THE TRAVEL INDUSTRY'S BUSINESS MODEL IS BROKEN. WHAT'S NEXT?

DISCUSSION PAPER

General Assembly of the World Tourism Organization (WTO)
Beijing, China
October 17 – 24, 2003

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THE TRAVEL INDUSTRY'S BUSINESS MODEL IS BROKEN. WHAT'S NEXT?

"The business model is broken and it must be fixed without burning any more furniture… the industry needs to embrace a culture change and a new way of doing business."
Robert Milton, President & CEO, Air Canada,
Star Alliance member

Having started the millennium with a remarkable year of growth in 2000, the travel industry has since been debilitated by a series of disturbing events: an uncertain economic climate; the terrorist attacks in the United States on September 11, 2001; the terrorist bombing in Bali in October 2002; the war in Iraq in March 2003, which was prefaced and followed by an extensive period of uncertainty (October 2002 through May 2003); the outbreak of severe acute respiratory syndrome (SARS) in March 2003; and two other terrorist attacks in 2003, one in Casablanca in May and another in Jakarta in August.

This paper looks at the repercussions of these events on overall tourism demand, the airline industry, the hotel industry, tour operators and the online travel market. With current conditions undermining the very structure of the travel industry, it is an opportune moment to examine the major issues facing each of its sectors. And such an examination always raises further questions:

With the deteriorating economic and political context, major players are becoming increasingly vulnerable and the travel industry as a whole is weakening. What can be done?

What changes must the airlines make to get back their feet?

With hotels seeking to consolidate their current holdings, what strategies should the industry adopt to encourage new development?

Are there any limits to the growth of the online travel market?

As the economy recovers, will customers, particularly business travellers, become discriminating once more and demand a higher level of service?

OVERVIEW

Seesawing international demand

Economic uncertainty caused relatively weak growth of only 2.9% in the global demand for tourism during the months of January through August **2001**. This was followed by a sharp 8.6% drop in international tourist arrivals in the wake of the terrorist attacks of September 11. The year 2001 closed with an overall decline in arrivals of some 0.6% compared to 2000 (693 million) and a drop in receipts of 2.6% (US$462 billion).

In **2002**, despite the Bali attack late in the year and the threat of war in Iraq, demand picked up, growing by 3.1% to 715 million international arrivals.

As for **2003**, the various global regions have registered uneven growth because of the war in Iraq, the SARS outbreak and persistent economic uncertainty. Upon declaring war on Iraq in March, the United States experienced a 20.3% drop in international tourist arrivals. SARS also had an immediate impact on tourism demand, seriously affecting Asia and Canada and, at the same time, the regions dealing with these markets. Nevertheless, by the end of 2003, the World Tourism Organization (WTO) expects overall tourism growth to reach 0 to 3%. One positive sign is that the most affected markets had begun to recover slightly as of July 2003.

In short, the events of the past 24 months have altered the demand for tourism, a change characterized by a shift from international travel to domestic tourism. These events have also increased traveller interest in some pre-existent trends: last-minute reservations, intra-regional travel and short stays.

Concrete signs of recovery are linked to improved economic conditions, a reduction in the uncertainty caused by international tensions and the waning of the SARS outbreak.

"Crisis has given us the opportunity to look at structural priorities. Intra-regional travel has become increasingly important as has domestic travel, which keeps the plant running in times of crisis."
John Koldowski, PATA Managing Director, Strategic Intelligence Centre.

A positive economic outlook

According to the *World Economic Outlook* of the International Monetary Fund (IMF) presented in April 2003, growth of worldwide Gross Domestic Product (GDP) is estimated to reach 3.2%, almost the same as that recorded in 2002. Still in the throes of a weak economy, most advanced economies – including the major tourist-generating countries – should see slow but steady improvement during the second half of the year[1] although growth will not be consistent throughout the world's regions. Global economic growth is expected to pick up to 4.1% in 2004.

Growth in real gross domestic product (GDP) – Annual variation in %
Projections from the International Monetary Fund

				Current estimates	
	2000	**2001**	**2002**	**2003**	**2004**
Africa	2.8	3.6	3.4	3.9	5.2
Americas	3.9	0.4	1.7	2.1	3.7
Asia and Pacific	5.8	3.9	4.9	4.9	5.1
Europe	4.3	2.0	1.8	2.0	2.8
Middle East	4.4	1.8	1.9	3.6	3.4
Worldwide*	**4.8**	**2.4**	**3.0**	**3.2**	**4.1**

* Estimates for this category were revised in August 2003.

Business travel: A changing market segment

Business travel has long been the cash cow of the travel industry because of its insensitivity to price. However, a transformation has occurred in the past few years and various business travel surveys have revealed the following:

- after a major drop, business travel is showing signs of recovery
- business travellers are more sensitive to economic conditions than they are to geopolitical or health factors

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- companies are tightening their policies with regard to business travel expenses
- the cost factor has become a concern
- a growing number of business travellers are turning to discount carriers
- more and more business travellers are making reservations online[2]

Leisure travel could fall short of its promise

The estimated growth curve of the leisure travel market has long been thought very promising in light of certain socio-demographic factors, particularly when it comes to seniors. However, the actual growth of this market could be quite different, because of the following:

- diminished pleasure in air travel
- fear of terrorist attacks
- exhausting security measures that increase waiting times
- various taxes and high fees that are being passed on to the consumer
- the major drop in performance of retirement funds due to falling market values, low interest rates, the steady increase in the ratio of pensioners to workers, an uncertain economy and the governance scandals that rocked several major companies

These elements could call for a downward revision of the anticipated leisure travel growth curve.

