BUSH'S FIRST TEST IN ANTITRUST: THE UNITED/US AIRWAYS MERGER

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As the Bush administration begins to disclose its agenda, many believe that, rather than reprising his father's moderate Republican tone, George W. Bush's administration is beginning to look like the second coming of Ronald Reagan. If true, we are headed for a period of minimalist antitrust enforcement, and a significant departure from the Clinton administration's active review of proposed mergers under the Clayton Act.[2] John Ashcroft's eight year tenure as Missouri Attorney-General only reinforces the view that Bush might lead us back to the dark ages of lax antitrust enforcement. 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 Bush'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. His first response to that test was not promising: on March 16, the Bush Department of Justice ("DOJ") cleared American Airline's acquisition of T.W.A, apparently foregoing an extended antitrust review merely because a bankruptcy court approved the transaction.[3] 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 weak antitrust enforcement – higher prices and reduced service.

The United/US Airway/American Airlines Transaction

This transaction came about when United encountered objections from the Clinton DOJ regarding its attempt to acquire US Airways. United's proposed acquisition raised clear antitrust concerns in the Washington D.C. market, where United and US Airways respectively are the largest carriers at Dulles and Reagan National airports. To overcome the DOJ's concerns, United proposed spinning off 20% of US Airways to American Airlines. Through this separate deal, American would acquire 49% of DC Air, a newly formed regional carrier, which would hold landing slot and gates at Reagan National. American would also acquire US Airways four gates at Logan Airport in Boston, and 5 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.

If this complex arrangement clears antitrust review, United and American Airlines would control roughly half of all US air travel. American Airlines 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 Airport, taking half of US Airways shuttle flights, 36 slots and 5 gates from US Airways, and 51 landing slots and 4 gates from T.W.A.[4] Because of these increases in market concentration, and United 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 US 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 Department of Transportation ("DOT")) sole jurisdiction to review mergers 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.[5] This approach encountered little opposition from the Reagan DOJ.[6] In fact, as was often the case in the 1980s, the only real antitrust enforcement in the airline industry was undertaken by the States.[7]

The "hub-and-spoke" airline system emerged in this loose regulatory environment. In such a system, carriers combine "local" passengers (those originated at or destined to the hub) with "connecting" passengers (those traveling through the hub to another destination) 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 non-stop routes. Moreover, as the major carriers established their hubs at airports across the country, they often achieved market power over routes between certain cities (typically referred to as "City Pairs"). Consumers suffered the consequences through higher prices and diminished service. This is apparent from a comparison of fares on routes that connect two hub airports, where at least two carriers provide nonstop service, to fares on 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.[8]

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, travel agent commission practices that encourage the use of hub carriers, and 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 discourage entry into a hub carrier's spoke routes, especially by other carriers with similar cost structures.[9] As a result, in many airports, hub carriers account for more than 70% and in some cases more than 80% of passengers. And, according to former Assistant Attorney General Joel Klein, these forces will likely continue to dominate the airline industry in the near future.

Lastly, the large carriers have entrenched (and perhaps exacerbated) their market power through collusion. The most famous example of attempted collusion in the industry occurred in 1983 when Robert Crandall, then CEO of American Airlines, told Howard Putnam, his counterpart at Braniff, raise your prices 20% and "I'll raise mine the next morning."[10] Fortunately the conversation was secretly recorded by Putnam and Crandall's scheme was foiled.[11] Allegations of collusion in the industry resurfaced after the DOJ uncovered evidence that the Airline Tariff Publishing Co. ("ATP"), 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 the DOJ in 1994.[12]

Market Definition

There are two ways to approach the threshold question of determining which markets might be affected by the United/US Airways/American transaction. The first approach examines competition within the narrow geographic confines of hub airports and "City Pairs" emanating from hubs. The second approach takes a broader geographic view, examining the merger's potential impact on competition on a regional or national scope. 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.'"[13] This approach seems 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 were increased.[14]

However, an exclusive focus on City Pairs may result 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 that made coordinated interaction possible in the early to mid 1990s still exist today: the dominant carriers offer homogenous products through computerized systems that generate instantaneous fare and schedule data; and deviations from any price-fixing or market allocations scheme can be easily detected and punished. Reducing the number of market participants in this industry simply increases the likelihood of tacit or express collusion.[15]

These concerns are reinforced by the strong possibility that the United/US Airways/American Airlines deal will lead to further consolidations in the industry. Delta has conducted merger talks with both Continental and Northwest, and Delta Chairman Leo Mullin told the Senate Judiciary Committee that Delta should be allowed to merge with other large carriers to counter the "huge duopoly" threatened by United and American's actions.[16] All of this may ultimately lead to an industry with only three national carriers, a prospect that should frighten travelers across the country.

