OIG COMMENTS ON DOT STUDY OF AIR TRAVEL SERVICES

Office of the Secretary

Number: CC-2002-061

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U.S. Department of Transportation
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Office of Inspector General

Memorandum

Subject: INFORMATION: OIG Comments on DOT Study of Air Travel Services, Office of the Secretary CC-2002-061

Date: December 13, 2002

From: Kenneth M. Mead
Inspector General

Reply to Attn. of: JA-50

To: The Secretary
The Deputy Secretary

This report presents the results of our review of the Department of Transportation (Department) Study of Air Travel Services. On June 27, 2002, the Office of Aviation and International Affairs issued a report to Congress on its efforts to monitor air travel services related to Orbitz. The Office of Inspector General (OIG) was directed by the House and Senate Transportation Appropriations Subcommittees in the Conference Committee Report on the DOT Appropriations bill for Fiscal Year (FY) 2002[1] to evaluate and comment on the Department's findings.

We have reviewed the Department's report and evaluated the reasonableness and accuracy of the Department's analysis and conclusions. We selectively verified data cited in the report to the information submitted to the Department by Orbitz' airline-owners, Charter and non-Charter Associates,[2] Global Distribution Systems (GDSs), and online travel agencies. In addition, we held discussions with and reviewed supplemental data submitted by online and brick-and-mortar travel agencies, Department officials, GDSs, and large and small carriers. We also conducted tests of online travel agencies to determine the validity of some of the claims Orbitz' critics have made.

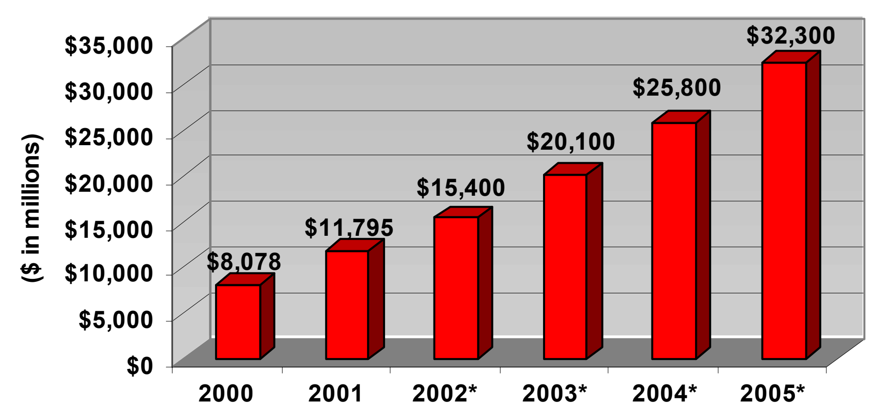
[1] House Report 107-308, Making Appropriations for the Department of Transportation and Related Agencies for the Fiscal Year Ending September 30, 2002 and for Other Purposes.
[2] Orbitz' owners and other airlines that chose to enter into a contractual relationship with Orbitz related to booking fee rebates and access to certain fares are referred to as Charter Associate airlines. Non-Charter Associate airlines are those airlines that were invited, but declined to enter into a contractual agreement with Orbitz.

Several negotiations and other activities were in process at the time the Department conducted its review and the Department could not fully evaluate their impact on the industry. Some of these activities have subsequently been finalized and we have included them in our analysis and report.

INTRODUCTION

Since the late 1990s, the Internet has claimed an increasing share of the travel sales market as both travel suppliers and consumers recognize the potential for substantial savings—in distribution costs for suppliers and prices for consumers. Between 2000 and 2001, airline ticket sales over the Internet increased by 46 percent and are expected to increase again in 2002 by another 31 percent. Currently, about 15 percent of all airline tickets are sold over the Internet. Figure 1 illustrates the past and projected growth of airline tickets sold online through 2005.

Figure 1. Past and Projected Growth of Airline Tickets Sold Over the Internet, 2000 Through 2005



Source: PhoCusWright, May 2002 * Projected

In November 1999, four of the largest U.S. airlines announced their intent to jointly launch an online travel agency, a venture they ultimately named "Orbitz."[3] At that time, consumer groups, Congress, government agencies, and industry stakeholders voiced concerns about the possible antitrust and anticompetitive issues associated with this collaborative effort among competitors. The primary concerns were:

- The contracts Orbitz entered into with Charter Associate airlines included a Most Favored Nation (MFN) clause. The MFN clause entitled Orbitz to

[3] The original founding airlines included Delta, United, Northwest, and Continental. American Airlines later joined the venture and is also considered a founding airline.

receive any fare made available on a Charter Associate airline's website. It also required Charter Associate airlines to provide Orbitz with any fares they made available to Orbitz' online competitors as long as Orbitz was able to match the terms offered by the competing agency. In exchange, Orbitz committed to substantial Global Distribution Systems (GDS)[4] fee rebates, a schedule of declining airline transaction fees, and to develop the capability to link directly into airlines' internal reservation systems. Opponents argued that the MFN clause would result in the airlines acting in an anticompetitive manner by not sharing their fares with distribution outlets other than Orbitz.

- Orbitz committed to neutrally displaying all airfares, regardless of whether or not an airline had an ownership interest or had signed a Charter Associate agreement with Orbitz. Concerns were raised that Orbitz' airline owners would skew displays to give preferential display to their own fares.

In July 2000, we testified before the Senate Commerce Committee on our initial review of the above concerns.[5] We stated that in the long term, barring any anticompetitive behavior, Orbitz could generate competitive pressure on other online agencies to eliminate bias and upgrade search capabilities. Orbitz could also put competitive pressure on GDSs to lower booking costs and improve services.

However, we also noted Orbitz' potential for harmful impacts on the travel marketplace. We cautioned that if Orbitz were extremely successful and eliminated its online competitors, it could develop the power to charge premiums to airlines to participate, benefiting its equity owners to the detriment of other airlines and resulting in higher fares to consumers. We encouraged the Departments of Justice and Transportation to evaluate the likelihood of these and other scenarios playing out in determining whether prior intervention was needed to protect competition and consumers.

In April 2001, as a result of an informal investigation, the Department of Transportation issued a letter to Orbitz indicating that it would not prevent Orbitz from beginning operations or require it to change its business strategy. The Department advised, however, that it would continue to monitor Orbitz to ensure

[4] A Global Distribution System is a computer system that allows subscribing travel agents to search for and book airline reservations for their clients. Airlines must pay a transaction fee for every booking made through a GDS. The terms Computer Reservation System (CRS) and GDS are often used interchangeably, but a CRS technically refers to one airline's internal reservation system. All GDSs were formerly CRSs, and were all started as individual airline systems that were later expanded to include the fare and service offerings of all participating airlines.

[5] CR-2000-111, July 20, 2000. *Internet Sales of Airline Tickets,* Office of Inspector General, U.S. Department of Transportation.

that its actual operations did not harm consumers. In June 2001, Orbitz launched and has remained the subject of ongoing scrutiny. The Conference Report that accompanied the FY 2002 Department of Transportation Appropriations Act required the Department to report on its monitoring efforts of Orbitz and to provide its report to our office for review. This memorandum conveys the results of our review.

In addition, in April 2000, Congress established the National Commission to Ensure Consumer Information and Choice in the Airline Industry (the Commission) to examine the market position and overall state of retail travel agents for the sale of air travel services.[6] The Commission held hearings in June and July 2002 to determine whether the financial condition of travel agents was declining; whether airlines were creating barriers to information regarding their services and products; and whether consumers, travel agents, and online travel distributors were being affected by the changes in the travel marketplace.

The Commission's November 13, 2002 report found that consumers have benefited greatly from the changes in travel distribution, including more efficient access to travel information as a result of the Internet. However, the picture is less rosy for travel agents, who have faced consolidation and downsizing in the wake of shrinking commissions, growth of sales via the Internet, and reduced travel spending tied to the recession and the post-September 11, 2001 environment.

While concerned about these impacts, the Commission did not recommend new legislation or regulations, noting that the Government as a rule does not intervene in how suppliers distribute their products; nor does it shield private businesses from downward swings in the business cycle or from marketplace shifts in demand for their services. The Commission did not support mandating that webfares be made available to all distribution channels, noting that airlines have traditionally segmented fares among various distribution channels, and that the harms to consumers from such a policy would likely outweigh the benefits derived by travel agents.

However, the Commission recommended that the Government consider whether Orbitz should be allowed to maintain its MFN clause. The Commission cited concerns about Orbitz' potential for artificially inhibiting competition which would result in less competition among travel web sites, fewer "special deals" outside of Orbitz, and higher airfares to consumers. The Commission also stated that it found no aspect of Orbitz' business or goals that require the MFN or which justifies its existence.

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[6] Congress established the Commission as part of the Aviation Investment and Reform Act for the 21st Century (AIR-21).

RESULTS IN BRIEF

We agree with the Department's finding that Orbitz' operations have been consistent with its original plans and that it has adhered to its business model. Orbitz has entered into agreements with airlines that guarantee reduced distribution costs in exchange for access to the airlines' webfares. Orbitz has also made progress with its plans to establish direct links into the airlines' own reservation systems. We also concur with the Department that Orbitz has adhered to its commitment to an unbiased display of airfares and services.

However, one element of Orbitz' business plan that has not come to fruition is the planned public stock offering. Orbitz contends that the introduction of minority shareholders will dilute the airline ownership of Orbitz and thus mitigate concerns regarding a joint venture formed by competitors. The currently planned structure of the company following the public offering will not provide minority shareholders with sufficient powers to institute checks and balances on the actions of the airline-owners, and is therefore not an adequate substitute for continued monitoring of this joint venture.