PORTRAIT OF THE AIRLINE INDUSTRY

Already vulnerable, air transport has suffered more than any other sector

The attacks of September 11, 2001 had major repercussions on the air transport industry and since then the major airlines have had no respite from a series of events beyond their control.

Billions of dollars in losses

In the wake of September 11, the stocks of U.S. carriers plummeted. Already weakened, some airlines were forced out of business: Ansett, Canada 3000, Midway, Sabena and Swissair. The largest airline company in the world, American Airlines, narrowly avoided bankruptcy, while others had to file for bankruptcy protection: US Airways (August 2002), United Airlines (December 2002) and Air Canada (April 2003). Many others experienced major financial losses.

The ICAO[3] estimates that, for 2001 and 2002, worldwide net losses totalled US$13 billion and US$11.7 billion, respectively. For 2003, the IATA[4] is forecasting losses of US$5 billion on international services; system-wide losses could reach US$10 billion.

Decline, stagnation and growth in international passenger traffic

After seeing international passenger traffic decline for a year (-2.9% in 2001) and then stagnate for two years (0.4% in 2002 and an estimated 0.0% for 2003), the ICAO is forecasting global growth of 4.4% for 2004 and 6.3% for 2005.

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In 2003, SARS appears to have had a greater negative impact on the air transport industry than the Iraq conflict. With positive growth in January and February 2003 (10.9 and 3.6%, respectively), international passenger traffic fell 7.1% in March and 17.4% in April; the most noticeable declines were recorded in Asia-Pacific (-36.3%) and North America (-22.4%).[5] Overall, the first quarter of 2003 registered a worldwide reduction in passenger traffic of 7.1%.

Although the world's regions have shown varying degrees of increased traffic, statistics from July 2003 show a drop of 3.6% compared to July 2002 and a drop of 8% compared to July 2000. Airline companies are expressing cautious optimism with regard to growing passenger traffic. In any event, even if demand were to rise quickly, it would not necessarily signal a return to profitability.

The reaction of traditional airline companies

In response to the current global malaise, the airlines have reduced their capacity and the number of flights, cut over 400,000 jobs,[6] negotiated new labour contracts with unions and reduced operating costs.

As a whole, North American airlines have been the hardest hit. Despite US$15 billion in financial assistance from the United States government in the wake of September 11, airline companies have been unable to recover in the difficult climate that has followed. In 2002, the region posted negative results across the board (operating results, operating margin, net results and net margin) as well as lower revenues than in 2001. The global ranking of airlines with the largest operating losses in 2002 is topped by three U.S. companies (United Airlines, American Airlines and US Airways), and the ranking of net losses features five U.S. carriers at the top of the list, four of them for the second year in a row.

Generally speaking, European companies have weathered recent difficulties more successfully. In Europe, the drop in demand can be attributed primarily to the population's "wait-and-see" attitude and the repercussions of dealing with some of the directly affected markets. Overall, European airlines recorded positive results in 2002. After posting losses in 2001, Lufthansa Group ranked first among European carriers in operating results and net results in 2002.

In the Asia and Pacific region, airlines were reporting an overall increase in passenger traffic until the SARS outbreak. Following the outbreak, Asian carriers had to drastically reduce their capacity by more than 650 flights per week. Cathay Pacific Airways transported 75% fewer passengers in May 2003 than it did in May 2002. China Eastern Airlines saw its passenger load factor for April plummet from 72 to 23%. As for Singapore Airlines, it had to cut total capacity by 29% for the months of April and May. Despite SARS' devastating effect on passenger traffic, it is estimated that the region will quickly return to its earlier growth pattern.

Low-cost carriers post impressive gains

Although the events of recent years have dealt a striking blow to traditional carriers, not all airlines have suffered. In fact, many discount carriers are recording impressive growth.

In the United States, Southwest Airlines has a market capitalization of US$13 billion, which is more than that of the six largest U.S. carriers combined; in 2002, it was ranked

8th in the world for operating results with US$417 million and 6th in the world for net profits with US$241 million. In May 2003, the seven biggest low-cost carriers transported 22% of all travellers, or a 15% increase over 1995.[7] Furthermore, it is estimated that their market share could reach 35% by the year 2010 or even before.[8] They have tripled their passenger traffic while major carriers have lost 15.5% of theirs.[9] In Canada, despite the difficult economic climate of the past few years, WestJet is posting a profit for the 26th quarter in a row and 65% of all its reservations are made online.

In Europe, the market capitalization of Ryanair in 2003 (US$5.290 billion) surpassed that of Lufthansa (US$5.061 billion), Air France (US$3.566 billion) and British Airways (US$3.188 billion). European discount carriers enjoyed a market share of 7% in the summer of 2002.[10] Ryanair (Ireland) enjoys the highest operating margin of any carrier, discount or regular, with 31%. In July 2003, British Airways increased its passenger traffic by 2.5% over the previous July, while easyJet posted a 74.9% jump and Ryanair attracted 40% more customers.

ISSUES

Low-cost carriers: Serious competition for traditional airlines

The global malaise of the past few years has caused a decline in international travel and long-haul flights and an increase in domestic travel. As a result, traditional airlines have seen international passenger traffic drop and, on the domestic market, part of their market share has been taken over by discount carriers.

