

Testimony of Matthew V. Scocozza
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U.S. Department of Transportation,
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Committee of Commerce, Science and Transportation,
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Good morning Madam Chairman. It is a pleasure to be here today. The topics under discussion are computer reservation systems (CRS), the rules governing these systems, and what additional actions, if any, the Department of Transportation, or the Congress, should undertake to ensure that these systems are not used to stifle competition in the airline industry.

The Department of Transportation is committed to preserving the price and service benefits that airline deregulation has brought about. A competitive marketplace -- a marketplace where all air carriers have an equal opportunity to succeed or fail on the basis of their efficiency and their ability to meet the needs of the traveling public -- is the best means of ensuring that air travelers have the fullest range of fare and service options available to them. Secretary Dole is committed to ensuring that competition in the airline industry is preserved.

I would like first to review the conclusions reached by the Civil Aeronautics Board (CAB) in its investigation of computer reservation systems and vendor practices. Next, I will briefly review the rules that now govern computer reservation systems -- rules that seek to prevent CRS vendors from acting in an anticompetitive manner. I will then briefly discuss why it is so

difficult to design and implement any effective regulatory policy -- including divestiture -- to deal with these systems and vendor practices. Finally, I will describe the course of action the Department of Transportation proposes to follow in order to gain a better understanding of whether and what regulatory actions should be initiated in this area.

Deregulation can work as the Congress intended only if carriers can compete on the merits of the fares and services they offer. The analyses conducted by the CAB and the Department of Justice demonstrated that CRS vendors enjoyed substantial market power. The CAB concluded that they used this market power to reduce competition and to distort the information travel agents received. It is important to note here that this distortion, or "bias" is not, by itself, a sufficient reason for government intervention. Bias exists to some degree in virtually all markets.

Today, travel agents sell approximately 70 percent of all airline tickets, and roughly 90 percent of the tickets issued by travel agents are issued through automated reservation systems. Given the proliferation of fare and service offerings that has followed in the wake of deregulation, and the substantial productivity gains these automated systems permit, it is easy to understand why almost all travel agents consider the use of a computer reservation system essential for profitable operations. Given the agents' reliance on these systems, and the fact that a small difference in a carrier's average load factor in certain markets

can make the difference between earning a profit and incurring a loss, air carriers are concerned that their fare and service offerings are accurately and fairly displayed on these systems. The evidence gathered by the CAB and the Department of Justice on CRS practices demonstrated that the vendors had substantial power over an important part of the marketing and distribution system in the airline industry. First, the major CRS vendors have high market shares. At the national level, American's Sabre system has a 49 percent share of automated travel agent revenues, and United's Apollo system has a 31 percent share. Four other vendors serve the remaining 20 percent of the market. In certain major travel markets, one vendor often dominates the marketing of air transportation. In Denver, for example, United's Apollo system has a 72 percent market share; in Portland, United's market share is 66 percent; and in Cleveland, it is 64 percent. American's Sabre system is similarly dominant in other important travel markets.

Second, barriers to entry into the the computer reservation market were found to be high. Market forces could not be relied upon in the short term to discipline vendors and ensure competitive behavior and performance. High barriers to entry were found to result from substantial costs that a potential entrant would have to incur to develop and market an alternative system, the inability or unwillingness of agents to switch systems, and the fact that vendors priced their services artificially low on the basis of the increased air transportation revenue they could

expect to receive because agents were tied to their systems. Finally, the fee structures imposed by the vendors on participating carriers were found to be unjustly discriminatory and were not related in any reasonable manner to the costs incurred in providing the information to the agent. Through anticompetitive bias and discriminatory fees, vendors could selectively exert a substantial degree of control over their airline competitors' costs. Indeed, the evidence indicated that CRS vendors could, and did, increase their fees at the same time they increased the amount of bias they programmed into their displays -- in effect, offering an inferior product for a higher price.