The Department did not draw conclusions on the anticompetitive effects of Orbitz' MFN clause because of the Department of Justice's ongoing review. Based on our review, we did not find substantive evidence to indicate that the MFN clause has resulted in monopolistic or anticompetitive behavior by Orbitz' airline-owners and Charter Associates. With about 24 percent of the online travel agency air market, Orbitz has not accumulated sufficient market share to control the online distribution market. Orbitz' ability to gain additional market share is limited by several factors including its consumer ticketing fees and the fact that some airlines have chosen not to become Charter Associates.

In our tests of online ticket distribution sources, we found that nearly every advantage Orbitz demonstrated in finding or matching the lowest fares was negated by the $5 to $10 ticketing fee Orbitz charges consumers. While Orbitz offered or matched the lowest *fare* in 76 percent of our tests, once the ticketing fee was added, Orbitz offered the lowest *price* to consumers in only 3 percent of the tests. It is important to note that at the time of our tests (November 2002), neither Expedia nor Travelocity had yet instituted consumer ticketing fees. Since our testing, Expedia has begun implementing a $5 consumer ticketing fee on most domestic fares and Travelocity has announced that it will also institute a similar fee beginning early next year. In 24 percent of tests where Orbitz did not find or match the lowest fare, it was primarily because the lowest fare in the market for that itinerary was offered by non-Charter Associate airlines that typically reserve their lowest fares for their own websites. In approximately 4 percent of our tests, Orbitz had access to a significantly better fare than its competitors, although nearly half of these were attributable to itineraries that its competitors did not display.

We also found that a significant percentage of the lowest fares was offered by non-Charter Associate airlines *only* for purchase on their own websites. To the extent that non-Charter Associate airlines continue to offer lower fares exclusively on their own websites, the airlines undermine Orbitz' ability to gain market power.

Further, we found evidence that Orbitz' airline-owners and Charter Associates are increasingly providing Orbitz' competitors access to their webfares when distribution cost savings are offered. Webfares—or airfares that are available for sale only over the Internet—constitute a small percentage of fares that are offered for sale at any given time, but travel agencies have stressed the importance of having access to webfares in order to attract consumers to their websites. In August 2002, our tests to determine which agencies had access to deeply distressed weekend webfares found that all of the top three online travel agencies had access to at least some of the webfares, although the degree of access varied significantly.

In recent months, new agreements that guarantee webfare access have been signed between the airlines and Orbitz' online competitors. In addition, one major Charter Associate airline has signed agreements with two GDSs that will also make its webfares available to all online and brick-and-mortar travel agents using those respective systems. Orbitz' competitors have complained that they have had to offer better terms than Orbitz to access these webfares; however, this was difficult to evaluate because of the contingent structures of the agreements. Many involve market share-shifting override incentives that could result in terms that are either better or worse than the Orbitz deal, depending on whether market-shifting targets are met.

1. Whether Orbitz' operations have been consistent with its plans and whether Orbitz has adhered to its business model.

Orbitz' business model included developing contractual "Charter Associate" relationships with airlines that require the airlines to provide access to their most discounted published inventory in exchange for significant savings on distribution costs.[7] The contractual agreements commit to a gradually declining schedule of transaction fees that Charter Associate airlines pay Orbitz for every ticket sale. Orbitz' charter agreement also commits to neutral display of all airfares, regardless

[7] Orbitz has signed Charter Associate agreements with 42 airlines, 5 hotel companies, and 7 rental car companies. The focus of this review was on the airline ticket distribution portion of Orbitz' operations. A list of the Charter Associate airlines is provided in Exhibit B.

of whether or not the airline has invested in Orbitz or signed a Charter Associate agreement. Orbitz' airline-owners launched the website as a privately-owned entity, but planned to eventually dilute the airline ownership through a public stock offering.

The Department concluded that Orbitz' operations have been consistent with its plans and that Orbitz has adhered to its business model. We agree generally with this finding, although Orbitz has delayed its public stock offering because of Government scrutiny and the unfavorable stock market environment.

Concerns continue to linger regarding Orbitz and the idea that the five largest airlines have created a joint venture for ticket distribution. The Department of Justice, the Department of Transportation, and our office reviewed Orbitz' plans prior to its launching, as well as its operations since that launch in June 2001. While no tangible harms have been proven to date, many of Orbitz' opponents are still skeptical of the airline-owners intentions.

Orbitz has contended that taking the company public will introduce minority shareholders that could eliminate some of the ongoing need for intense Government scrutiny by providing some internal checks and balances against the possibility that the airline-owners could use Orbitz to harm the marketplace. *On its face, diluting airline ownership should help to assuage some of the concerns over Orbitz' control issues. In our view, however, this approach will do little in substance to mitigate the ownership and control issues because the proposed structure of the public company essentially places all operating decisions in the hands of the airline-dominated Board of Directors.*

Orbitz believes that such control is necessary to preserve several pro-market elements of its business plan, including nonbiased displays of airfares and services, and commitment to being a distribution outlet price competitor. According to Orbitz, these elements are pro-consumer, but may run contrary to the financial interests of non-airline shareholders. This may be correct; however, the proposed structure of the public company, as it stands, does not provide an adequate substitute for Government oversight of Orbitz and its owners.

2. Whether Orbitz has adhered to its contractual commitment to an unbiased display of fares and services.

The Department concluded, and we concur, that Orbitz has not deviated from its commitment to an unbiased display of airfares and services. The issue of industry display bias was first raised in the late 1970s and early 1980s when *individual* airlines owned the Computer Reservation Systems (CRSs) used by travel agents to access data on fares and services of nearly *all* airlines. The airlines skewed—or biased—the screens viewed by the travel agents in favor of their own products and services. While regulations now prohibit screen bias for integrated CRS displays of fares and services, the regulations do not extend to how online agencies then relay information on fares and services to their customers.

Commission override agreements, which provide incentive payments based on an agency's ability to shift market share to a particular carrier, are still prevalent in the industry. Online agencies have various techniques for highlighting and promoting airlines with which override agreements have been negotiated. *When Orbitz incorporated in 2000, it committed to an unbiased display of all fares and services regardless of whether or not an airline had become a Charter Associate or invested in Orbitz. To date, we have seen no evidence to suggest that Orbitz has deviated from this commitment.*

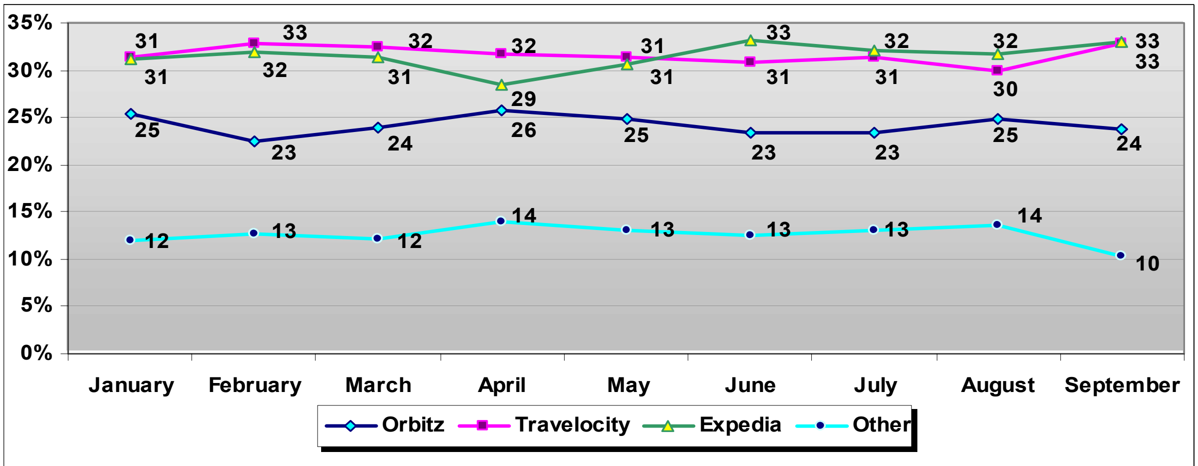
3. Whether the MFN clause has resulted in Orbitz' airline-owners and Charter Associates engaging in monopolistic or anticompetitive behavior.

We selectively reviewed the extensive data provided to the Department, interviewed industry stakeholders, and conducted our own tests of online distribution sites. Based on our review, we did not find substantive evidence to indicate that the Orbitz MFN clause has resulted in monopolistic or anticompetitive behavior by Orbitz' airline-owners and Charter Associates.

First, in order for Orbitz to exercise market power, it must first accumulate a dominant market share and it has not done so. After an initial period of rapid growth, Orbitz has maintained a steady market share for Internet travel agency air sales of about 24 percent, lagging behind both Expedia and Travelocity. Figure 2 illustrates the air market share of Travelocity, Expedia, Orbitz, and other online agencies between January and September 2002.[8]

[8] The "other" category includes online travel agencies such as Cheaptickets.com and GetThere.com that sell airfares in a predominantly non-opaque manner. Excluded are opaque sites such as Hotwire.com and Priceline.com.

Figure 2. Average Monthly Air Market Share of Online Agencies, January Through September 2002*



Source: MIDT Data, January 2002 through September 2002

* Orbitz implemented Supplier Link technology with American Airlines in mid-August 2002. American's air bookings through Supplier Link are not reflected in the Marketing Information Data Transfer (MIDT) data and are not represented in Orbitz' overall air market share data for August and September 2002.

Second, even though Orbitz' Charter Associates provide access to low fares and give Orbitz an opportunity to gain a marketplace advantage over its competitors, Orbitz' consumer ticketing fees often negate that advantage. In November 2002, we selected a statistical sample of 251 airport-pairs from a universe of 3,027. We performed two tests in each market—one with a typical business travel itinerary, and one with a typical leisure travel itinerary. With a sample size of 502 tests, we can be 90-percent confident that the margin of error of our estimates is no larger than 4.9 percent. A table with detailed results showing confidence limits and margins of error is included in Exhibit A.