Conclusion

Hopefully, the quick decision to clear the American Airlines/T.W.A. deal is not indicative of the Bush Administration's approach to the problematic United/US Airways/American transaction. United and American Airlines have proposed a sweeping restructuring of the airline industry that will affect millions of travelers throughout the country. The transaction raises antitrust concerns in hub airport markets or markets defined by City Pairs emanating from hub airports. It also raises antitrust concerns in regional or national airline markets as the deal may facilitate or increase the likelihood of tacit or express collusion. 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.

ENDNOTES

1. Jeffrey I. Shinder received an LLM in antitrust from New York University Law School, and is a partner in the law firm of Constantine & Partners, an antitrust boutique in New York City.

2. 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. § 18.

3. Because the DOJ quickly cleared American Airlines' purchase of T.W.A. once the 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. For the defense's stringent requirements, *see Citizen Publishing Co. v. United States*, 394 U.S. 131, 138-39 (1969). 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 Carl Icahn's competing bid, and possibly a bid from Continental Airlines, who expressed interest in buying T.W.A. assets in January. *See* Laurence Zuckerman, *2 Airlines Offer Alternatives To T.W.A. Sale,* N.Y. Times, January 24, 2001 at C1. The DOJ should have intervened in the bankruptcy proceeding or, at a minimum, continued to examine the viability and competitive consequences of alternative purchasers.

4. The transaction's potential impact on La Guardia has caught the attention of New York Attorney General, Eliot Spitzer, who indicated recently that he was prepared to block the merger because the transaction would give the new company 38% of La Guardia's slots. As a possible solution, Mr. Spitzer suggested a divestiture of slots to JetBlue Airways, a low cost carrier that has reduced fares to Buffalo and Rochester. *See* Randy Kennedy, *Spitzer Threatens Suit to Stall Merger of Two Airline Giants*, N.Y. Times, March 1, 2001, at B6.

5. 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, over 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* Statement Concerning Antitrust Issues in the Airline Industry of former Assistant Attorney General Antitrust Division, Joel I. Klein, Before The Committee on Commerce, Science, and Transportation, ("Klein Statement") presented on July 27, 2000, at 25.

6. 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; T.W.A's acquisition of Ozark and Northwest's purchase of Republic in 1986.

7. *See, e.g.,* Gary Cohn & Thomas E. Ricks, *Texas Air's Bid to Buy Eastern May be Challenged,* Wall St. J., March 7, 1986.

8. *See* Klein Statement at 5.

9. 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 used predatory tactics to eliminate incipient competition from low cost carriers.

10. *See* Stephen Labaton, *An Antitrust Hurdle,* N.Y. Times, January 10, 2001, at C1.

11. *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 attempt to monopolize claim under Section 2 of the Sherman Act).

12. The DOJ alleged that the airlines used the ATP to fix fares by using footnotes, first and last tickets dates, and fare codes to increase fares and eliminate discounts. The ATP also was utilized 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 Justice 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. Airline Tariff Publ'g Co.,* 58 Fed. Reg. 3971 (1993) (Proposed Final Judgment and Competitive Impact Statement); *United States v. Airline Tariff Publ'g Co.,* 836 F. Supp. 9 (D.D.C. 1993) (settlement with two defendants); *United States v. Airline Tariff Publ'g Co.,* No. CIV.A. 92-2854, 1994 WL 502091, (D.D.C. Aug. 10, 1994) (settlement with remaining defendants).

13. *See* Klein Statement at 21.

14. Klein also noted that the market may be narrower as certain passengers (*ie*. 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 non-stop service between City Pairs.

15. According to the DOJ & FTC Merger Guidelines "a merger may diminish competition by enabling the 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." Department of Justice, Federal Trade Commission, Antitrust Division, 1992 Horizontal Merger Guidelines, 57 Fed. Reg. 41552, 41558-9 at § 2.1.

16. *See Gun Fight at Last Chance Saloon,* Airwise News, February 7, 2001.