Commentary:

United and American Airlines' Restructuring Of the Airline Industry: Will the Bush Administration Act?

*By Jeffrey I. Shinder**

As the Bush administration begins to disclose its agenda, many observers believe that, rather than reprising his father's moderate Republican tone, George W. Bush's administration is more akin to Reagan II. If that holds true in antitrust, we are headed for a period of minimalist antitrust enforcement. Such a retreat would be a significant departure from the Clinton administration's traditional approach to reviewing proposed mergers under the Clayton Act.[1] Attorney General John Ashcroft's eight-year tenure as Missouri's attorney general is hardly reassuring for those who believe in the critical importance of antitrust. During that time, Ashcroft completely ignored antitrust, with the noteworthy exception of a baseless antitrust suit he brought against the National Organization for Women regarding its decision to boycott Missouri for failing to enact the Equal Rights Amendment.

The first test of the Bush administration's commitment to antitrust comes from a bold plan by the two largest airlines in the country, United and American Airlines, to restructure and consolidate the airline industry. The Ashcroft-led Department of Justice's first response to that test came March 16, when it cleared American's acquisition of TWA, apparently foregoing an extended antitrust review merely because a bankruptcy court approved the transaction. If this laissez-faire approach is extended to the second major airline transaction at the DOJ, the United/US Airways/American Airlines deal, millions of Americans will feel the consequences of lax antitrust enforcement — higher prices and reduced service.

The United/US Airways/American Airlines Transaction

This transaction came about when United encountered objections from the Clinton DOJ regarding the carrier's attempt to acquire US Airways. United's proposed acquisition of US Airways raised clear antitrust concerns in the Washington, D.C., market, among other things, where United is the largest carrier at Dulles Airport and US Airways is number one at Reagan National Airport. To overcome its problems with the Clinton DOJ, United proposed spinning off 20 percent of US Airways to American Airlines. Through this separate deal, American would acquire 49 percent of DC Air, a newly formed regional carrier, which would hold landing slots and gates at Reagan National. American would also acquire US Airways' four gates at Logan Airport in Boston, and five gates and about 40 landing slots at La Guardia Airport in New York, among other things. American also agreed to jointly operate the US Airways Washington–New York–Boston shuttle with United. In sum, United and American are proposing a transfer of key US Airways assets to American, and the introduction of a new competitor into the lucrative Washington–Boston corridor, to overcome the DOJ's objections to the United/US Airways deal.

If this complex arrangement clears antitrust review, United and American Airlines would control roughly half of all U.S. air travel. American would become the largest carrier at Washington's Reagan National Airport, with United a close second. Moreover, American Airlines would vastly expand its operations at La Guardia, taking half of US Airways' shuttle flights, 36 slots and five gates from US Airways, and 51 landing slots and four gates from TWA. Because of these increases in market concentration, and United's and American's powerful (if not dominant) positions in key airports on the East Coast, there is a serious risk that these deals might substantially lessen competition. This concern is particularly relevant to the airline industry given its history of collusive conduct, and the structural impediments to effective competition that have accompanied the hub-and-spoke airline system that formed after the U.S. airline industry was deregulated in the late 1970s.

Competition in the Airline Industry After Deregulation

When the airline industry was deregulated, the federal government neglected the axiom that rigorous antitrust enforcement is particularly important when an industry is deregulated. Instead, it essentially suspended the Clayton Act's application to airline mergers by providing the Civil Aeronautics Board (and later the Department of Transportation) sole jurisdiction to review mergers

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and acquisitions. Captive to the airline industry and in the sway of contestable market theory, which postulated that potential competition would prevent the formation of durable market power in the industry, the DOT approved every airline merger that came its way.[2] This approach encountered little opposition from the Reagan DOJ.[3] In fact, as was often the case in the 1980s, the only real antitrust enforcement in the airline industry was undertaken by the states.[4]

The hub-and-spoke airline system emerged in this laissez-faire regulatory environment. In a hub system, carriers combine "local" passengers (those originating at or destined for the hub) with "connecting" passengers (those traveling via the hub) on the same flights. The system was designed to enable carriers to serve more cities from their hubs ("spoke" routes) and offer more frequent service than had been possible with point-to-point service. In theory, "local" passengers receive nonstop service to more cities than otherwise would be available, and connecting passengers benefit from more frequent flights and routing alternatives.

But for many Americans the new system merely meant fewer nonstop routes. Moreover, as the major carriers established their hubs at airports across the country, they often achieved market power over routed servicing "City Pairs" and spoke routes. Consumers suffered the consequences through higher prices and diminished service. This is apparent from a comparison of fares on spoke routes that connect two hub carriers, where at least two carriers provide nonstop service, to fares on spoke routes where the hub carrier is the only carrier offering nonstop service. In the latter scenario, the hub carrier typically raises prices, particularly to business passengers, who lack the time to use a connecting service. Hub carriers can easily identify such "time-sensitive" passengers and discriminate in the fares they charge them.[5]

Moreover, this market power is protected by entry barriers that impede the emergence of effective competition. Because they provide more departures to more destinations, hub carriers usually attract a disproportionate share of the hub airport's passengers. This trend is caused and exacerbated by frequent-flyer programs that motivate consumers to exclusively fly on the dominant airline in their home city, by travel agent commission practices that encourage the use of hub carriers, and by deals that hub carriers often enter into with local businesses that provide incentives to use the hub carrier. The powerful combination of these structural forces discourages entry into a hub carrier's spoke routes, especially by other carriers with similar cost structures.[6] As a result, in many airports, hub carriers account for more than 70 percent and in some cases more than 80 percent of passengers. And, according to former Assistant Attorney General Joel Klein, these forces should continue to dominate the airline industry in the near future.

