

LUFTHANSA MOVES ON DISTRIBUTION COST.

T2RL Staff

THE FACTS

On 2nd June 2015 Lufthansa announced they would be adding a surcharge of 16 Euros for each ticket issued by any global distribution system (GDS) on their group carriers. The charge would not apply for any of the Lufthansa group's direct channels, which include their airline.com sites for corporate customers, travel agents and consumers.

THE ANALYSIS

Lufthansa has attempted to drive direct distribution before in 2008 by surcharging agents for tickets created in the GDSs. Amadeus was quick to challenge Lufthansa's 2008 action in court but lost the case. Amadeus increased their payment of incentives to agents to make up or contribute to the surcharge for a period of time, however eventually Amadeus and Lufthansa reached agreement in 2010 for content and charging. Many including T2RL saw this as a negotiation tactic to obtain lower booking fees.

T2RL see the move in 2015 as far less of a negotiation tactic to achieve a lower cost but part of an integrated direct selling strategy. Lufthansa believe this action is necessary to compete effectively and head-on with low-cost carriers who pass on the benefit of lower costs to their consumers. According to T2RL's analysis, since the share of low-cost carriers has increased significantly in Europe, it is more important than ever for network carriers like Lufthansa to adopt a lower cost base to compete with low-cost carriers including operating their own brands such as Germanwings.

So far for many airlines the GDSs have been able to exert considerable pricing power with respect to booking fees by increasing them each year or each contract period. Airlines are particularly fed up with year on year booking fee increases. Cost reductions are actually fee increase avoidance and even in individual cases where the booking fee is lowered, this reduction takes place in the context of a long-term trend of increases in booking fees over time. Ultimately booking fees are negotiated heavily in return for content. T2RL's research suggests that the GDSs provide the largest discounts when the airlines offer content in terms of fares and availability parity with their direct channels. Lower discounts are offered for GDS parity and no discounts are available for participation based on any content. Furthermore, T2RL's research suggests that some GDSs do not offer all three options to airlines exerting an additional lever on the airline for their channel content by making participation available only on the basis of non-discrimination and parity with either direct channels or GDS.

By surcharging customers for the use of the GDS, costs will become far more transparent to the end users. Costs will have to be absorbed by the channel (agent) or passed on to the end consumers or corporates. Cost-sensitive customers will clearly switch to the most cost-



effective channel. The question for the GDSs and Lufthansa is how many of those customers are indeed highly price-sensitive and how fast will they switch. T2RL see the smaller corporate customers as a primary target for Lufthansa. These are usually the agents with lower levels of incentives and limited technology. Lufthansa will be offering their own technology as an alternative and a 16 Euro incentive to work with that technology.

The distribution move is not therefore without some risk for Lufthansa's revenue. The largest online agents such as Expedia already have the ability to switch their content source from GDS to direct connection relatively easily. Some larger travel agents may prefer to see Lufthansa's market share reduced to demonstrate they have both market and demand aggregation power. GDSs may also increase incentives to agents again, as Amadeus did in 2008, especially if they now receive significantly increased GDS fees for those bookings.

Smaller corporate agents and their customers however may not be able to switch over so quickly and easily and this may indeed hurt Lufthansa's revenue the most, although it is likely that fares can be adjusted quickly to take into account the increase within the context of the total transaction cost if there's a loss of Lufthansa market share. Undoubtedly Lufthansa will be ready and expecting to respond.

Lufthansa have been preparing for this move for some time. They have invested heavily in their IT infrastructure which sits on top of their Amadeus-provided PSS solution. The business case for the investment must have been made on the basis they will be successful in shifting share as the commercial incentive provided by their Distribution Cost Charge will give the infrastructure the impetus necessary to drive increased volumes.

Somewhat counter-intuitively Amadeus' revenues are likely to increase in the short-term as they move bookings from what is likely to have been deeply discounted rate from the full content agreement to a standard- or surcharge-based participation agreement. Once the surcharge is exposed to customers the rate of shift for each passenger customer segment will undoubtedly be different. This variable will undoubtedly become a topic for financial analyst calls that follow airlines and GDSs.

T2RL's view is that this change is not all downside for Amadeus; Amadeus provides the underlying PSS solution to Lufthansa. The PSS solution will be working harder and it is likely that Amadeus will have some benefit from the increased level of activity in the PSS solution from a significant increase in direct sales. This is despite the fact that Lufthansa have made a modest investment in a pricing and shopping technology provider Vayant.

THE SPECULATION

T2RL do not believe this is a storm in a teacup designed to increase leverage for Lufthansa in their GDS negotiations, but believe it is the start of a push to make distribution cost and services transparent to consumers, whether they be corporate, leisure or otherwise.

T2RL also see the timing of the move as critical. In the USA, Expedia dominate the agency landscape with their brands, volumes and customer acquisition economics especially in the



price-sensitive leisure space. Lufthansa want to secure their share of this segment in Europe at economics that make sense. Allowing this market segment to be GDS incentive driven would weaken their market position and would make them uncompetitive with low-cost carriers. This is a must-do transformation of distribution for Lufthansa.

T2RL believe the Lufthansa announcement will force the GDS/PSS providers, particularly Amadeus, to rethink their strategy with respect to the provision of solutions. PSS is ultimately about powering distribution with the right inventory to the right customer at the right time. PSS/GDS providers are uniquely positioned to provide this service if they can manage the PSS and GDS together and not separately. T2RL believe if they remain separated, especially for the larger carriers, then alternatives including integration of best of breed will thrive and threaten the currently unassailable market positions in PSS in the long-term.



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