We found that while Orbitz offered or matched the lowest *fare 76 percent* of the time,[9] more often than not, the *price*—or cost to consumers to purchase that fare—was higher than its competitors once Orbitz' fee was added. *Orbitz charges a consumer ticketing fee of between $5 and $10 for all tickets purchased on Orbitz. When this fee is added to the airfare, the total cost to the consumer—or price—was lowest on Orbitz in only 3 percent of our tests. Almost 97 percent of the time, consumers could have paid less for the same airfares on one or more of Orbitz' competitors' websites or on an airline's own website.*

Although Orbitz displayed the lowest fare in a majority of our tests, its ticketing fee often negated this advantage. At the time of our testing, Orbitz was the only one of the top three online agencies that charged a consumer ticketing fee. Since

[9] In the 24 percent of tests where Orbitz did not display the lowest fare, that fare was primarily offered by a non-Charter Associate airline that was only making that fare available for sale on its own website.

our tests, Expedia has implemented a $5 fee on most domestic sales of airline tickets. In addition, Travelocity recently announced that it too will institute a similar fee beginning early next year. The fees and any others charged to consumers in the future by Orbitz' competitors would likely minimize the differences we found between Orbitz' performance and that of its competitors.

In addition, we found that in most of the tests where Orbitz offered a significantly better fare than its competitors, it was not because of the MFN clause. Orbitz' search engine was able to splice together fares from multiple carriers or find fares from non-Charter Associate airlines, such as AirTran or American Trans Air, that are not bound by the MFN clause to provide Orbitz their lowest fares.

Orbitz' ability to gain market power by having access to the lowest fares in the marketplace will likely continue to be limited by airlines, such as Southwest and JetBlue, that have substantially lower fares in some markets but choose not to enter into Charter Associate agreements with Orbitz. In many cases, the lowest fares from these airlines will appear only on their own websites, and to some extent, on other online agency websites that agree to shift market share in exchange for access to low-fare inventory.[10] In our November 2002 tests to determine which agencies had access to the lowest fares, we found that in the 24 percent of the 502 tests where Orbitz did not find or match the lowest fare, the reason was primarily because the lowest fare in the market for that itinerary was offered by a non-Charter Associate airline on its own website. To the extent that these non-Charter Associate airlines continue to offer lower airfares only on their own websites or through special deals with Orbitz' competitors, Orbitz will be precluded from gaining access to a significant share of the low-fare market.

4. Whether Orbitz' airline-owners and Charter Associates were acting in an anticompetitive manner by refusing to provide their lowest fares to Orbitz' competitors.

In addition to making all of their regularly published fares available through standard distribution channels, airlines also make some fares available *exclusively* on the Internet, including their own airline websites and to some extent, third-party agency websites. These Internet-only fares are called webfares because they are available for sale only via the World Wide Web. Generally, webfares constitute a very small percentage of the universe of fares for sale at any given time through an online agency, including Orbitz, Travelocity, and Expedia. Further, weekend

[10] Most domestic airlines have eliminated domestic base commissions, which provided a commission to travel agents equal to a set percentage of the value of the ticket sold. Airlines have instituted "share shift" agreements, sometimes referred to as travel agent commission overrides, which provide financial incentives to travel agents to sell tickets on an airline disproportionate to its share of the available seat miles in that market. Generally, the greater the share sold, the higher the commission.

webfares, which are deeply distressed inventory offered for sale in selective and varying markets just days prior to travel, represent a small percentage of all webfares. However, despite their relatively minor market presence, nearly all travel agencies have stressed the importance of having access to webfares in order to attract consumers.

We selected a judgmental sample of 108 webfares that were offered in August 2002 for last-minute weekend travel to determine which agencies could access those fares. We found that all of the top three online travel agencies had access to at least some of the airlines' weekend webfares, although the degree of access varied significantly. Of the 108 webfares tested, Orbitz had access to 92 (85 percent), Expedia had access to 42 (39 percent), and Travelocity had access to 7 (6 percent).

Since our testing in August 2002, new agreements that grant webfare access have been signed between the airlines and Orbitz' online competitors. Furthermore, one major Charter Associate airline recently signed agreements with two GDSs that grant subscribers of these GDSs access to its webfares, including brick-and-mortar agents, in exchange for reduced booking fees.

In some cases, Orbitz' competitors have complained that they have had to offer better terms than Orbitz to access these fares. We have looked at the terms of a sample of these agreements and believe that while some of the provisions are very similar to Orbitz', including a declining scale of airline transaction fees, there are differences in most of them that make a financial comparison difficult. Most notably, the inclusion of market-shifting override incentives makes the financial terms of the agreements contingent upon what plays out in the market. If certain market-shifting targets are met, the terms of the agreement could potentially provide *better* terms than what the Orbitz deal offers. If the goals are not met, the terms are not as good.

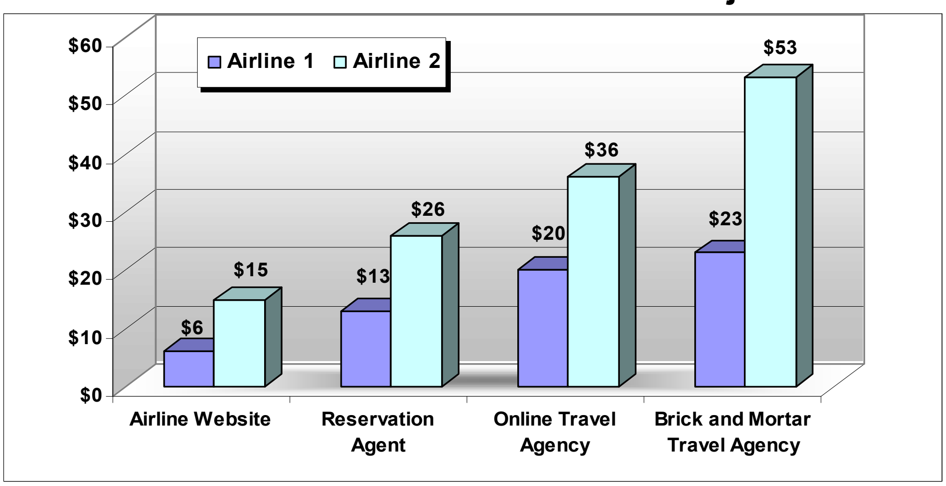
BACKGROUND

Before airline deregulation in 1978, airlines sold more tickets through their reservation call centers and city ticket offices than through any other distribution source. Following deregulation and the resulting explosion of airfare and service options, most airline ticket distribution shifted to brick-and-mortar travel agencies. In recent years, however, reductions in airline commissions along with the proliferation of Internet travel channels have eroded the travel agencies' consumer and economic base as airlines encourage consumers to purchase tickets through less costly distribution outlets. Before the Internet, brick-and-mortar travel agencies sold between 70 and 75 percent of airline tickets; that number is now estimated to be between 50 percent and 70 percent. Online distribution channels include airline websites, online travel agencies, and online consolidators and discounters.

After several generally profitable years, the airline industry lost approximately $8 billion in 2001. With the recent airline economic climate showing few signs of recovery and consumer confidence returning slowly, the U.S. airline industry is expected to report substantial losses in 2002. To reduce losses, airlines have attempted to lower their cost structures and reduce capacity. One area of focus has been ticket distribution costs, the third highest category of costs behind labor and fuel for many airlines, as a means of controlling overall cost growth. In March 2002, most major airlines eliminated travel agent base commissions. Nevertheless, the GDS fees incurred with travel agent bookings combined with override commissions or other ticketing fees continue to make this distribution outlet relatively costly for airlines.

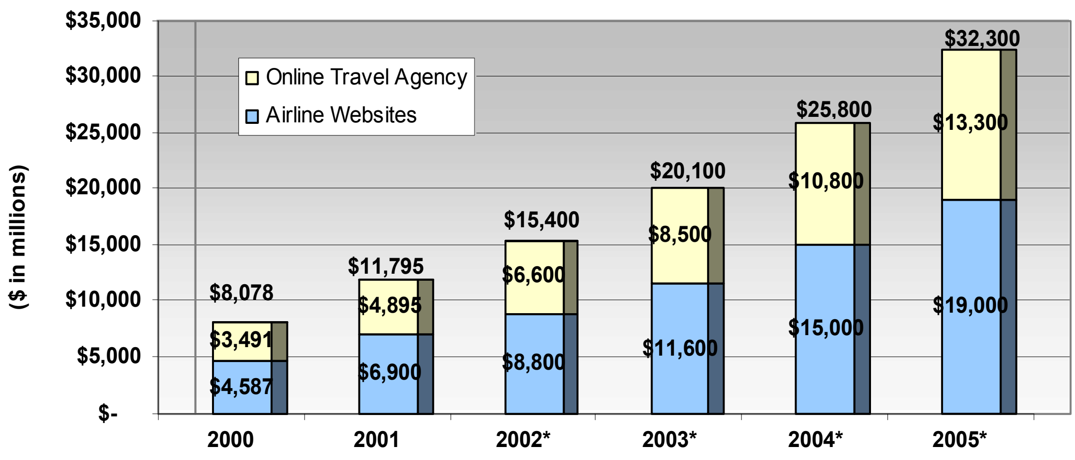
Airlines incur the lowest ticket distribution costs on their own Internet websites. Airlines have encouraged consumers to purchase tickets on the Internet by making special fares—sometimes referred to as "e-fares," "webfares," or "web-only" fares—available for purchase only on the Internet. Figure 3 illustrates distribution costs from two major carriers in 2000. Although the absolute costs reported for each distribution channel differ substantially between the two carriers, the relative costs per channel follow the same pattern.