The low-cost, no-frills sector was launched in the United States by Southwest Airlines[11]. "Low cost mania" then spread to Europe and, more recently, to Asia-Pacific with the success of Air Asia. However, the operating climate differs along with the region. In North America, discount carriers essentially operate in the domestic market, while the European Union creates a single market in Europe. Therefore, discount carriers can operate in both regions without open skies agreements. In Asia, the situation is completely different and does not facilitate the development of this type of carrier. Since the domestic market alone is not profitable in many countries, discount carriers must operate on what are considered international routes, which requires the creation of open skies agreements. Furthermore, since distances are longer, carriers have a limited number of aircraft to choose from that are less expensive to operate and travellers are more hesitant to use such carriers because services are limited as well.

Originally targeted at leisure travellers, discount carriers have made significant inroads into the business travel market of traditional carriers, despite the latter's attractive loyalty programs. The move towards the low-cost sector is due primarily to the economic downturn and corporate efforts to cut back on business travel expenses.

Summary of competitive strategies used by national carriers and discount carriers

	National carriers	**Discount carriers**
Business model	Global strategy and high costs	Niche strategy and low costs
Network	Hub & spokes Global alliance	Point-to-point service using secondary airports
Fleet	Different types of planes	Standardized, single type of aircraft
Product	Full service Loyalty program	Self service
Distribution	Sales department Global distribution system (GDS)	Direct sales Call centres and Internet

Having seen these carriers achieve impressive growth and profitability, many major airlines are responding by launching their own low-cost divisions. However, given their very high cost structure, it is uncertain whether traditional carriers can succeed in this market niche.

Supply and demand in the airline industry

According to some analysts, there are too many seats on the market and demand is growing simply because of lower ticket prices and not because of a true increase in demand.[12] In fact, in traditional markets like North America and Europe, the increase in passenger traffic remains very low while low-cost carriers and less-developed markets like Asia-Pacific and the Middle East have taken advantage of new opportunities for growth. And the situation is not predicted to change in the short term. The upswing in demand is due largely to discount carriers, who rank the highest in increased passenger traffic. Encouraged by recent signs of growing demand, some carriers are reacting too quickly by increasing capacity (seats and flights) in an effort to capture a bigger market share, even though many experts do not predict a significant rebound in demand until 2005.

High cost structure

The performance of major airlines began to deteriorate long before the events of September 11 and the climate of the past 24 months has simply exacerbated this decline. Southwest Airlines spends approximately 7.5¢ per passenger kilometre compared to traditional carriers, which spend about 11¢ and sometimes even more on short hauls.[13] Also, discount carriers will continue to exercise pressure on the market and regular carriers because they are flexible. Their flexibility stems from having met the following conditions:

- use secondary airports to avoid hubs whenever possible, a source of congestion and high costs
- operate short-haul flights
- use a single type of aircraft to reduce maintenance costs
- hire employees with lower salaries and benefits
- offer no-frills onboard service
- utilize a simplified rate structure that does not require complex and costly computer reservation systems
- encourage online reservations

One part of cost rationalization is convincing one's partners to co-operate and agree to cut costs as well. Airlines pay a total of US$40 billion each year to airports and air traffic service providers, which represents 10% of their costs. Moreover, because of their position, airports and air traffic service providers can often employ monopoly practices.

Labour costs: A key issue

Faced with the crisis gripping the industry and the threat of bankruptcy, employees have made major concessions with regard to wages and benefits in addition to the loss of over 400,000 jobs.[14] However, as soon as the industry shows signs of recovery, workers will try to win back their former conditions. Nevertheless, airline companies require flexibility and renegotiated working conditions are one attempt to compensate for lost revenues and bring down operating costs. Labour costs are a key issue for the airline industry and must be part of any cost-cutting measures.

The efficiency of online reservations

Online reservations are another way to reduce operating costs and the practice of this method has grown phenomenally over the past few years. Discount carriers have been a major proponent of online reservations: 90% of easyJet's reservations and 94% of Ryanair's are booked online.[15] In the United States, Southwest Airlines handles over 70% of its reservations on its Web site, in comparison to traditional carriers who book around 10 to 15% of their reservations online.

Hubs lose their lustre

Since hubs serve many different destinations, offer more frequent flights and promise shorter connecting times, they are very costly to operate and make up a large percentage of an airline's costs. Moreover, hubs have become victims of their own success and now suffer congestion and delays. Another drawback is that since hubs are usually dominated by a single carrier, they tend to bar new players from entering the market.

There is another, major, factor behind the decline of hubs: business travellers are no longer interested in paying top dollar to ensure the viability of hubs and their attendant benefits. As a result, although hubs gave the airlines a competitive edge in the 1990s, they have now become a burden.

Time slot allocation

An issue closely related to hubs is the system for allocating time slots, which has led to disastrous consequences. The current method of allocating time slots unquestionably favours the first carriers to set up shop in a given airport.[16] A few time slots may free up because no one is using them or a carrier goes bankrupt, but they generally remain under the thumb of the carrier controlling the hub.

National ownership rules and foreign capital

Periodically, the issue is raised that current ownership rules limit airline access to global capital market, with experts often advocating that these rules be liberalized. Access to foreign capital markets help revive airlines who are currently foundering, give smaller carriers with a much-needed shot in the arm, promote the economic development of certain countries and assist carriers in meeting future challenges. Governments respond by citing a number of reasons justifying these limits: national and economic security, the problem of competition, bilateral issues, etc. This debate indirectly puts the privatization of national carriers back on the agenda while the government continues to limit the amount of foreign investment capital.