Lastly, the airline industry has a notorious history of collusion. The most famous example of attempted collusion occurred in 1983 when Robert Crandall, then CEO of American Airlines, told Howard Putnam, his counterpart at Braniff, "Raise your prices 20 percent and I'll raise mine the next morning." Fortunately Putnam secretly recorded the conversation, and Crandall's attempt to monopolize a segment of the airline industry was foiled.[7] Allegations of collusion in the industry resurfaced after the DOJ uncovered evidence that the Airline Tariff Publishing Co., a joint venture of several major airlines formed to disseminate current and future fares to airlines and travel agents, was used to facilitate fare collusion. This complex scheme apparently ended when the airlines entered into a consent decree with Justice in 1994.[8]

Market Definition

There are two ways to approach the threshold question of determining which markets might be affected by these mergers. The first approach examines competition in hub airports and "City Pairs" emanating from hubs. The second method considers national or regional competition. The Clinton DOJ clearly focused on the first approach. According to former Assistant Attorney General Klein, "Relevant airline markets are likely to consist of scheduled airline service between a point of origin and a point of destination, generally referred to as 'City Pairs.'"[9] This approach would strike anyone who flies today as sensible. Passengers who want to fly from St. Louis to San Francisco do not view a flight from St. Louis to Kansas City as a reasonable alternative if the fare on the St. Louis to San Francisco flights was increased. Klein also noted that the market may be narrower as certain passengers (*i.e.*, business travelers) may not view connecting service as a reasonable alternative to nonstop service between City Pairs. For those travelers, the market should be defined as nonstop service between City Pairs.

However, an exclusive focus on City Pairs risks missing the big picture, resulting in the United/US Airways American deal being cleared (perhaps with limited divestitures), even though it threatens to substantially lessen competition in broader national or regional markets. The characteristics of the airline industry

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that made coordinated interaction possible in the early to mid-1990s still exist today. The dominant carriers offer homogenous products through computerized systems that offer instantaneous fare and schedule data. Conditions in the airline industry are highly conducive to both collusion and the rapid detection and punishment of deviations from any price-fixing or market allocation scheme. Simply put, reducing the number of market participants will likely improve the already suitable conditions for unlawful collusion.[10] For these reasons, before rubber-stamping this deal, the DOJ should carefully consider Delta Chairman Leo Mullin's statements to the Senate Judiciary Committee that Delta should be allowed to merge with another large carrier (either Continental or Northwest) to counter the "huge duopoly" threatened by United's and American's actions.[11]

While the DOJ continues its review of the United/US Airways/American deal, the New York Attorney General Eliot Spitzer recently stated that he was prepared to block the merger because the transaction would give the new company 38 percent of La Guardia's slots.[12] As a possible solution, Spitzer suggested a divestiture of slots to JetBlue Airways, a low-cost carrier that has reduced fares to Buffalo and Rochester. Spitzer also expressed concerns that DC Air, the spin-off airline created by United's and American's purchase of US Airways, would not be a viable competitor to United in Washington.

The 'Failing Firm' Defense and American Airlines' Acquisition of TWA

Because the DOJ cleared American Airlines' purchase of TWA immediately after a federal bankruptcy court approved the transaction, it is easy to conclude that the "failing firm" defense influenced the DOJ's decision. This defense applies when a merger is the only way to keep a firm and its assets in the market.[13] Under Supreme Court precedent, three requirements must be satisfied for the defense to apply: (1) the target must be in imminent danger of failure; (2) the failing firm must have no realistic prospect of a successful reorganization; and (3) there must be no viable alternative purchaser that poses a lesser risk to competition.[14]

While a full analysis of the failing-firm defense and the American Airlines/TWA transaction is beyond the scope of this article, the DOJ's apparent deference to a bankruptcy court is troubling. Bankruptcy judges are not competent to decide antitrust questions, such as whether viable alternatives pose a reduced threat to competition. Clearly there were alternatives to the American Airlines offer, including former TWA owner Carl Icahn's competing bid, and possibly a bid from Continental Airlines, which expressed interest in buying TWA assets in January.[15] The DOJ should have intervened in the bankruptcy proceeding or, at a minimum, continued to examine the viability and competitive consequences of alternative purchasers, notwithstanding the bankruptcy decision.

