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ON THE IMPACT OF CONSOLIDATION ON THE AVIATION INDUSTRY

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Introduction

I am Albert A. Foer, President of the American Antitrust Institute. The AAI is a ten year old independent non-profit education, research, and advocacy organization. We operate as a network of approximately 100 antitrust experts, including men and women trained and experienced in law, economics, and business. The AAI believes that the vigorous enforcement of the antitrust laws is the best way to protect consumers, innovation, and the economy as a whole from anticompetitive corporate behavior, and in this way ensure that competition will be both aggressive and fair. For further background, visit www.antitrustinstitute.org. We are currently working on a white paper on competition in the airline industry.

1. Getting the Perspective Right

Although this testimony focuses primarily on the proposed merger of Delta and Northwest, it is critical to place this merger into context. The essential points are that: (1) this is an industry in which there are substantial network effects, but the incremental costs of expanding an already large network may offset the network benefits; (2) the industry is already moderately concentrated on a national basis, but this generalization underestimates the market power that is present at most hubs and on most routes; and (3) a merger of this magnitude will in all probability lead to at least one more merger of similar size. These three considerations require us to consider whether the five or possibly four national networks that will emerge from this process are sufficient to provide a satisfactory range of choice and service and sufficient competition to keep prices close to costs.

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The airlines predictably assert that merger brings efficiency benefits from economies of scale and scope, but these must be weighed against inefficiencies due to other diseconomies of scale and scope, the cost of consummating the merger, and the reduction in competition arising from the merger. For consumers not to be harmed, the benefits of the merger must outweigh the costs *and* at least some of these net benefits must be passed on to consumers in the form of lower prices and improved service.

2. The Limits of Standard Antitrust Analysis

Standard antitrust analysis focuses on horizontal overlaps between city pairs. If an origin and destination route is served by only a few airlines and the merger will leave the particular market highly concentrated, the DOJ will likely—and properly—require a divestiture or some other arrangement with respect to that route, as a condition of approving the transaction. I will not address this further, but I would note that this conventional approach tends to downplay the important role of potential competition in airline markets. Airlines not presently serving a route but which can fairly readily enter, serve to constrain pricing, so that mergers that eliminate such a constraint may be anticompetitive just like mergers between airlines that currently do serve the market.

Standard overlap analysis is necessary but it should not be considered sufficient, because it captures only one part of the competition picture. The observer's lens needs to be adjusted in order to look not only at the trees but also at the forest. A more complete analysis must answer these questions: how many systems are enough to guarantee the kind of pricing, service, and convenience that the American public desires from its air transportation industry? How many are enough to provide the current competition or potential entry that can serve as a constraint on higher prices by other systems?

3. Three Business Models

The airline industry in the U.S. consists of carriers following three principal business models or strategic segments: network, point-to-point, and hybrid. There are six major network carriers, all of roughly the same size (American, United, Northwest, Delta, Continental, and US Airways, although by some measures American, United and Delta are substantially larger than the other three). Other carriers, including those that are categorized as "low cost carriers" and "connectors" either operate point-to-point or, as is the case of Southwest, have begun to move to a combination of point-to-point and hub-oriented service.

It is possible that one day Southwest will become a national network carrier, but that remains to be seen. As things stand today, with Delta and Northwest saying that they do not intend to close any hubs, it seems unlikely that Southwest would evolve into an additional network system within the two years required for "easy entry" under the current federal Horizontal Merger Guidelines. There are disadvantages as well as advantages to a network strategy, which will be discussed below.

The non-network carriers do play a role as competitors to the networks. In terms of planes in the fleet, Southwest, the only airline projected to be profitable in 2008, comes just behind American and United; and SkyWest, a holding company with two hubs and several connector airlines whose code-sharing agreements with Delta, Continental and United limit its incentives to compete with any of them for fear of losing the interline traffic, has more planes than Continental or USAirways. Southwest clearly influences prices wherever it competes (often causing fares to fall substantially), and even when it is perceived as a potential competitor. But Southwest and the other low cost carriers have found their success by competing indirectly rather than directly with the networks.

4. The Importance of Systems on the Demand Side

There is some question as to whether the DOJ considers networks relevant from the demand side. Airline passengers benefit through demand-side economies known as network effects. When an airline adds service between its hub and a new location to accommodate passengers at that location, it also creates new service offerings between that location and other locations that can be reached through its hub. Code-sharing arrangements between airlines and other alliance functions can also facilitate network effects to the extent they promote coordination of schedules, route expansion, and the appearance of increased flight frequency.

