

T2RL'S First View is our rapid analysis of breaking news. It helps provide perspective, putting the facts in the context of our wider and deeper knowledge of the market.

Back to the Future with Travelport

T2R Staff

The Facts

Travelport has announced that from January 1st 2012 travel agents will have to pay a monthly fee of \$35 per month per active device under its so-called Agility Program. Although it is described as an optional program of add-on features it contains some of the existing core GDS functionality that is essential to the vast majority of agents. Reaction from the travel trade has been almost entirely negative while airlines have been largely silent.

The Analysis

The pricing mechanisms for GDSs have evolved over the thirty-five years since American Airlines and United Airlines first installed Sabre and Apollo terminals in selected travel agency branches. In the very early days the systems were primarily used to influence the sale of airline seats and their role as revenue generators in their own right was secondary. This changed with the adoption of regulations for the CRS business in 1984, which required the owners of such systems to offer them equally to all airlines and to participate in all other systems in the market. By 1992, when the two European CRS projects delivered Amadeus and Galileo within a couple of months of each other, a standard model had emerged in which airlines paid a modest fee for all flights booked and travel agencies paid a subscription for each terminal in use.

Evolution over the subsequent 18 years was driven by the unintended consequences of the regulations in both the United States and the European Union. The CRSs, by now rebranded as GDSs, had recognised that airlines were effectively forced to participate in all systems. This meant that there was no real restraint on the fees that they could be charged and airline booking fees increased at a rate far in advance of any measure of inflation - even at a time when most IT costs were falling rapidly. The GDSs' revenues were largely driven by the number of travel agencies they could sign up to make bookings. Unlike airlines, travel agencies generally needed to use only one GDS and they did have the choice of which they would select. As a result travel agency subscription rates were reduced and then eliminated. Eventually they were thrown into reverse and the GDSs began to share the booking fee revenue with the agencies, leading to the situation that applied in the mid 2000s.

At that time the growth of Internet distribution channels persuaded the regulators that there was no longer a need to control the GDS business and deregulation came to North America in 2004 and a couple of years later, and in a slightly watered down form, to the European Union. Freed from the constraint that all airlines had to be charged the same fees, larger carriers were able to negotiate prices. Where they had market power they were able to dictate much better terms from the GDS companies. Texas court filings in the case of American Airlines versus Sabre and Travelport show that AA is back to paying a little over two dollars per segment in the USA - about the same fees as it had in 1992. While this has been partially offset by an increase in fees where airlines have lower market power, by definition these cases are the minority. Airlines have power in territories where they do a lot of bookings and vice versa. For the first time in their history GDS booking fee revenues are

coming under significant pressure. This is the background to the Travelport announcement of its Agility Program.

Travelport appears to be attempting to rebalance its revenue streams between the airline booking fees and travel agency subscriptions. Alone of the major GDSs, Travelport does not have another line of business to balance its portfolio. Sabre and Amadeus both have airline IT services and Sabre also owns the online travel agency Travelocity. This has probably driven Travelport to be the first mover, as any further reduction in booking fees without a compensating improvement in other revenues would be catastrophic very quickly. The new fees are tied to user log-ins so the impact is harder to quantify than older schemes based on fixed network connections. With 67,000 travel agency customers and over 130,000 terminals, \$420 per user per year could easily amount to \$75 million in a full year. While this is a useful amount it represents no more than about 3% of annual revenue for Travelport.

The danger in this strategy is that for a 3% revenue uplift Travelport risks becoming isolated if Sabre and Amadeus do not follow its lead. Should that happen agencies may decide to move their contracts to one of the competitors and Travelport will lose not only the incremental agency revenue but also the booking fee income generated by those users. Since each agency generates an average of \$35,000 per year in revenue for the GDS company this could be very bad news. It would be even worse if it turned out to be the largest agencies that decided to make the move as their revenue generation is many times higher than the average.

The Speculation

Travelport appears to be launching a high-risk strategy in attempting to force a major change to the GDS business model, in effect taking it back to where it was 20 years ago. The interesting question is why?

The Private Equity owners of the company attempted to launch an IPO in 2010 but were defeated by market conditions and an ineptly-presented offer. They are known to be anxious to exit their investment and perhaps see a short-term revenue boost as a way to make the stock more attractive to investors. If they can convince analysts that they are ahead of the competition in this respect the market may just possibly reward them. This will only deliver longer term benefits if the other two major systems eventually follow suit and this seems extremely unlikely. Amadeus in particular will surely scent a major opportunity to increase its share of the North American market by offering attractive contract terms to disgruntled Travelport subscribers.

If this gambit from Travelport proves as disastrous as it might the investors could see the value of their holding eroded very quickly. In those circumstances the possibility of a fire sale cannot be discounted. Although there are relatively few potential buyers - both Sabre and Amadeus would face anti-trust issues if they made a move - one party with a strong interest in increasing its international presence does spring to mind. And if Travelsky did make a move it would only have to change the second part of the name.