Figure 3. Per Ticket Distribution Costs for Two Major Carriers in 2000



Currently, about 15 percent of all airline ticket sales revenue is from sales over the Internet, which is nearly double the 8 percent of all airline ticket sales revenue in 2000. Of the 15 percent sold online, about 42 percent of tickets were sold through third-party sites, such as Expedia, Travelocity, and Orbitz, and 58 percent were sold through the airline websites.[11] In 2001, airline website revenues increased 50 percent over 2000 to $6.9 billion. Figure 4 illustrates the growth of airline ticket sales over the Internet.

Figure 4. Airline Internet Ticket Sales, 2000 Through 2005*



Source: PhoCusWright Inc, May 2002

* Actual sales are reported for 2000 and 2001 and sales are projected from 2002 through 2005.

In June 2001, five major airlines—Delta, United, Northwest, Continental, and American Airlines—launched Orbitz, an online travel agency. Orbitz invited any domestic or foreign airline to become a Charter Associate, which would require the airline to enter into a contractual agreement with Orbitz regarding access to certain fares, marketing support, and booking fee rebates. To date, Orbitz has 42 airline Charter Associates, including Orbitz' airline-owners. According to the airline-owners, Orbitz was created to apply pressure on rising GDS distribution costs. Consistent with its business model, Orbitz has begun implementing Supplier Link,[12] which enables Orbitz to access an airline's internal reservation system directly, thus bypassing the GDSs.

As part of its business model, Orbitz has also committed to displaying each airline's fare and service information without bias, regardless of whether the airline has opted to become a Charter Associate. To provide continued cost savings to the Charter Associates, Orbitz committed to a declining distribution cost schedule, including gradually diminishing transaction fees paid by the airlines and continued implementation of Supplier Link technology.

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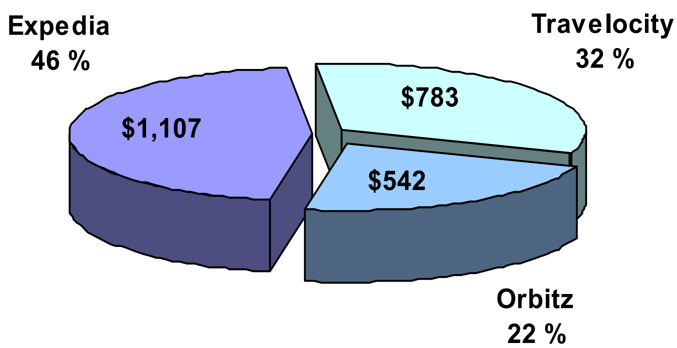
[11] Figures based on May 2002 PhoCusWright report and Gary Doernhoefer's June 2002 testimony before the National Commission to Ensure Consumer Information and Choice in the Airline Industry.

[12] Supplier Link is the term applied to Orbitz' direct connection to an airline's internal reservation system. Reservations made through Supplier Link are not channeled through a GDS and thus avoid all GDS fees.

Since its inception, Orbitz has grown to become the third largest online travel agency behind Expedia and Travelocity, in terms of total travel bookings. Based on the data provided to the Department, in the first quarter of 2002, Expedia's travel bookings totaled $1.1 billion, Travelocity's totaled $783 million, and Orbitz' totaled $542 million (see Figure 5).[13]

Figure 5. Travel Sales and Relative Share of Market for the Three Largest Online Travel Agencies, First Quarter 2002 ($ in millions)



Source: PhoCusWright Inc., May 2002

OBJECTIVE, SCOPE, AND METHODOLOGY

Our objective was to evaluate the reasonableness and accuracy of the Department's analysis and conclusions reached on its monitoring efforts as required by the Conference Report on the DOT Appropriations bill for FY 2002. The conferees requested that the Department evaluate and comment on the following four potential concerns.

- Deviations from plans, policies, and procedures initially proposed in the joint venture's business plan and contained in its charter associate agreements.
- Extent to which the joint venture has adhered to its commitment to not bias displays of fares or services.
- Extent to which ties between the airline-owners and the "Most Favored Nation" clause in the charter agreement have resulted in monopolistic or other anticompetitive market behavior.
- Whether airline-owners of the joint venture or charter associates have acted in an anticompetitive manner by choosing not to distribute fares through other distribution outlets.

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[13] Total travel sales include airline tickets, hotels, car rentals, packages, cruises, and other travel-related products.

We examined the Department's June 27, 2002 report and selectively reviewed data submitted to the Department by Orbitz' airline-owners, Charter and non-Charter Associates, GDSs and online travel agencies. We held discussions with and reviewed supplemental data submitted by online and brick-and-mortar travel agencies, Department officials, GDSs, and large and small carriers. We also reviewed industry analyses from widely recognized Internet experts, such as Forrester Research and PhoCusWright, Inc., to evaluate trends in the online travel environment.

We independently designed two sets of tests of online ticket distribution to provide us with additional data to help evaluate: (1) whether Orbitz' MFN clause has resulted in anticompetitive behavior by its airline-owners or whether the MFN clause has given Orbitz a significant marketplace advantage and (2) whether Orbitz' airline-owners are restricting the distribution of their webfares exclusively to Orbitz and their own websites.

We began Test 1 in the summer of 2002 by selecting a preliminary statistical sample of 110 airport-pairs from a universe of 3,027. We divided the 110 airport-pairs and tested 55 markets using itineraries with parameters typical of business travelers and 55 markets using itineraries with parameters typical of leisure travelers to determine how many times a website found or matched the lowest fare or price. In order to improve the precision of our results, we expanded our review in November 2002 to include another statistical sample of 251 airport-pairs. We performed two tests in each market—one with a business itinerary, and one with a leisure itinerary, for a total of an additional 502 tests. Table 1 identifies the parameters used in our tests to distinguish between a typical "business" itinerary and a typical "leisure" itinerary.

Table 1. Business and Leisure Itinerary Parameters

Parameters	Business	Leisure
Connections	Non-stop 1-Stop	Non-stop 1-Stop 2-Stop
Layover	3 hours	5 hours (each)
Travel Times	Depart: No earlier than 5:50 a.m. Arrive: No later than 12:10 a.m.	Depart: Any Arrive: Any (Overnight travel permitted)
Restrictions	No Saturday stay	7-day minimum stay, Saturday night stay
Advance Purchase	2-3 day	21 day

To conduct the tests, we simultaneously accessed the top three online travel websites, Charter Associate airline websites, and the websites of any non-Charter Associate airline serving that market. Fares were noted including all taxes, security, and airport fees. Any additional fees—such as consumer service fees or fees for issuing paper tickets—were identified separately. Results were analyzed on a "fare-only" basis as well as a "fare+fee" basis to determine the actual cost of the product to consumers.

We found that our second sample verified the results of our first. We can be 90 percent confident that the margin of error of our estimates is no larger than 4.9 percent. A table with detailed results showing confidence limits and margins of error is included in Exhibit A.

In Test 2, we selected a judgmental sample of 108 webfares offered for sale by eight Charter Associates, including the five founding airlines. We selected between 12 and 15 weekend webfares for the eight airlines that were being offered for travel for the approaching weekend. We simultaneously tested these itineraries on the three major online travel agencies to identify which online agencies had access to this fare inventory. We also simultaneously tested the offering airline's own website to ensure that an agency's inability to display a fare did not reflect a lack of availability.

We also compared a sample of 118 webfares offered in July 2001 to webfares offered in August and September 2002 to determine whether and to what extent average webfares have increased in those markets. The markets were judgmentally selected based on whether a webfare between the two markets was available in both 2001 and 2002. Exhibit A provides a more detailed discussion of our testing methodology.

To evaluate the accuracy of the Department's report, we judgmentally selected statements of facts cited in the Department's report and verified the items to the data, letters, narrative, and interrogatories the Department received from the online agencies, GDSs, and airlines.

RESULTS

Orbitz Has Not Materially Deviated from Its Original Business Plan or Business Model

The Department found that at the time of its report, Orbitz' implementation had been generally consistent with its business plans and business model. We found that this was generally true, although events subsequent to the Department's report, including sustained difficulties in financial markets and continued

Government oversight activity, have caused Orbitz to delay its intended public stock offering.

Some of Orbitz' critics have alleged that the Orbitz business model is fundamentally uneconomic as a viable, independent, ongoing concern. The allegation reflects a belief that Orbitz was never intended to make money and was only established by the airline-owners to force all online travel agencies out of business. Orbitz' competitors claim that Orbitz' pricing model is too low to adequately cover its costs, which is forcing them to offer uneconomic matching pricing schemes in order to gain access to the airlines' best fares. They argue that lowering costs to match Orbitz' offer will force them out of business because they do not have the deep pockets of the airlines to continue to fund sustained losses.

The Department reviewed Orbitz' business plan, its financial statements and projections, and public filings with the Securities and Exchange Commission in anticipation of a public offering, and concluded that the business model is viable. We also reviewed Orbitz' more recent cash flow forecasts and additional financial data, held discussions with Orbitz officials, and essentially concur with the Department's conclusion. In addition, we considered the claims made by Orbitz' competitors and their estimates of the cost of selling tickets through Orbitz. We determined that competitors' cost estimates for selling air tickets through Orbitz were significantly higher than Orbitz' actual costs. Orbitz' competitors' high cost estimates have likely been the genesis of their criticisms of Orbitz' potential for ever making a profit.

Orbitz Has Adhered to Its Commitment to Unbiased Displays of Fares and Services

The Department concluded that Orbitz, to date, has adhered to its contractual commitment to an unbiased presentation of airline fares and services. This commitment prevents Orbitz from accepting traffic-share shifting override commissions from airlines and engaging in preferred carrier relationships similar to those pursued by Orbitz' competitors. We agree with the Department's conclusion that Orbitz has sustained its commitment to unbiased displays. In addition, Orbitz has instituted protections to ensure that such a commitment could not easily be overturned with the introduction of minority stockholders following a public stock offering. To our knowledge only one former Charter Associate airline, which is no longer operating, complained about how its fares were displayed on Orbitz. However, we found no evidence that this was a result of bias. To the contrary, other low-fare airlines including one that is not a Charter Associate indicated that Orbitz' unbiased display makes their lower fares more visible to consumers.