From the perspective of the individual non-business air traveler, whether or not a carrier is part of a network may or may not be important, depending on what service is available from the origin to the destination. The benefit of a larger network is that it enables a consumer at any given city to reach more cities on the same airline, although most if not all of the additional choices involve changing planes. (The enhanced ability of a consumer to fly non-stop rather than via multiple legs would be an important consumer benefit.) If the traveler has frequent flier miles, he or she may be biased to stay within a particular system, and indeed this may be a factor that makes new entry more difficult.

From the perspective of businesses that negotiate the purchase of large amounts of travel service requiring specific scheduling, there is an advantage in that a single negotiation can cover a larger fraction of potential destinations and origins of flights.

If two airlines merge, both business and non-business customers receive a convenience benefit only if the average number of hops to reach all destinations goes down. For this to be a non-trivial effect, there must be significant cities that are not served by one of these carriers. Otherwise, one can get to any other city in one or two hops on either carrier.

Although networks bring important consumer benefits as they grow, the incremental network benefits may decline as carriers get larger. Expanding a network by merger may add city-pair routes to those offered by the merged entity, but it does not create an in-system benefit to any given consumer if both carriers serve all major airports through each hub. Because low cost carriers compete only on certain non-stop routes, they provide at best only a limited discipline on a system-wide basis.

Networks therefore should be taken into account in antitrust analysis from the demand side.

5. The Value of Considering the Systems Competition

Each network can also be thought of as a "system," and we can say that for many purposes and for many travelers, a particular travel experience can usually be accommodated by only one or two systems. Price competition on overlapping point-to-point routes is not the only dimension of rivalry under a systems view of airline competition. Travelers also look to the ease of connections, arrival and departure times, airport amenities, seamless baggage transfers, frequent flyer programs, etc. in making their airline choices. But airlines tend to think of their seats as a commodity, such that the systems carriers usually do not want to go head-to-head against each other in circumstances where price would be the only differentiating factor-- which results in relatively few choices of airline for most non-stop flights..

6. The Role of Entry

What barriers constrain entry in the form of route expansion? With a number of important exceptions, gates are not constrained, although dominant airlines have succeeded in deterring entry at their hubs through predatory strategies which neither antitrust nor regulation has been unable to stop. To a large degree, it is a matter of strategic decision for the larger airlines whether they want to compete on certain routes. Why cannot Delta and Northwest independently expand routes to gain network effects? Why is it more costly for Delta to add service rather than to buy the service from Northwest, which is the practical effect of this merger? Overarching may be the efficiency question of why the most successful airlines are smaller, if network effects are the dominant factor in airline success?

Whether non-system airlines such as Southwest, AirTran, Jet Blue and Frontier will become more like the system airlines is not clear and their potential entry as systems should therefore not be counted on in our current analysis of the industry. If two or more mergers of systems carriers occurs, Southwest and other non-system carriers may have the opportunity to pick up additional routes and perhaps even hubs, if hubs are abandoned – a possibility that should not be taken for granted. Moreover, the non-network carriers might benefit from a raised price umbrella if a less competitive network strategic segment is able to raise its prices. The public would pay more to fly.

Entry is particularly difficult in several well-known airports. Government policies could make entry for low cost carriers easier, which would improve the competitive situation in those airports. But such other factors as corporate contracts between businesses and systems airlines, frequent flier lock-in, and the difficulty of obtaining financial capital, availability of planes, and the FAA requirements for operating cash on hand are among the reasons why the public cannot count on low cost carriers to discipline post-merger price increases.

7. **Using Caution in Considering the Parties' Efficiency Claims**

If there is one thing that we have learned from the long history of antitrust, it is that efficiencies are easy to assert, difficult to achieve, and rarely of the magnitude that the parties–in their self-interest–claim.

The principal efficiency claims being put forward in justification of this merger are economies of scale and scope on the supply side and rationalization of the use of planes to "right-fit" them to their routes.

The network airlines initially obtained large supply-side cost economies through the hub and spoke system resulting from increased traffic density, particularly as they induced increased passenger volumes on hub-to-hub flight segments.

However, it appears that a system which relies too heavily on hubs is expensive to operate compared to a point-to-point system, and that there may be limits to the efficiency gains achievable through networks. For example, bigger networks create peak-load problems at an airport. The basic idea of a network is that all planes arrive at an airport at about the same time, the through-passengers then reassemble on different planes, and the planes depart at about the same time. This increases the disparity during the day in the number of arrivals and departures, and so creates problems for efficient staffing of gate, ticket, and maintenance personnel. By contrast, back-and-forth non-stops and multistep puddle jumps do not create as much of a peak-load problem.

The just-in-time structure of the networks means that if weather or a mechanical problem causes a delay in the arrival of a plane at a hub, the problem quickly metasticizes throughout the system, as each delay causes a multitude of other delays. As networks grow, therefore, minor inconveniences become major national inconveniences, if not emergencies.