Based on its authority under section 411 of the Federal Aviation Act (49 U.S.C. 1381), the CAB issued rules that were designed to limit, with a minimum of regulatory interference, the vendors' ability to use their market power in an anticompetitive manner. The rules went into effect on November 14, 1984 (amendments to the rules were issued shortly thereafter). The major provisions of those rules are:

- o Bias is prohibited in primary information displays. (The rule applies to both direct and connecting flights.)
Vendors are also required to load other carriers' flight information in the CRS "with the same care and timeliness" used in loading information regarding their own services.

- o Access fees are prohibited from being "unjustly discriminatory."
- o Contracts between vendors and travel agents are limited to five years.
- o Vendors are required to supply participating carriers with any marketing, sales, and booking data they elect to generate on "reasonable and non-discriminatory terms."
- o Vendors are permitted, but not required, to discriminate against those foreign carriers whose computer reservation systems discriminate against U.S. carriers.
- o Finally, the Board determined that the rules should terminate on December 31, 1990, unless the Department of Transportation determines that the rules should remain in effect.

These rules have not put an end to the controversy surrounding CRS. As you know, the rules are currently being challenged in the Court of Appeals for the 7th Circuit. Aside from the court challenge, the two issues that have raised the most concern are continued anticompetitive bias in automated displays and the level of airline access fees.

The CAB's original rules prohibit bias in "primary" displays, but permit vendors to provide travel agents with "secondary" displays that are biased. In formulating its rules, the CAB apparently believed that if agents had equal access to biased and unbiased displays, agents would opt for the unbiased display. It is now claimed that the continued availability of biased displays, coupled with mechanisms and incentives that make it less attractive to use primary displays, threaten to undercut the rules against bias. Some carriers, moreover, contend that the rules have not eliminated all display bias even in the primary displays.

As a general matter, given the financial incentives vendors have for offering biased displays, and the economic incentives that are available to agents who utilize a biased system, it is extremely difficult to design rules that completely foreclose a vendor's ability to bias its system to give it some advantage.

With regard to the secondary display issue, the CAB was aware that it was creating a loophole when it allowed bias in secondary displays. The question is whether that loophole is indeed as large and as threatening as many argue it is, and, if it is, what corrective action is needed. To make these determinations, we require additional information.

There is also considerable concern within the aviation community as to the fee structure the major vendors have imposed in response to the rule. The new fees charged by some of the CRS vendors do

indeed represent a sharp increase for many carriers. But the fees actually went down for some carriers, and it is by no means clear that new fees are unreasonable. The CAB was aware of the vendors' proposed fees before the rules went into effect, and it allowed them to go forward. In doing so, the CAB noted that the new fees were close to the range it had expected.

The Department believes that it would be premature to undertake draconian measures like the regulation of access fees or divestiture. The rules have only recently become effective, and they should be given a chance to work. The magnitude and exact nature of any remaining problems with the rules are not fully clear, and it is even less clear that extreme solutions are necessary. We should be especially wary of such solutions because they involve substantial problems of their own.

For example, whether access fees are reasonable is difficult to determine, especially given the complexity of estimating and allocating the costs of providing automated reservation services to non-vendors, travel agents, and the vendor itself. Madam Chairman, I think you will also agree that a regulatory structure designed to judge whether automated reservation fees are reasonable would be highly bureaucratic, inefficient, and could easily result in market distortions that would serve to discourage entry into the automated reservation industry. However, if a significant share of reservations are still being booked on biased systems, then participating carriers may have a valid argument

when they claim they are receiving the worst possible outcome: higher fees and continued anticompetitive bias. These issues deserve serious attention.

Madam Chairman, before determining what, if any, further actions the Department should take, we intend to carefully evaluate the current CRS rule, especially the secondary bias and pricing issues. Of course, as an important part of our evaluation, we will consult with the Department of Justice to consider their views on this matter. We are aware that the Justice Department will continue to evaluate these matters as well, and coordination between our Departments will be desirable and necessary.

This concludes my prepared statement, Madam Chairman. I would be pleased to answer any questions you or other members of the Subcommittee may care to ask.