$5.58	$5.58	-48.4%	-48.4%	-48.4%
Distribution Cost to Airline	$26.20	$16.43	$16.22	$9.58	-37.3%	-38.1%	-63.4%
Agency Fee to Passenger [4/]	26.55	5.25	5.25	5.25	-80.2%	-80.2%	-80.2%
Total Booking/Ticketing Fees	$52.75	$21.68	$21.47	$14.83	-58.9%	-59.3%	-71.9%

1/ Assumes $4.00 Supplier Link Booking Fee (provided by Orbitz), Charter and Industry Average Booking Fee of $13.64 ($4.40 per segment times 3.1 average segments per Orbitz transaction), and Travel Agents/Sabre Booking Fee 12.8% higher (from Sabre presentation) than Worldspan Booking Fee during Nov. 2002-June 2003 period and then increased by 4% in each subsequent period, based on recent GDS booking fee rate escalation history.

2/ $3.00 Offset/Rebate for Charter members who account for 93% of all Orbitz members. Industry Average Offset/Rebate of $2.79 reflects that ratio.

3/ 75% of Orbitz issued tickets cost more than $150.00, thus the average commission is $5.58 during Nov. 2002-June 2003 period, $4.67 during the July 2003-June 2004 period, and $3.40 during the July 2004-June 2005 period. For Travel Agents/Sabre, the average commission is $10.82 (an average commission rate of 3.0% times the average systemwide round trip fare of $360.58).
Source: Department of Transportation OD1A and Form 41 databases, both reflecting the 2nd Quarter 2002.

4/ Rates are for 2002-2003 and assume no escalation.

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Orbitz vs. Sabre (June 2003 - May 2004)

Cost Category	Travel Agency	Orbitz Industry Average	Orbitz Charter Associates	Orbitz Supplier Link	Percent Orbitz Total Cost Is Less Than Travel Agency: Industry Average	Charter Associates	Supplier Link
GDS Booking Fee[1/]	$16.00	$13.64	$13.64	$4.00	-14.8%	-14.8%	-75.0%
Less: Offset[2/]	$0.00	($2.79)	($3.00)	$0.00			
Net GDS Booking Fee	$16.00	$10.85	$10.64	$4.00	-32.2%	-33.5%	-75.0%
Commission/Transaction Fee[3/]	$10.82	$4.67	$4.67	$4.67	-56.8%	-56.8%	-56.8%
Distribution Cost to Airline	$26.82	$15.52	$15.31	$8.67	-42.1%	-42.9%	-67.7%
Agency Fee to Passenger [4/]	26.55	5.25	5.25	5.25	-80.2%	-80.2%	-80.2%
Total Booking/Ticketing Fees	$53.37	$20.77	$20.56	$13.92	-61.1%	-61.5%	-73.9%

1/ Assumes $4.00 Supplier Link Booking Fee (provided by Orbitz), Charter and Industry Average Booking Fee of $13.64 ($4.40 per segment times 3.1 average segments per Orbitz transaction), and Travel Agents/Sabre Booking Fee 12.8% higher (from Sabre presentation) than Worldspan Booking Fee during Nov. 2002-June 2003 period and then increased by 4% in each subsequent period, based on recent GDS booking fee rate escalation history.

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Less: Offset[2/]	$0.00	($2.79)	($3.00)	$0.00			
Net GDS Booking Fee	$16.64	$10.85	$10.64	$4.00	-34.8%	-36.1%	-76.0%
Commission/Transaction Fee[3/]	$10.82	$3.40	$3.40	$3.40	-68.6%	-68.6%	-68.6%
Distribution Cost to Airline	$27.46	$14.25	$14.04	$7.40	-48.1%	-48.9%	-73.1%
Agency Fee to Passenger [4/]	26.55	5.25	5.25	5.25	-80.2%	-80.2%	-80.2%
Total Booking/Ticketing Fees	$54.01	$19.50	$19.29	$12.65	-63.9%	-64.3%	-76.6%

1/ Assumes $4.00 Supplier Link Booking Fee (provided by Orbitz), Charter and Industry Average Booking Fee of $13.64 ($4.40 per segment times 3.1 average segments per Orbitz transaction), and Travel Agents/Sabre Booking Fee 12.8% higher (from Sabre presentation) than Worldspan Booking Fee during Nov. 2002-June 2003 period and then increased by 4% in each subsequent period, based on recent GDS booking fee rate escalation history.

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