It is an empirical, not theoretical, issue to identify the point at which an airline begins to experience diseconomies of scale and scope. For mergers among big carriers, no one has found a significant net benefit. As such, many of the efficiency claims by the parties should be viewed with some skepticism.

For example, Delta and Northwest say they anticipate large savings because they operate different types of aircraft and, if merged, the new company can "right-size" by flying more small or large planes on short or long routes. A proper analysis will ask the following questions and answer them with the help of experts not employed by the companies: (1) To what extent can these changes be made internally over time? (2) Why can't Delta and Northwest simply swap some assets to accomplish these changes, which would be in each airline's interests. (3) Given that many planes are leased, why is a merger the only way to right-fit planes to their routes? In any event, the projected savings from this type of efficiency need to be scrutinized route by route and plane by plane.

8. **Strategies and Counter-Strategies**

Delta and Northwest justify their merger in terms of the desirability of increased scope – which they refer to as "presence" – and scale. They argue that the savings they can attain will help them survive the current fuel crisis and economic downturn.

Northwest says that the very same motivations are likely to lead to at least one additional systems merger in the near term, probably between United and USAirways. They reason that the other systems carriers will see that the new largest carrier has unit cost advantages deriving from the economies and will have no choice but to quickly emulate the size of Delta via the only possible method, which is merger. Presumably the remaining two airlines would also have to find a way to bulk up. Thus, if Delta and Northwest are right, the merger wave that this one will kick off will not stop here.

On the other hand, if Delta and Northwest are wrong about the efficiencies, then there is no justification for distorting the current equilibrium of six systems. We see no reason to believe that the benefits of merger are due to efficiencies rather than market power and are therefore quite skeptical.

Giving additional market power to the airlines that survive the mergers will not reduce the price of fuel. That is out of the airlines' control and will have to be passed on to consumers, as will be occurring in all of our industries. This will predictably result in fewer people flying. The question is whether the inevitable downsizing needs to be handled through cartelization of the industry or by individual decisions by the incumbent airlines. It is our commitment to competition in the airline industry, as opposed to regulation, that is fundamentally at stake here. Downturns are not forever and the country will be better off in the next growth period if there are more rather than less systems in competition with one another.

We are at a critical moment in the structural history of the US air transportation industry. While there are a few instances in which an antitrust agency has looked at two proposed mergers in the same industry simultaneously, the usual approach is to say that the agency can only consider that which is immediately before it. Taking this narrow view would be a disservice to the public, which is already concerned about the increasing unreliability and discomfort associated with air travel.

We urge that the antitrust analysis take the broad view of the industry and that the strategic plans and counter-plans of all large carriers must be examined and analyzed before any antitrust decision is rendered.

9. International Considerations

Domestic air transportation is closely related to international air transportation and this relationship will grow stronger as the US/EU Open Skies agreement takes effect. There are currently only three global alliances that dominate international air travel: Star Alliance (United/Lufthansa), SkyTeam (Delta/Air France/Northwest/KLM), and oneworld (American/British Airways). The first two have U.S. antitrust immunity to jointly set prices and allocate capacity on those international routes covered by the immunity grants.

The international alliances are coming to look more and more like single global companies that operate as closed systems using various brand names. (While Delta and Northwest may be acting as if they are already one company with respect to trans-Atlantic flights, they are still two competitive companies domestically.) Are we satisfied that these systems, with or without US antitrust immunity, will provide sufficient competition? The individual airlines within the alliances will have fewer incentives to compete against each other so there will be minimal intra-system competition. Arguably, a merger between alliance members such as Northwest and Delta would exacerbate this problem. With only three alliances, the chances are that inter-system competition will often be indirect rather than direct, unless antitrust and aviation policies mandate non-discrimination in interline services, a condition about which we have no reason to be sanguine.

With the large US carriers participating in immunized global alliances, the competition injected by a seemingly larger number of different airlines becomes less and less meaningful.

CONCLUSION

The ultimate question is whether the public will be satisfied with four domestic and three global air transportation systems? There is little if any empirical knowledge that says how many systems are needed to provide a workable degree of intersystem competition. There is substantial data, both empirical and theoretical, that suggests that competitive problems increase as a market becomes highly concentrated. There is substantial experience with domestic air mergers that suggests how difficult they are to execute successfully; how few efficiencies have resulted from big carrier mergers; and how slow entry has been at the network level. To the extent there is doubt about the Delta/Northwest merger, it should be resolved as essentially a public policy question as to whether we are willing to interfere with business decisions in order to preserve the few competing systems, at the possible expense of whatever efficiencies might realistically be lost. We suggest that the magnitude and certainty of these proclaimed efficiencies should be analyzed with great skepticism and must be weighed against inefficiencies due to other diseconomies of scale and scope, the cost of consummating the merger, and the reduction in competition arising from the merger.