Orbitz' Charter Associate agreements for the non-owner airlines are valid for 3 years from the date originally finalized. Many of these agreements will expire next year. If, at that time, Charter Associate airlines do not believe that Orbitz has treated them fairly, including how their fares and services have been displayed, these airlines may choose not to renew the agreement.

OIG Observations on Orbitz' MFN Clause and Potential for Anticompetitive Behavior by the Airline-Owners or Other Charter Associates

The most controversial Orbitz issue is the so-called MFN clause contained in Orbitz' Charter Associate agreements. The MFN clause requires that Charter Associate airlines provide all fares that they offer on their own websites to Orbitz. It also requires Charter Associate airlines to make any fare that they make available to any other third-party travel distributor available to Orbitz, as long as Orbitz is able to meet the terms offered by the other agency. The MFN clause expressly allows Charter Associate airlines to give the *same* fares it gives Orbitz to other distribution outlets. However, it restricts airlines from giving Orbitz' competitors *better* fares without giving Orbitz a chance to match the terms.

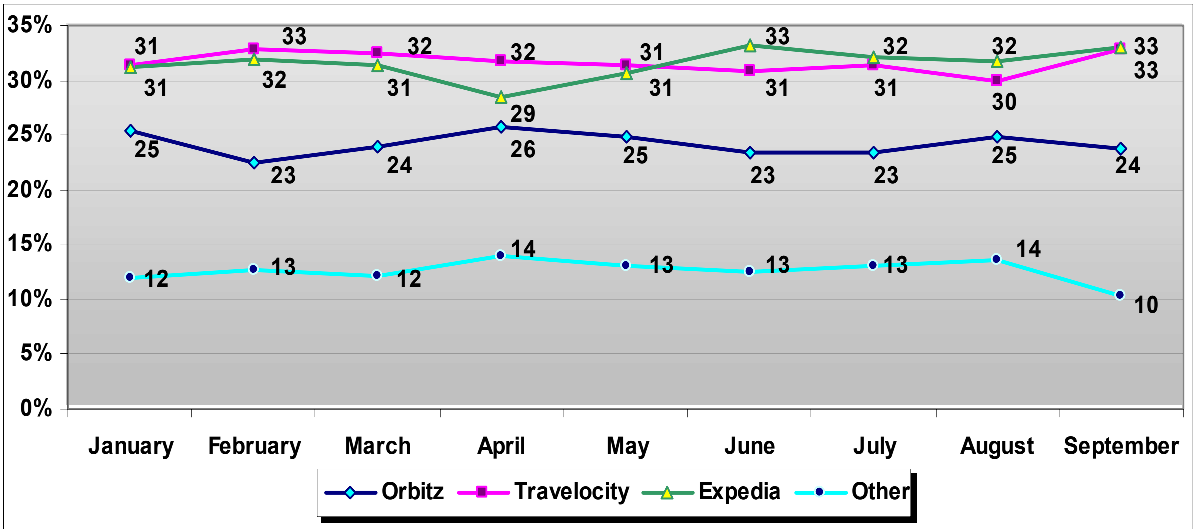
We reviewed data supplied to the Department, conducted interviews with industry stakeholders, and performed our own tests of online ticket distribution sources to determine whether conclusions could be drawn about the impact of Orbitz' MFN clause on the marketplace. A summary of our observations follows.

Orbitz' MFN Clause Has Not Resulted in Sustained Market Share Growth for Orbitz

Orbitz' critics claimed that the MFN clause would give Orbitz exclusive access to its owner-airlines' lowest fares, which would enable it to drive its competitors out of business. Orbitz would then use its market power to charge higher fees to airlines for the privilege of selling through Orbitz, and/or raise the service fee that consumers must pay when they purchase a ticket on Orbitz. Either would ultimately result in higher costs for consumers.

We have found no substantive evidence to date to support claims that Orbitz was gaining and exerting its market power to dominate the online travel industry. In order for Orbitz to exercise market power in this way, it must first accumulate a dominant market share, which it has not done. Although Orbitz is a significant player in the online travel industry, its market share (for air sales only) lagged both Expedia and Travelocity. After an initial period of rapid growth after its launch in June 2001, Orbitz' market share relative to Expedia and Travelocity has stabilized. As Figure 6 illustrates, since January 2002, Orbitz' average monthly air market share ranged from 23 percent to 26 percent, with a 9-month overall average of about 24 percent. Furthermore, recent agreements between Charter Associate airlines and Orbitz' competitors will limit Orbitz' ability to accumulate further market power as its competitors gain access to a wider range of webfares.

Figure 6. Average Monthly Air Market Share of Online Agencies, January Through September 2002*



Source: MIDT Data, January 2002 through September 2002

* Orbitz implemented Supplier Link technology with American Airlines in mid-August 2002. American's air bookings through Supplier Link are not reflected in the MIDT data and are not represented in Orbitz' overall air market share data for August and September 2002.

Orbitz Consumer Ticketing Fees Diminished Most of the Advantages That Resulted When Orbitz Found or Matched the Lowest Fare

Based on our tests, Orbitz found the lowest *fare* significantly more often than its online competitors; however, the $5 to $10 service fee that consumers must pay for booking airfares on Orbitz in many cases closed the *price* gap. When its competitors had access to the same fares, Orbitz was more expensive because of this fee. When Orbitz did provide a significantly better fare than its major online competitors, it typically was not the result of having exclusive access to special fares.

Orbitz Outperformed Competitors in Finding or Matching Lowest Fares. In 502 tests, the $370 average roundtrip fare returned by Orbitz was approximately $11 better than the average roundtrip fare found on Travelocity ($381) and $13 better than the average roundtrip fare found on Expedia ($383). Orbitz found or matched the lowest fare currently available in the tested market on 76 percent of the tests, which was better than Expedia (61 percent) or Travelocity (59 percent).

In 24 percent of tests where Orbitz did not find or match the lowest fare, it was primarily because the lowest fare in the market for that itinerary was offered by non-Charter Associate airlines, such as JetBlue or Frontier Airlines, that typically reserve their lowest fares for their own websites, or Southwest Airlines that does not provide *any* of its fares to online agencies. Table 2 illustrates the results of our 502 tests for access to lowest fares. These fares do not include ticketing fees.

Table 2. Percent of Time Each Site Found or Matched Lowest Fare
(Based on 502 Tests)

Website	Number of Tests	Percent of Time
Orbitz	380	76
Charter Associate Website	345	69
Expedia	305	61
Travelocity	296	59
Non-Charter Associate Website	81	16

Orbitz displayed fares that neither Travelocity nor Expedia displayed in 70 of the 502 tests. In the majority of these tests, the results did not appear to be because Orbitz had exclusive access to significantly lower fares from its Charter Associates. In 52 (74 percent) of the 70 tests, the fare found on Orbitz was within $6 of the next lowest fare found by another online agency website. Once Orbitz' consumer ticketing fee was added, the marketplace advantage from having the lowest fare all but disappeared. In 11 (2 percent) of the 502 tests that we performed, Orbitz had access to a significantly better fare than its competitors. In another seven tests, Orbitz' search engine was able to combine flight segments by different carriers in ways its competitors could not or did not.

Orbitz' Consumer Ticketing Fee Negated Nearly All Market Advantage of Finding Lowest Fares. Although Orbitz found or matched the lowest *fare* more often than its online competitors, the $5 to $10 ticketing fee that consumers would have paid for booking airfares on Orbitz in many cases closed the *price* gap. When Orbitz had access to a fare that was on a carrier's website, it was $5 to $10 more expensive for consumers to purchase that fare on Orbitz than by going directly to the airline website. Consumers could also have saved $5 to $10 by purchasing on Orbitz' competitors' sites when they had access to the same fare inventory, because neither Travelocity nor Expedia charged fees to purchase airline tickets at the time of our tests.[14] Table 3 illustrates how the websites performed when the actual purchasing price to the consumer was considered.

[14] On December 4, 2002, Expedia began charging a $5 fee on most airline tickets. Travelocity recently announced that it will institute a similar fee beginning early next year.

Table 3. Percent of Time Each Site Found or Matched Lowest Price to the Consumer (Fare + Fee)
(Based on 502 tests)

Website	Number of Tests	Percent of Time
Charter Associate Website	377	75
Expedia	345	69
Travelocity	336	67
Non-Charter Associate Website	81	16
Orbitz	***17***	***3***

It is notable that consumers appear to be aware of the impact of the fee on the price of tickets. In September 2002, Orbitz' look-to-book ratio[15] (72 to 1) was more than double Expedia's look-to-book ratio. For Orbitz, this means that for every 72 unique consumers that visit Orbitz' website, only 1 makes a purchase. This suggests that a substantial number of consumers use the Orbitz website to research fares but purchase them elsewhere.

Non-Charter Associate Airlines Including Southwest and JetBlue Also Place Limits on Orbitz' Ability to Potentially Dominate the Online Market

Although Orbitz invited every commercial airline to sign on as a Charter Associate, several carriers declined to participate. The largest of the non-Charter Associate Airlines is Southwest, which does not participate in any online agencies. Among other airlines choosing not to sign the agreement are Frontier, American Trans Air, AirTran, and JetBlue. Orbitz has access to the carriers' fares that are filed in Worldspan and ATPCo[16] that can be sold by all travel agents, but these carriers are not subject to the MFN clause which would require the carriers to give Orbitz all fares that they offer publicly, including special deals they make with other agencies or fares they place on their own websites. Some low-fare airlines have been exceptionally successful in attracting consumers to their own airline websites by offering discounts for online purchases. One airline reported to us that website sales represented over 65 percent of its total ticket sales.