Conclusion

Hopefully, the quick decision to clear the American Airlines/TWA deal is not indicative of the DOJ's approach to the problematic United/US Airways/American transaction. United and American have proposed a sweeping restructuring of the airline industry that will affect, perhaps negatively, millions of travelers in the Midwest and the East Coast, as well as those who travel from coast to coast. The transaction raises antitrust concerns in hub airport markets or markets defined by City Pairs emanating from hub airports. It also raises more subtle, and perhaps difficult to prove, antitrust issues in the national airline market, as the deals may render unlawful collusion easier to accomplish. Given the seriousness of these issues, a return to the Reaganite laissez-faire approach to merger enforcement in this context would be disastrous for American consumers.

Notes

[1] The competitive effects of mergers and acquisitions are principally governed by Section 7 of the Clayton Act, which prohibits such transactions "where in any line of commerce ... the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly." 15 U.S.C. §§ 1-2.

[2] During this time frame, the airline industry was considered the poster child for "contestable market theory" in the mistaken belief that entry was easy as airlines were mobile assets and ground facilities could be leased or sub-leased. As discussed below, more than a decade of experience with the hub-and-spoke system has refuted this analysis. Former Antitrust Division Assistant Attorney General Joel Klein addressed this issue in a recent speech, stating that the contestable market theory "simply does not conform to the facts in a post-deregulation world consisting of hub airports." *See* former Assistant Attorney General Joel I. Klein, Statement Concerning Antitrust Issues in the Airline Industry Before the Committee on Commerce, Science, and Transportation (July 27, 2000), at 25.

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[3] During this time frame, the DOJ could submit comments and objections to the DOT's decisions. The Reagan DOJ approved all but two of the DOT's actions — TWA's acquisition of Ozark, and Northwest's purchase of Republic in 1986.

[4] *See, e.g., Texas Air's Bid to Buy Eastern May be Challenged*, WALL STREET JOURNAL, March 7, 1986.

[5] *See* Klein statement at 5.

[6] Most of the recent evidence of entry into a carrier's hub involves low-cost carriers, such as Southwest. Such entry, however, has been gradual and limited. Moreover, as evidenced by the DOJ's predatory-pricing lawsuit against American Airlines, hub carriers have successfully used predatory tactics to eliminate incipient competition from low-cost carriers.

[7] *See United States v. American Airlines Inc.*, 743 F.2d 1114, 1118-19 (5th Cir., 1984) (fact that executives "arguably" could have implemented market allocation scheme that would have created monopoly power was sufficient to find a dangerous probability of monopolization for purposes of an attempt-to-monopolize claim under Section 2 of the Sherman Act.)

[8] The DOJ alleged the airlines used the Airline Tariff Publishing Co. to fix fares by using footnotes, first and last tickets dates, and fare codes to increase fares and eliminate discounts. The ATP also was used to exchange favors among competitors where rates were raised on certain routes and discounting eliminated on others. The transparency of airline prices made this remarkable scheme possible. The airlines entered into a consent decree with the DOJ that banned the information sharing and related conduct that facilitated the price-fixing, while permitting the continued use of the ATP system. *See United States v. ATP*, 58 Fed. Reg. 3971 (1993) (Proposed Final Judgment and Competitive Impact Statement, *U.S. v. Airline Tariff Publishing Co.*) *See United States v. Airline Tariff Publishing Co*, 836 F. Supp. 9 (D.D.C., 1993) (settlement with two defendants); *United States v. Airline Tariff Publishing Co.*, 1994 WL 502091, 1994 WL 454730 (D.D.C., 1994) (settlement with remaining defendants).

[9] *See* Klein statement at 21.

[10] According to the DOJ and FTC merger guidelines, "a merger may diminish competition by enabling firms selling in the relevant market more likely, more successfully, or more completely to engage in coordinated interaction that harms consumers." Moreover, "[i]t is likely that market conditions are conducive to coordinated interaction when the firms in the market previously have engaged in express collusion and when the salient characteristics of the market have not changed appreciably since the most recent such incident." DOJ & FTC Merger Guidelines at § 2.1.

[11] *See, Gun Fight at Last Chance Saloon*, AIRWISE NEWS, Feb. 7, 2001.

[12] *See, Spitzer Threatens Suit to Stall Merger of Two Airline Giants*, NEW YORK TIMES, March 1, 2001, at B6.

[13] As the Supreme Court held in *United States v. General Dynamics Corp.*, 415 U.S. 486, 507 (1974), the failing-firm defense "presupposes that the effect on competition and the 'loss to [the company's] stockholders and injury to the communities where its plants were operated'-will be less if a company continues to exist even as a party to a merger than if it disappears entirely from the market."

[14] *Citizen Publishing Co. v. United States*, 394 U.S. 131, 138-39 (1969). The DOJ and FTC merger guidelines state that the failing-firm defense applies in the following circumstances: "(i) the allegedly failing firm would be unable to meet its financial obligations in the near future; (ii) it would not be able to reorganize successfully under Chapter 11 of the Bankruptcy Act; (iii) it has made unsuccessful good-faith efforts to elicit reasonable alternative offers ... and (iv) absent the acquisition, the assets of the failing firm would exit the relevant market." DOJ & FTC Merger Guidelines at § 5.

[15] *See, 2 Airlines Offer Alternatives To T.W.A. Sale*, NEW YORK TIMES, Jan. 24, 2001, at C1.

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