Security measures and increased fees

Security has become a critical issue. New airport security measures have increased the waiting times for customs and boarding. And more are on the way. Some of the projects under consideration involve the field of biometrics, and several airports are already experimenting with certain technologies. Furthermore, upcoming legislative changes will likely strengthen security regulations. As it is, current measures have already helped dissuade many people from travelling by plane and the adoption of new measures, in addition to raising concerns about individual rights and freedoms, will only increase public resistance to air travel.

At the same time, increased security has meant additional fees and taxes that have increased airline operating costs and created higher ticket prices. Security cost the airline industry US$5 billion in 2002. Fearful these measures could hinder the industry's recovery, many companies are asking governments to help offset their cost.

Consolidation and alliances

The trend towards consolidation is not over and continues to shape the airline industry. Some current examples are: alliance membership used as a lifeline to financial health; the formation of a mega-airline to dominate the industry; new members joining alliances to improve their position on the world market; pressure on regional carriers to merge together; an aborted takeover agreement; and discount carriers who have begun to buy up other low-cost carriers.

"Wide open skies"

The European Commission and the United States recently began talks aimed at liberalizing the regulatory climate between the two continents, a framework many consider outdated. The results of these negotiations could open the door to a sustained wave of consolidation and a redefinition of existing bilateral agreements. According to the European Union, the planned easing of restrictions would save consumers an estimated US$5.8 billion per year.[17]

QUESTIONS

"Clearly, the global aviation sector will be fundamentally changed over the next few years. Presidents of major carriers around the world have said that the existing business models for major network airlines no longer work and must be rethought."
J. Clifford Mackay, President & CEO,
Air Transport Association of Canada. [18]

In its efforts to emerge from the worst crisis in its hundred-year history, the airline industry faces a number of challenges. Despite signs of recovery in passenger traffic, airline companies cannot assume an immediate return to profitability. Many measures must be taken before this is achieved.

The time has come for recovery and restructuring. In this context:

Is this industry, a contributing factor to economic globalization, subject to an outdated regulatory framework?

Will the restructuring of the air transport industry lead to another wave of liberalization?

What strategy should major airlines adopt to regain their market share? Will they continue to operate low-cost divisions?

Will the competition among low-cost carriers lead to a surge of consolidation?

Will the configuration of existing alliances change radically?

Will the price sensitivity of business travellers lead to the creation of niches within this market segment?

Will the major airlines succeed in attracting financial investors?

What does the future hold for major international airline companies, national carriers and low-cost carriers?

What will the regulatory framework and competition authorities look like?

Who will benefit from the current upheaval: destinations, airlines, shareholders or consumers?

PORTRAIT OF THE HOTEL INDUSTRY

The repercussions of recent events have affected the hotel industry differently in each region of the globe. In the United States, the industry has experienced 24 difficult months in a row, while in Europe, hotel performance suffered more from the circumstances of 2003 than the events of September 11, 2001.[19] As for Asian hotels, spring 2003 was without question their most difficult period.

Hotel performance varies by region

Hotel performance in the United States has improved since the end of the Iraq war, although not enough to bring about positive growth. For the year 2003 as a whole, the estimated revenue per available room (RevPAR) will drop 0.4%, a negative result for the third year in a row. Although the second half of 2003 should prove more profitable, it will doubtless be insufficient to make up for the losses of the first half.[20] U.S. hotels have watched their operating profits continue to fall – by 19.4% in 2001 and by 9.6% in 2002. Despite losses stemming from the overall slowdown in the travel industry, the North American hotel sector added 80,000 new rooms in 2003.

In Europe, after a period of gradual recovery in 2002, hotels once again experienced a dramatic drop in RevPAR in spring 2003 (falling by 22% in April 2003). The region recorded a significant decrease in the number of travellers from the United States and Asia.

Not surprisingly, SARS also had an extremely negative effect on Asian hotel performance. Though the year began quite promising, it ended up being worse than the 1997-1998 financial crisis.[21] According to figures from the WTO, the number of tourists in Hong Kong, Singapore and Taiwan dropped by 50% in April 2003, compared to the year before. As a result, the hotel occupancy rate in April plummeted nearly 88% in Hong Kong, 64% in Beijing and 65% in Singapore. This trend continued into May when the occupancy rate continued to skydive (by 91% in Beijing).[22]

Economy and mid-range hotels weather the storm

Persistent economic uncertainty combined with slashed corporate travel budgets have changed the make-up of the industry. Mid-range hotels probably weathered the vagaries of the year 2002 more successfully than any other segment and this trend appears to be continuing in 2003.[23] In the United Kingdom, for example, the occupancy rate for this type of establishment grew by 3 percentage points from January 2000 to May 2003. During the same period, the average room rate rose by 2.5%, creating a 5.5% in RevPAR.[24] Economy hotels also performed relatively well, increasing both their occupancy rate and RevPAR. Conversely, luxury hotels consistently posted negative returns.[25] On the whole, recent events have affected the performance of major chains more than that of independent hotels. The main reason for this is that business travel has not recovered, a fact which forces hoteliers to find other markets to maintain their occupancy rates. Boutique hotels in particular have suffered as a result of the devastating events afflicting the travel industry.[26]

A global trend towards restructuring rather than consolidation

Contrary to the trend observed until 2001, the number of acquisitions has tapered off in the past two years and the world ranking of the ten largest hotel groups has remained unchanged. Two structural factors explain this definite slowdown in hotel mergers and acquisitions. Firstly, the uncertain political and economic climate around the world has not been conducive to a continuation of the trend towards consolidation. In addition, the significant drop in the market capitalization of the biggest hotel groups has removed easy access to large amounts of capital for major investments. In fact, since most of the major international chains saw their earnings per share fall dramatically in 2002 (by an average 20 to 30%),[27] they are hardly in a position to make any new purchases. Overall industry revenues decreased by 2.2% in 2002 (-6.6% in 2001). As a whole, the sector is slowly winding up a cycle of investment.