Non-Charter Associate airlines' websites returned the lowest fare in approximately 16 percent of our tests. We found that where a market was served by at least one non-Charter Associate airline, the average of the lowest fare offered on a non-

[15] Look-to-book ratios are a prevailing metric in the travel industry that measures the percentage of people who actually buy a product after visiting the travel website.
[16] ATPCo (Airline Tariff Publishing Company) collects and distributes fares and fare-related data for the airline and travel industry.

Charter Associate airline website[17] was $304, which was 24 percent better than the $378 average fare found by Orbitz, Travelocity, and Expedia for those markets.

Orbitz obtains a degree of market advantage by having access to a substantial inventory of the lowest fares. Orbitz has attempted to access all of the lowest fares by pursuing Charter Associate agreements with every operating carrier. To the extent that airlines have chosen not to enter into an agreement with Orbitz and reserved their lowest fares for their own websites or negotiated special deals with other online agencies, these airlines limit Orbitz' ability to increase its market share.

Deeply Discounted Fares Have Changed Little Since 2001

Some of Orbitz' competitors have alleged that the MFN clause would harm the market in the short run by causing airlines to eliminate or reduce the number of webfares they offer on their own websites and/or third-party sites. They argued that the MFN clause, which requires airline-owners and Charter Associate airlines to provide Orbitz with all fares offered through their own websites, would make the lowest fares too visible, thus inviting wide-scale price competition from other carriers in those markets. Rather than invite this competition, the critics argue that airlines will simply not offer these low fares or will not offer them on terms as beneficial to consumers as prior to Orbitz' launch.

We found that the deeply discounted webfares have changed little since 2001. We compared 118 webfares offered for weekend travel during one week in July 2001 to webfares offered for comparable itineraries in 2002. We could not compare the *quantity* of seats available at these fares, since the airlines do not disclose how many seats are available at the advertised fares, with the number available in 2001, but we did look at the *qualitative* aspects—how the fares compared in various market-pairs in 2001 (immediately following Orbitz' launch) to September 2002. For our judgmentally selected sample, we found that the average webfares decreased by $1.49 between 2001 ($149.14) and 2002 ($147.65).

Some of Orbitz' competitors provided data to demonstrate that the number of webfares being offered by the industry was declining and that this was the result of the MFN clause. We attempted to evaluate this issue but since 2001, many changes have occurred in the airline industry that have caused a variety of pricing, capacity, and marketing actions that have impacted consumers' access to airline fares. The events of September 11, 2001 and the economic pressures caused by reduced business travel have pressured airlines to fill more seats with discounted

[17] In some cases, more than one non-Charter Associate airline operated in the sample of the markets we tested. In those tests, we selected the non-Charter Associate airline that had the lowest fare and used that fare to calculate our lowest average fare.

fares. These same pressures have also caused airlines to reduce capacity, which has likely made fewer seats available at *all* fares, counteracting the discounting with a reduced seating inventory.

With the launch of Orbitz in June 2001, it is possible that the MFN clause has also impacted pricing and marketing strategies pursued by the airlines during the past year. However, with these events occurring simultaneously, it is difficult to conclusively pinpoint the drivers behind airline pricing and marketing actions, or to specifically link the availability and quality of webfares to Orbitz' MFN clause.

The Department Did Not Draw Conclusions Related to the Impact of the MFN on Competition

Because of the open investigation at the Department of Justice, the Department of Transportation refrained from drawing conclusions concerning the extent to which ties between the airline-owners and the MFN clause in the Charter Associate Agreements have resulted in monopolistic or other anticompetitive market behavior. The Department did, however, identify positive impacts that Orbitz has had on the ticket distribution market. Examples include Orbitz' unbiased display of airfares, development of search technology that enables consumers to see more fare options, Supplier Link technology, and GDS fee rebates to Charter Associates that will pressure other distribution outlets to lower their distribution costs.

The Department, however, raised concerns that the Orbitz MFN clause could discourage selective discounting and other direct marketing initiatives through various distribution channels. The concern was that Orbitz' airline-owners would attempt to protect their investment in Orbitz by withholding their best fares from Orbitz' competitors, even if the economic terms for distributing through those sites are the same or better than what Orbitz is offering. By withholding these fares from other distribution outlets, Orbitz' airline-owners could ensure that Orbitz maintains a competitive advantage. If Orbitz loses its competitive advantage, the value of the investment made by the airline-owners would likely diminish. The Department did not indicate that it found evidence of such problems. In our review, we found evidence that the owner-airlines were distributing their lowest fares through a variety of distribution channels. Our observations related to that issue are included in the following section.

Orbitz' Airline-Owners and Charter Associates Are Increasingly Providing Their Lowest Fares to Orbitz' Competitors

Both online and brick-and-mortar travel agencies have stated that access to webfares is critical for attracting and maintaining a customer base. Orbitz has contractually negotiated access to most of its Charter Associates' webfares through the MFN provisions of its Charter Associate agreement. Orbitz claims that no Charter Associates have provided it with exclusive fares—meaning that these fares would only be available on Orbitz. However, there have been many instances where Charter Associates have offered fares only on their own websites and on Orbitz. Orbitz' competitors have alleged that the MFN clause has both discouraged and prevented airlines from sharing their webfares with other agencies—both online and brick-and-mortar. They also alleged that when the airlines refuse to distribute webfares beyond Orbitz—even when the competing agencies offer equivalent economic terms—Orbitz gains a commanding marketplace advantage.

We reviewed data supplied to the Department, conducted interviews with industry stakeholders, and performed our own tests of online ticket distribution sources to determine what conclusions could be drawn about whether Orbitz' airline-owners and Charter Associate airlines were acting in an anticompetitive manner by refusing to distribute their lowest airfares to other online travel agencies.

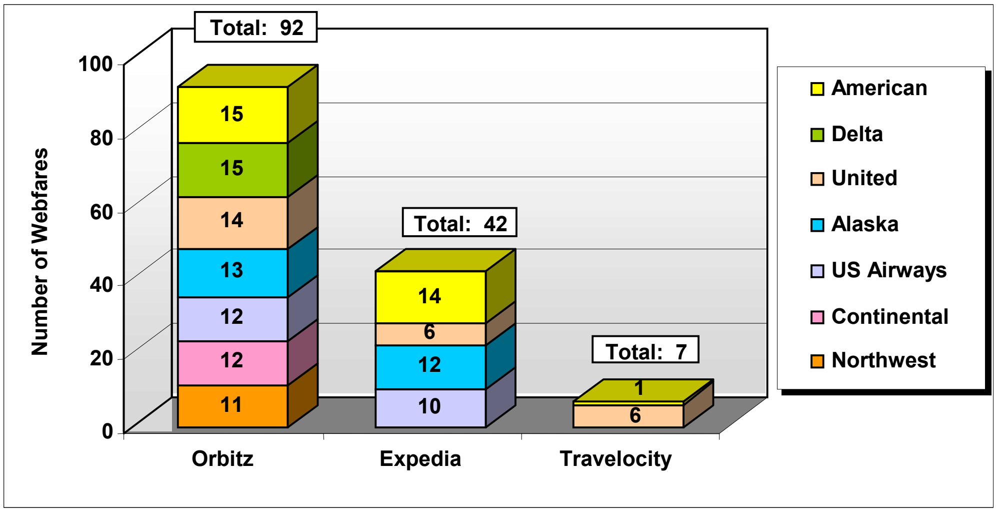
Our Tests Showed That Orbitz Had Advantageous Access to Webfares, But Recent Agreements Have Narrowed That Advantage

At any given time, the bulk of the fares that can be purchased online are the same fares that could be purchased through a brick-and-mortar travel agency or through the airlines' call centers. Only a small portion of fares are reserved as "web-only" fares that can be purchased only on the Internet. In many cases, the fares are heavily restricted and require the consumer to purchase and travel with only a few days notice. However, nearly all of the travel agencies have claimed that having access to this small inventory of webfares is essential to attracting consumers.

To determine which agencies were getting access to webfares, we designed a separate test that consisted of a judgmental sample of 108 deeply discounted webfares offered for travel over an approaching weekend. We tested between 12 and 15 webfares offered on eight airlines.

During our tests in August 2002, we found that all of the top three online travel agencies displayed at least some of the airlines' weekend webfares, although the degree of access varied significantly. Of the 108 webfares tested, Orbitz had access to 92 (85 percent), Expedia 42 (39 percent), and Travelocity 7 (6 percent) (see Figure 7).

Figure 7. Numbers of Weekend Webfares Displayed By Each of the Top Three Online Agencies (Out of a Total 108 Tested)*



* When we conducted our tests, America West's webfares did not appear on any third-party agency websites. They were available only on the airline's own website.

All of the airlines whose webfares we tested are Charter Associates and are bound by the MFN clause to provide all their webfares to Orbitz. Of the airlines we tested, all except one were abiding by that clause. America West had just become a Charter Associate when we conducted our tests and stated that it had miscoded its weekend webfares when filing them with ATPCo. We have since checked America West's weekend webfares and found that Orbitz is now able to access and display those fares.

In recent months, several deals have been finalized between the Charter Associates and Orbitz' competitors that will allow those agencies to access the airlines' publicly-available webfares. For example, in July 2002, Travelocity and American Airlines signed an 8-year contract that will give Travelocity access to American webfares in exchange for reduced distribution costs for all American fares and services sold on Travelocity. We have reviewed the terms of several of these agreements and their basic terms appear similar to those offered by Orbitz. The fact that the airlines are now sharing these fares with other online agencies would seem to refute the notion that the airline-owners are tacitly colluding to withhold them.

The online agencies believe that their terms are actually better than what Orbitz is offering, but that claim is difficult to evaluate. The agreements between the airlines and Orbitz' competitors include override provisions that can cause the economic terms to vary depending on whether the agency meets its sales targets. Because of the new agreements, we expect any future tests to show a distribution of webfares that closes the gap with Orbitz' offerings; thus, further eroding Orbitz' marketplace advantage.

Competitive Pressure From Orbitz Has Resulted in Price Concessions From Two GDSs

One Charter Associate, US Airways, recently became the first airline to allow brick-and-mortar travel agencies to access all publicly available webfares. By signing 3-year agreements with Sabre and Galileo, US Airways expects to reduce its GDS fees on all bookings in those systems by about 10 percent and freeze the fees for 3 years. In exchange, all travel agencies that subscribe to Sabre and Galileo will be able to access and sell US Airways' webfares.

When we testified before the Senate Commerce Committee in July 2000, we said that Orbitz could potentially benefit the marketplace by putting competitive pressure on GDSs to lower booking costs and improve services. We stated, "[i]f airlines are successful in drawing consumers to distribution channels that incur lower booking fees—such as Orbitz—the [GDSs] that provide services for the higher cost distribution channels will lose business. If the [GDSs] want to keep this business, reducing their fees would give airlines more of an incentive to provide them with their lowest fares." The fact that the recent agreements with Sabre and Galileo reflect an effort by the GDSs to compete with Orbitz and other distribution sources that have reduced their costs in response to Orbitz would seem to indicate that Orbitz has indeed brought about this positive market effect.

The Department Did Not Reach Conclusions On Whether Airlines Were Refusing to Share Their Lowest Fares With Orbitz' Competitors.

The Department did not reach a conclusion on whether airlines were refusing to provide their lowest fares to Orbitz' competitors even when the same economic terms were offered. The GDS costs and transaction fees are relatively simple to calculate, but the in-kind marketing promotion costs are more complicated.[18] Orbitz assigns values to certain kinds of promotions, such as in-flight movie spots or advertising in frequent flyer newsletters; but the cost to the airline to provide such promotion is considerably less. For example, Orbitz might credit an airline for hanging a banner in its terminal commensurate to the amount that the airline could charge another advertiser to use that space, but the cost incurred by the

[18] The Charter Associate Agreement also requires airlines to market Orbitz to their customers. The amount of advertising required is commensurate with sales of the airline's services on Orbitz. The credit for this "in-kind" marketing is valued at the rate another entity, like Orbitz, might pay for the marketing opportunity, and not the actual cost incurred by the airline to provide the marketing material.

airline for making this space available is inconsequential. Orbitz claims none of the Charter Associates are likely to reject paying customers in order to meet their marketing requirements on Orbitz.

The Department also identified the difficulty in quantifying other nontangible benefits that are of significant value in the Orbitz deal, including the value of an unbiased display, a long-term contract with declining airline transaction fees, and the potential for Supplier Link (which will eliminate the majority of GDS booking fees on bookings through Orbitz). Because Orbitz is contractually precluded from biasing its display, Orbitz cannot agree to override commissions. Orbitz' competitors, however, depend on agreements that are based on shifting market share as a means for obtaining override commissions. The economics of these agreements depend on whether or not those targets are met. When the Department was preparing its report, a number of those deals were in the midst of negotiations and the Department was not able to analyze the final terms of the agreements to determine whether they were comparable to Orbitz' economics. We have looked at excerpts of some of the final agreements, and in our opinion, they are comparable.

Finally, in its report, the Department did not reach conclusions as to whether it would be considered anticompetitive if the airlines did refuse to provide Orbitz' competitors access to their lowest fares when similar terms were offered. However, we note that the Department of Transportation Office of General Counsel (OGC) recently dismissed two complaints alleging that the airlines' distribution strategies were anticompetitive.[19] In dismissing the complaints, the OGC emphasized that longstanding public policy affirmatively allows each airline to decide what fares to charge, where to offer their goods for sale, and under what terms.[20] The opinion states, "[t]he antitrust laws generally allow firms to decide how to distribute their own goods and services, including whether and to what extent to do so directly or by agents. A carrier's unilateral decision to stop selling its services through travel agencies would thus violate no antitrust principle."

Planned Public Stock Offering Does Not Negate Need for Continued Departmental Oversight

Oversight bodies and industry stakeholders have voiced concerns about the intentions of Orbitz' airline-owners. The Department of Justice, the Department

[19] On September 4, 2002, the OGC dismissed two complaints filed with Department of Transportation in October 1999 and March 2002 by the American Society of Travel Agents. The complaints alleged that the airlines and Orbitz, through its airline ownership, have reduced commissions and acted in such a way as to drive travel agents out of business or force them to institute fees for their services.

[20] Except to the extent that such practices constitute an unfair or deceptive practice or are judged to be a violation of the antitrust laws. Airlines with ownership interests in GDSs are also required to participate equally in competing GDSs.

of Transportation, and our office have reviewed Orbitz' plans prior to launching as well as its operations since that launch in June 2001. While no tangible harm has been proven to date, many industry observers remain skeptical.

Orbitz' airline-owners have maintained that a publicly-held company would introduce internal checks and balances that could mitigate external concerns about the airline-owners operating a joint venture. *We have reviewed the initial public offering and have concluded that the minority shareholders are likely to exert very little control over the general operations of the public company.* The structure of the company following the stock offering, in Orbitz' own words, provides the airline-owners with, "…a greater degree of control and influence in the operation of [the] business and the management of [company] affairs than is typically available to stockholders of a publicly-traded company."

When Orbitz goes public, the airline-owners will control six seats of the nine-seat board, and maintain the ability to nominate (and vote on) the remaining three seats. In addition, by giving themselves "supermajority" voting rights, the airline-owners state that they will be able, "to exercise control over all matters requiring approval by the board of directors or our stockholders. […]." Although the airline-owners will assume a fiduciary responsibility to act in the best interest of the company rather than in ways that primarily benefit their respective airlines, pursuing a breach of fiduciary duties lawsuit through the courts is expensive and time-consuming, and often the legal standard used to evaluate management decision making allows a great amount of latitude.

According to the Securities and Exchange Commission, many family-owned businesses adopt a similar control structure in order to preserve parts of the business that are important to the family, but may possibly run contrary to shareholders' financial interests. In Orbitz' case, the airline-owners believe that maintaining substantial control of the company after it goes public is necessary to preserve Orbitz' commitment to unbiased fare and service displays and to act as a price competitor on distribution costs, which non-airline shareholders may not believe are in their own financial interest. If such is the case, however, it would be disingenuous for Orbitz to hold out the introduction of minority shareholders as a substitute for external monitoring.

Title 49, United States Code, Section 41712 gives the Department the authority to act to prevent airlines and agents from engaging in unfair methods of competition in air transportation and the sale of air transportation. More specifically, the authority allows the Department to prohibit unfair practices, deceptive practices, and competitive practices that (1) violate the antitrust laws, (2) violate antitrust principles, or (3) are likely to become antitrust violations if allowed to continue unchecked. The Department has an ongoing responsibility to monitor the behavior of all of the airlines to ensure they are not engaging in unfair methods of competition and as part of this general responsibility, should continue to observe how the airlines use all distribution outlets, including Orbitz, to distribute their services.

We provided the Office of the Assistant Secretary of Aviation and International Affairs with an advance copy of this report and have received and incorporated comments on our observations as appropriate.

We appreciate the courtesies and cooperation of representatives from the Department of Transportation, Office of the Assistant Secretary for Aviation and International Affairs, during this evaluation. If you have any questions concerning this report, please call me at (202) 366-1992 or Mark Dayton, Assistant Inspector General for Competition and Economic Analysis, at (202) 366-9970.

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EXHIBIT A. STATISTICAL SAMPLE METHODOLGY PLAN

TESTING METHODOLOGY

We independently designed two tests of online ticket distribution to provide us with additional data to help evaluate: (1) whether Orbitz' MFN clause has resulted in anticompetitive behavior by its airline-owners or whether the MFN clause has given Orbitz a significant marketplace advantage and (2) whether Orbitz' airline-owners are restricting the distribution of their webfares exclusively to Orbitz and their own websites.

We began Test 1 in the summer of 2002 by selecting a preliminary statistical sample of 110 airport-pairs from a universe of 3,027. We divided the 110 airport-pairs and tested 55 markets using itineraries with parameters typical of business travelers and 55 markets using itineraries with parameters typical of leisure travelers to determine how many times a website found or matched the lowest fare or price. In order to improve the precision of our results, we expanded our review in November 2002 to include another statistical sample of 251 airport-pairs. We performed two tests in each market—one with a business itinerary, and one with a leisure itinerary for a total of an additional 502 tests.

Airfare testing was limited to five online travel distribution channels—three major online travel agencies (Orbitz, Travelocity, and Expedia); Charter Associate airline websites; and non-Charter Associate airline websites including AirTran, Frontier, Southwest, JetBlue, and American Trans Air, and all other non-Charter Associate airlines operating in the airport pairs tested. Testing was conducted simultaneously on Orbitz, Travelocity, Expedia, and non-Charter Associate airline websites. The Charter Associate airline websites were tested after the lowest fare from each of the other four online distribution channels was found. Fares were noted including all taxes and fees, and any additional fees, such as consumer service fees, fees for paper tickets, etc. were noted. Analyses of results were conducted on a "fare-only" basis as well as a "fare+fee" basis to determine the actual cost of the product to consumers. Table 4 summarizes the parameters for the respective tests.