This difficult period has led the major hotel groups to focus on cutting expenses and cleaning up their finances instead of making major acquisitions. Nonetheless, new brands have emerged to better fulfil the customer expectations of certain business market segments.

The few acquisitions made in the past few years have been primarily in the segment of mid-range hotel chains. In 2002, Asia had the greatest number of transactions, worth an estimated US$700 million.[28]

Marketing associations

An increasing number of commercial agreements are being signed between different sectors of activity to enable each party to benefit from enhanced synergy in marketing and distribution (Accor/TUI[29], Expedia/Hilton, Accor/Air China, etc.).

ISSUES

Cutting room rates during a crisis is relatively ineffective

To counter a decline in their occupancy rate, hotels will often reduce room rates in an effort to attract customers. However, a study conducted by the Cornell Center for Hospitality Research[30] shows that this is a relatively ineffective gesture. Rate reductions are usually unable to stimulate demand enough to offset a loss in revenues, and this holds true for all hotel categories. The study also showed that a drop in price does not attract new customers. Therefore, the reduction primarily benefits customers who are already on-site, who then receive the same services for a lower price, leading to a further drop in revenues. The question remains, however: what strategy should hotels adopt during a crisis?

A potential shortage of qualified employees

In a labour shortage situation, human resource management becomes a major issue for hotel managers. Despite an overall decrease in activity over the past few years, the hotel industry job market has remained somewhat tight. Should there be a recovery in the short term, hoteliers might have to raise salaries to attract the few professional, qualified employees available.

From standardized to personalized products

Seeking a major facelift, many large hotel chains have begun to personalize their products, thereby creating an upswing in boutique hotels, the use of design elements, the emergence of spas, etc. In the luxury segment, hoteliers are calling on fashion (Sonya Rykiel, Versace) and design gurus (Philippe Stark) to bring in new ideas. It is difficult, however, to assess whether there is a true demand for such products and whether the trend will endure.

Difficulty of keeping pace with technology

Many hotels target different clienteles by offering technology in the rooms (high-speed Internet connection, video games, etc.). Although such features can constitute a competitive advantage, they also involve major investment. Moreover, since technology is always evolving, hoteliers are constantly faced with investment decisions.

Online reservations: A headache for the industry

The online travel market has become a real headache for the hotel industry. Since room rates are relatively transparent online, price-sensitive customers are starting to shed any brand loyalty they may have had. Moreover, according to one survey,[31] the ability to select from among a wide variety of products (hotels, car rentals, plane tickets) is a greater influence on Web site selection than loyalty programs.

QUESTIONS

Will past and future waves of consolidation eventually lead to a decrease in the number of brands?

Will less profitable market segments be abandoned as the industry focusses on restructuring?

For hotels located in areas with a high density of available rooms, will the strategy of specialization become the key to success?

Is the hotel industry's reliance on yield management threatened by customers' increasing access to rate transparency?

Will the hotel sector be able to keep up with increasingly costly technology and its constant need for upgrading?

Are hoteliers ready to face the inevitable question of hotel security concerning potential terrorist acts targeting brands associated with specific clienteles?

PORTRAIT OF THE DISTRIBUTION NETWORK – TOUR OPERATORS AND TRAVEL AGENCIES

The portrait of the distribution network is in two parts: a look at the sector comprising tour operators and travel agencies and then a discussion of the online travel market.

Network structure differs by region

The American distribution network is composed primarily of horizontally integrated groups of associated travel agencies like American Express. With the exception of the European-style Carlson Group and Transat, there are very few large, vertically integrated tour operators who control the entire distribution chain.

The network in Europe, on the other hand, is characterized by several major conglomerates of tour operators, hotel chains, airlines, travel agencies, etc., located primarily in Germany and the United Kingdom, who control a large part of the distribution chain.

In the case of Asia, distribution is much more fragmented as very few agencies have developed networks to cover the entire Asia-Pacific region.

Losses and a gloomy outlook

In 2002, nearly every major travel agency group in North America recorded lower revenues. This was the case for American Express, Navigant International and Worldtravel BTI.[32] The Airlines Reporting Corporation has some particularly telling data about its accredited travel agencies:[33] in the past 30 months, 21,000 of its 45,000 accredited points of sale ceased operations, revenues from the sale of plane tickets declined by US$20 billion and business travel fell by more than 30%.

European tour operators have suffered enormous losses in the past two years and conducted massive layoffs. After a difficult year in 2002, Europe's largest travel industry players continued to post negative results in the first quarter of 2003; although negative results are not uncommon at that time of year, TUI and Thomas Cook suffered losses 40 to 50% higher than those recorded for the same period in 2002. The MyTravel Group (formerly Airtours)[34] was even forced to reorganize its financial structure. Although a few tour operators experienced sales growth in May and June 2003, this upswing will not be enough to wipe out first-quarter losses.