Table 4. Business and Leisure Itinerary Parameters

Parameters	Business	Leisure
Connections	Non-stop 1-Stop	Non-stop 1-Stop 2-Stop
Layover	3 hours	5 hours (each)
Travel Times	Depart: No earlier than 5:50 a.m. Arrive: No later than 12:10 a.m.	Any- overnight travel permitted
Restrictions	No Saturday stay	7-day, Saturday Stay
Advance Purchase	2-3 day	21 day

Auditors and analysts conducted a total of 540 tests which included 20 additional business and 20 additional leisure itineraries to replace tests that were later found to be invalid. Some reasons for the invalidated tests include itineraries selected that were outside the applicable parameters, failure to choose the lowest fare, and lack of supporting documentation of fare availability.

We found that our second sample verified the results of our first. We can be 90 percent confident that the margin of error of our estimates is no larger than 4.9 percent. Table 5 shows the detailed test results with the associated confidence limits and margins of error.

In Test 2, we selected a judgmental sample of 108 webfares offered for sale in August 2002 by eight Charter Associates, including the five founding airlines. We selected between 12 and 15 weekend webfares for the eight airlines that were being offered for travel for the approaching weekend. We simultaneously tested these itineraries on the three major online travel agencies to identify which online agencies had access to this fare inventory. We also simultaneously tested the offering airline's own website to ensure that an agency's inability to access a fare did not reflect a lack of availability.

We also compared a judgmental sample of 118 webfares offered in July 2001 to webfares offered in August and September 2002 to determine whether and to what extent average webfares have increased in those markets. The markets were judgmentally selected based on whether a webfare between the two markets was available in both 2001 and 2002.

Table 5 presents the confidence limits and margins of error for our final November 2002 test results.

Table 5. Confidence Limits for Simple Random Sample

Number of Airport-Pairs in Universe		3,027			
Number of Airport-Pairs in Sample		251			
Confidence Level		90%			
	Lowest Fare Found or Matched	**Best Estimate**	**90% Lower Confidence Limit**	**90% Upper Confidence Limit**	**Margin of Error**
Fare-Business					
Orbitz	181	72.1%	67.6%	76.6%	4.5%
Travelocity	158	62.9%	58.1%	67.8%	4.8%
Expedia	170	67.7%	63.1%	72.4%	4.7%
Non-Charter	47	18.7%	14.8%	22.6%	3.9%
Charter	182	72.5%	68.1%	77.0%	4.4%
Fare-Leisure					
Orbitz	199	79.3%	75.2%	83.3%	4.0%
Travelocity	138	55.0%	50.0%	59.9%	5.0%
Expedia	135	53.8%	48.8%	58.8%	5.0%
Non-Charter	34	13.5%	10.1%	17.0%	3.4%
Charter	163	64.9%	60.2%	69.7%	4.8%
Fare-Combined					
Orbitz		**76%**	71.4%	80.0%	4.3%
Travelocity		**59%**	54.1%	63.9%	4.9%
Expedia		**61%**	55.9%	65.6%	4.9%
Non-Charter		**16%**	12.5%	19.8%	3.7%
Charter		**69%**	64.1%	73.3%	4.6%
Price-Business					
Orbitz	8	3.2%	1.4%	4.9%	1.7%
Travelocity	164	65.3%	60.6%	70.1%	4.7%
Expedia	174	69.3%	64.7%	73.9%	4.6%
Non-Charter	47	18.7%	14.8%	22.6%	3.9%
Charter	185	73.7%	69.3%	78.1%	4.4%
Price-Leisure					
Orbitz	9	3.6%	1.7%	5.4%	1.9%
Travelocity	172	68.5%	63.9%	73.2%	4.6%
Expedia	171	68.1%	63.5%	72.8%	4.6%
Non-Charter	34	13.5%	10.1%	17.0%	3.4%
Charter	192	76.5%	72.3%	80.7%	4.2%
Price-Combined					
Orbitz		**3%**	1.6%	5.2%	1.8%
Travelocity		**67%**	62.2%	71.6%	4.7%
Expedia		**69%**	64.1%	73.3%	4.6%
Non-Charter		**16%**	12.5%	19.8%	3.7%
Charter		**75%**	70.8%	79.4%	4.3%

EXHIBIT B. ORBITZ' 42 CHARTER ASSOCIATE AIRLINES

Aeromexico
Air France
Air Jamaica
Air New Zealand
Alaska Airlines
Aloha Air
All Nippon Airways
America West Airlines
American Airlines
Asiana Airlines
Cathay Pacific Airways
China Airlines
Continental Airlines
COPA
CSA Czech
Delta Air Lines
El Al Israel
EVA Air
Finnair
Hawaiian Airlines
Iberia
Japan Airlines
KLM Royal Dutch
Korean Air
LanChile
LanPeru
LOT Polish
Lufthansa
Mexicana
Midwest Express Airlines
Northwest Airlines
Qantas
Scandinavian Airways
Singapore Airlines
South African Airways
Spirit Airlines
Swiss International Airlines
United Airlines
US Airways
Uzbekistan Airways
Varig
Virgin Atlantic Airways

EXHIBIT C. MAJOR CONTRIBUTORS TO THIS REPORT

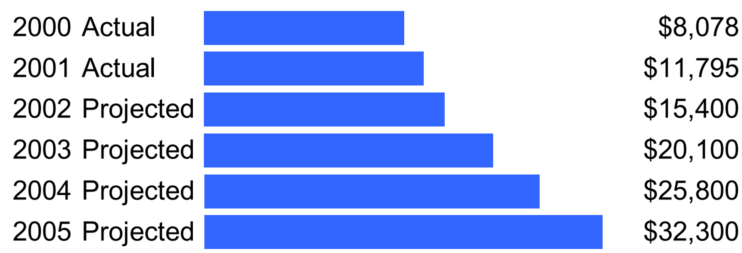
The following individuals contributed to this report.

Name	Title
Mark R. Dayton	Assistant Inspector General for Competition and Economic Analysis
Stuart A. Metzger	Program Director
Leila D. Kahn	Project Manager
Robert M. Finley	Analyst
Lisa T. Mackall	Auditor
Lauralyn J. Remo	Analyst
Kristen M. Rush	Analyst
Joshua L. Schank	Analyst

Main Document Charts and Tables

Note: The charts provided on the next two pages were not included in the original document, but have been provided here to allow screen readers access to the data that has been visually conveyed throughout this report.

Figure 1. Past and Projected Growth of Airline Tickets Sold Over the Internet, 2000 Through 2005



Source: PhoCusWright, May 2002

Figure 2. Average Monthly Air Market Share of Online Agencies, January Through September 2002

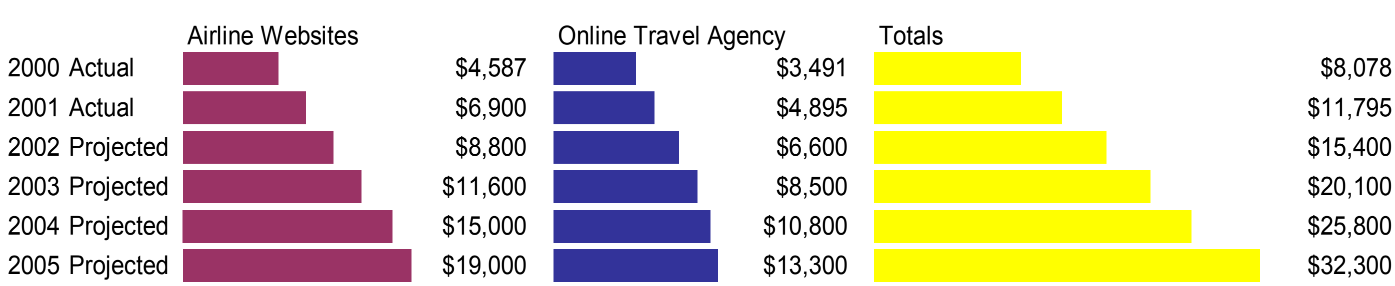
Online Travel Agency	January	February	March	April	May	June	July	August	September
Orbitz	25%	23%	24%	26%	25%	23%	23%	25%	24%
Travelocity	31%	33%	32%	32%	31%	31%	31%	30%	33%
Expedia	31%	32%	31%	29%	31%	33%	32%	32%	33%
Other	12%	13%	12%	14%	13%	13%	13%	14%	10%

Source: MIDT Data, January 2002 through September 2002

Figure 3. Per Ticket Distribution Costs for Two Major Carriers in 2000

Carrier	Airline Website	Reservation Agent	Online Travel Agency	Brick and Mortar Travel Agency
Airline 1	$6	$13	$20	$23
Airline 2	$15	$26	$36	$53

Figure 4. Airline Internet Ticket Sales, 2000 Through 2005



Source: PhoCusWright, May 2002

Main Document Charts and Tables

Figure 5. Travel Sales and Relative Share of Market for the Three Largest Online Travel Agencies, First Quarter 2002 ($ in millions)

	Travel Sales	Market Share
Orbitz	$542	22%
Travelocity	$783	32%
Expedia	$1,107	46%

Source: PhoCusWright Inc., May 2002

Figure 6. Average Monthly Air Market Share of Online Agencies, January Through September 2002

Online Travel Agency	January	February	March	April	May	June	July	August	September
Orbitz	25%	23%	24%	26%	25%	23%	23%	25%	24%
Travelocity	31%	33%	32%	32%	31%	31%	31%	30%	33%
Expedia	31%	32%	31%	29%	31%	33%	32%	32%	33%
Other	12%	13%	12%	14%	13%	13%	13%	14%	10%

Source: MIDT Data, January 2002 through September 2002

Figure 7. Numbers of Weekend Webfares Displayed By Each of the Top Three Online Agencies (Out of a Total 108 Tested)

Airline	Orbitz	Expedia	Travelocity
Alaska	13	12	0
American	15	14	1
Continental	12	0	0
Delta	15	0	0
Northwest	11	0	0
United	14	6	6
US Airways	12	10	0
Totals	**92**	**42**	**7**