The Asia-Pacific region was not affected by September 11 and the war in Iraq to the same extent that North America and Europe were. Although Japanese tour operators saw sales fall for the year 2002 as a whole (approximately 7%) compared with sales in 2000, this drop was minor compared to what happened during the SARS outbreak. SARS appears to have had a disastrous effect on the sales of Japanese tour operators (including Japan Travel Bureau), whose May-June 2003 sales were two-thirds lower than their sales for the same period the previous year.[35]

Interest in vertical integration wanes

Although major tour operators used to be caught up in a frantic rush for acquisitions to quickly increase market share, the last few years have been relatively quiet. The vertical integration model has not been challenged and the European travel distribution network remains concentrated in the hands of several conglomerates. Given their poor financial performance in 2002 and 2003, companies are currently focussing on restructuring and consolidating their existing holdings. One of the few recent major acquisitions was American Express' takeover of Rosenbluth International to consolidate its leadership position in the international business travel market. The lacklustre results of the past few years have meant vulnerable companies run the risk of being acquired for a discounted price. On the other hand, consolidated travel agencies will enjoy a stronger bargaining position, especially when to comes to negotiating distribution costs with service providers such as GDSs.

ISSUES

How should travel agencies position themselves?

The distribution network must continue to focus on what it does best: organizing trips for specialized niches. Consumer enthusiasm for using the Internet to purchase travel products is a sign of the times and traditional agencies must acknowledge that they cannot compete directly with online agencies in terms of price, particularly when it comes to plane tickets. Instead, these agencies must try various strategies to create profit centres with better profit margins in an environment increasingly devoid of middlemen. For example, some associated agencies are considering becoming hotel consolidators, like Hotels.com. Are such avenues truly viable?

Tour operators to face new competition

Although they are major travel industry players, companies like TUI, Thomas Cook and Transat are facing the challenges of changing consumer behaviour, the presence of low-cost carriers, the emergence of dynamic packaging and destination management organizations who actually market their destination’s products. The options now available to consumers mean that the packaging of travel products is no longer the exclusive domain of the traditional distribution network. It also means that low-cost carriers are providing stiff competition to charter airlines.

Will GDS deregulation lead to new rules of the game?

The United States Department of Transportation (DOT) is planning to deregulate the legislative framework of the air transport distribution network following a period of public consultation. GDSs came under government regulation in 1984 when they were primarily owned by the airlines to ensure they would not be abused or used unfairly. Since GDSs are no longer owned by airlines, United States authorities feel a regulatory framework is no longer necessary. If restrictions are lifted, new players like Orbitz will be able to compete directly with the GDSs.

QUESTIONS

Could the changing competitive environment be a true threat to tour operators? What strategies will they adopt to handle this new competition?

What sector will be targeted by the next wave of vertical integration? Low-cost carriers? The control of new resort destinations?

With consumers increasingly making their own reservations online, what role should traditional travel agencies adopt?

PORTRAIT OF THE DISTRIBUTION NETWORK – THE ONLINE TRAVEL MARKET

The sector least affected by recent events

Although the last few years have been very challenging for the tourism industry as a whole, the online travel market has held its own. In fact, this sector posted remarkable growth in 2001 and 2002, with online reservations increasing by 59% and 37%, respectively.[36] The primary effect of the recent poor economic conditions has been a decrease in the online agencies’ inventory of airline products.

Although online agency sales for 2003 are likely to grow more slowly than in years past, the online travel market nevertheless demonstrates a tremendous ability to adapt to changing market conditions.

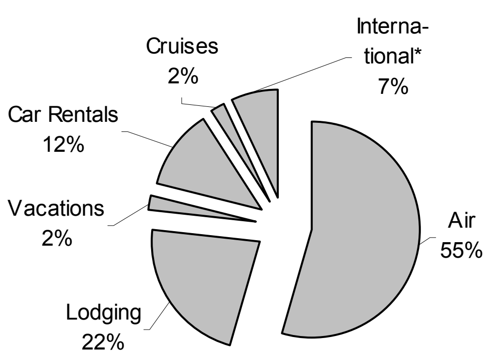
Steadily rising revenues

In 2002, revenues from online travel sales totalled US$42.9 billion in the United States, approximately US$8.7 billion (7.6 billion euros) in Europe and US$4.8 billion in the Asia-Pacific region. For the year 2003, it is estimated that the global online travel market will rack up more than US$85 billion in sales.[37] Online travel sales promise to continue growing by leaps and bounds in the coming years. In the United States, 15% of all travel reservations were made online in the year 2002. By the year 2005, this percentage should rise to nearly 30%. As for the developing European market, it is expected to more than triple.[38] With online distribution still in its infancy in many Asian countries (only accounting for 1 to 3% of travel reservations), there is even greater potential for growth.

Plane tickets top the list of travel products

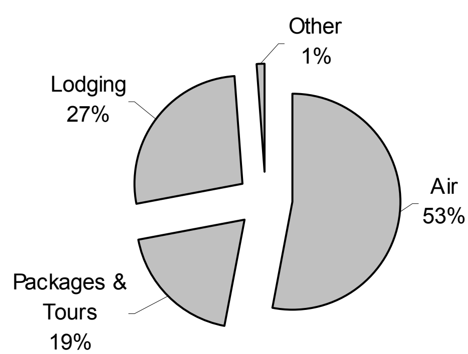
Plane ticket sales account for over half of the global online travel industry (United States – 54%, Asia-Pacific – 53%). Although other travel products are increasing their online market share, airline products are still expected to represent half of online sales in the United States in the year 2005. The hotel industry is currently experiencing tremendous growth in online transactions and hotel rooms are the second most popular travel product sold over the Internet (United States – 22%, Asia-Pacific – 27%). From 2001 to 2002, there was a 75% increase in the number of online hotel reservations (through agencies or hotel Web sites) and a subsequent drop in the number of reservations through traditional channels.[39]

Breakdown of U.S. Online Travel Market by Product, 2002



Source: PhoCusWright Inc., February 2003.
** Sales from non-U.S. travel suppliers that are transacted via U.S.-based online travel agencies*
(Corporate online booking systems are excluded)

Breakdown of Asia-Pacific Online Travel Market by Product, Projected 2002



Source: PhoCusWright Inc., July 2002.

The boom in travel portals

Online distribution is so efficient and has such tremendous growth potential that a wide variety of reservation portals have sprung up:

- general interest travel agencies (Expedia, Travelocity)
- consolidators[40] specialized in the distribution of a specific product (Hotels.com, Quickbook)

- 'last-minute' agencies, who sell off discounted inventory (Lastminute.com), and 'opaque' agencies, who find products to meet a proposed price or the lowest price without revealing the supplier before the item is purchased (Priceline, Hotwire)
- portals uniting companies operating in the same sector (Orbitz – founded by five airline companies, TravelWeb – created by five major hotel chains)
- destination management systems (DMSs), who focus on promoting a destination's products and sometimes take reservations (BonjourQuebec.com, Tiscover)
- best-price search engines (Travelaxe.com)
- agencies specializing in niche products (golf and ski packages)
- Web sites with auction-style formats (eBay)
- service provider sites (airlines, hotel chains)

ISSUES

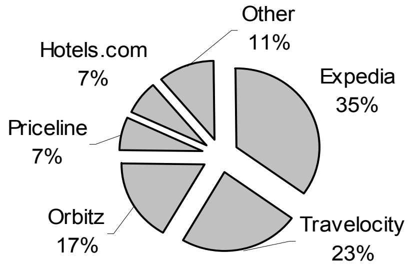
Dominance of traditional channels threatened

Although the online travel industry is steadily increasing its market share in the United States, holding a 21% share of the distribution network in 2002,[41] traditional channels still largely dominate with nearly 80% of distribution (traditional travel agencies – 45%, call centres – 34%). If the online travel market continues its rapid growth, it will likely constitute over 40% of the distribution network by the year 2005, to the detriment of the two traditional channels. In Europe, online travel sales represented only 3.5% of the total travel market in 2002, which means it has tremendous growth potential. In Asia-Pacific, traditional Asian travel agencies sell approximately 95% of all plane tickets.[42] When it comes to online distribution, more than half takes place directly on supplier Web sites. Despite their relatively recent arrival in the Asian travel industry, online agencies already hold nearly one-third of the online travel market. Traditional travel agencies who have developed an online division hold the remaining 15%.

The presence of major players

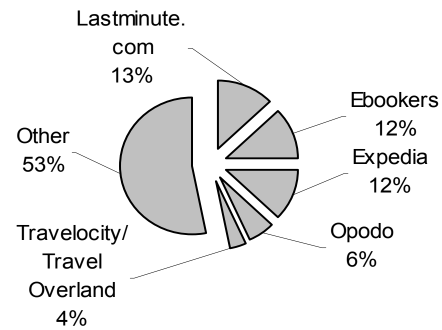
Together, online agencies Expedia (35%), Travelocity (23%) and Orbitz (17%) make up three-quarters of the U.S. online travel market and account for 21.5% of the sales volume of the travel industry as a whole. The largest players are Expedia and Travelocity, two general interest agencies, followed by two specialized agencies (Orbitz and Hotels.com) and a last-minute 'opaque' agency (Priceline).

Market Shares of Leading U.S. Online Travel Agencies, 2002



Source: PhoCusWright Inc., April 2003.

Market Shares of Leading European Online Travel Agencies, 2002



Source: PhoCusWright Inc., July 2003.

The European online travel market is much more fragmented than that in the United States, with the five largest agencies controlling less than half (47%) of the market. Two of the biggest European agencies, Lastminute.com and ebookers, position themselves as last-minute or discount agencies. Both are based in London and are the primary competitors of Expedia. The development of the European online travel market is attributed, in part, to the marketing strategies of low-cost airlines like Ryanair and easyJet who heavily promote online reservations.[43]

Founded by Travelocity and 16 airlines from the Asia-Pacific region, Zuji positions itself as a major portal for the online distribution of plane tickets. Expedia, also active in this market, aims to become a major player in the region. Travelocity and Expedia are therefore fighting for market share in this part of the world as well. As for the online distribution of hotel products, Asiatravel.com and asia-hotels.com are well-positioned in this market segment.

Impressive portals created by alliances

To improve their market position and better compete, many large companies have opted for "co-opetition"[44] and joined forces to create impressive reservation portals (hotels – TravelWeb, Asian Hotels Alliance; airlines – Orbitz, Opodo, Zuji). Although these portals represent a new approach to distribution, they (Orbitz, in particular) have stirred up controversy over their pricing practices and potential for unfair competition.

Struggling global distribution systems seek direct access to consumers

Initially founded by the major airlines, global distribution systems (GDSs) were the first to bring electronic distribution to traditional travel agencies. However, the rising popularity of the Internet and the inability of these systems to adapt to the needs of different users have engendered the development of many other channels that bypass these middlemen and deal directly with consumers. At the same time, the airlines themselves have built online portals for direct consumer access and sold off their GDS shares. Furthermore, since plane tickets are the primary source of revenues for traditional agencies, airline portals like Orbitz and Opodo are trying to attract these agencies as customers.

Facing stiff competition, a loss of airline capital and the defection of traditional agencies, GDSs have had to reassess their business model. Accordingly, to improve their market position in the distribution network and increase their share of the online travel market aimed directly at consumers, in the past few years GDSs have purchased or invested in online travel agencies or signed service agreements with such agencies.

Dynamic packaging: the logical outcome of product diversification

In the year 2002, some online agencies compensated for the drop in airline inventory by adding hotel rooms and car rentals to their product list. This trend has grown in recent years because it enables online agencies to increase revenues and decrease their dependency on a sector that is so susceptible to difficult conditions. Now many agencies offer consumers dynamic packaging, or the ability to put together their own combination of travel products (flight, hotel, car) from the agency's inventory. The formula is extremely popular among consumers because they can create personalized packages, but it is especially appreciated by the online agencies who are able to post higher average sales.

Cruises and vacation packages difficult to sell online

Online sales of cruises and all-inclusive vacation packages are also growing. These two products combined currently make up only 4% of the online travel market in the United States, but this number should rise to 7% by the year 2005. These products are very attractive to online agencies because they can involve commissions of up to 25%. However, the numerous components in such products and their high price tag make them more difficult to sell through the Internet.

Suppliers hope to regain control over product distribution

By selling their products directly from their company Web site, suppliers are aiming to:

- cut distribution costs, especially commissions and other fees paid to intermediaries
- exercise greater control over prices and information quality
- encourage customer loyalty

Despite the best efforts of suppliers to encourage consumers to reserve directly on their Web sites, online agencies still account for most online reservations because they can offer consumers a wide variety of brands and prices.

Hotels try to exercise tighter control over room rates

The primary issue affecting the online distribution of hotel products is control over room rates. The "merchant model" adopted by online agencies enables these agencies to offer very low rates, sometimes even lower than the rates charged by the hotel itself. The practice is so widespread that consumers in the know prefer to deal with online agencies to find the lowest price. The issue is all the more critical because by the year 2005, one out of five hotel reservations will be made online – compared to only one out of 12 in 2002 – and only about half of these will be made through hotel Web sites.[45] Some hotels have already taken action by guaranteeing the best price to consumers who visit their site while others offer added value for reservations made on their sites. However, the yield management[46] technique used by hotels further complicates the policy of offering the best price.

Airlines must curtail costs

If the major airlines are to survive, they absolutely must decrease their cost structures. Low-cost carriers are driving down ticket prices in domestic markets with their efficient business models and high proportion of online reservations. One way for the major carriers to counter this competition is to encourage consumers to reserve directly on the airline's Web site or affiliated reservation portal. This would eliminate middlemen and reduce distribution costs.

Diversification to counter the dominance of major players

By creating or utilizing a Web site, any company in the world can now target consumers directly and reach travellers who want more than a mass product or at least some autonomy in packaging their travel products. Product diversification therefore serves to counterbalance the dominance of Internet giants like Expedia and Travelocity. However, without the impressive numbers of visitors that mainstream sites attract, independents must find a way to distinguish their products from among the many offered by online travel players.

An overabundance of channels leads to consumer confusion

The Internet offers a profusion of travel product distribution channels: general interest travel agencies, airline portals, destination management systems, last-minute agencies and supplier sites. It is easy for consumers new to the online travel market to get lost.

On the other hand, savvy consumers looking for the best price will try to compare what is available on various different sites. However, it is sometimes complicated to compare products, given the sheer numbers of sites, uncertainty whether a specific site will actually offer the best price and the difficulty of assessing differences among available products. The situation can be confusing for the consumer and lengthen the reservation process.

QUESTIONS

The rapid growth and dynamism of the online travel industry have multiplied the types of electronic distribution channels and heightened the competition among them, with each player trying to win back customers or increase market share.

In this context:

What will become of GDSs?

How can one stand out or attract consumer attention when there are so many distribution channels and players? For distributors to survive, must they become global players?

Who will increase their market share – online agencies or supplier Web sites?

Will there be a new push for corporate alliances to build marketplaces featuring products from the same sector?

Will hotels regain control over the rates charged for their rooms?

How will the consumer respond to the proliferation of distribution channels? Are certain types of channels destined to get even bigger while others disappear altogether?

Will dynamic packaging pave the way for the online distribution of more complex products?

Planning for the future in a volatile, turbulent environment requires players to implement a business model that encourages adaptability, ethical governance and the optimum management of knowledge, experience and diversity. Furthermore, the adjustment period after the recent crises is accelerating changes in consumer habits and transforming the fabric of the industry.

"[This crisis period] is encouraging the creation of new operators, such as low-cost airlines. It has led to restructuring and regrouping, the implementation of new technologies, the modernization of marketing techniques and the strengthening of co-operation between the private and public sectors, to the benefit of all."
Francesco Frangialli, WTO Secretary-General

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