DEPARTMENT OF JUSTICE

THE IMPORTANCE OF ENTRY CONDITIONS IN ANALYZING AIRLINE ANTITRUST ISSUES

Address by

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Almost exactly a year ago, the International Aviation Club met during a turbulent time for the international and domestic airline industry. The far-reaching British Airways-American Airlines transatlantic alliance was working its way through the DOT, and open-skies with the U.K. looked within reach. The six largest U.S. carriers had proposed three broad alliances that offered the prospect of massive domestic code sharing for the first time. The DOT had proposed guidelines addressing unfair exclusionary conduct. Any one of these proposals would have been notable. Collectively, they promised dramatic changes for the aviation industry.

It is tempting to dismiss the past year as much-ado-about nothing. After all, the proposed BA-American alliance appears to be further from consummation today than it was a year ago. The two proposed domestic alliances involving the four largest carriers have not moved ahead with attempts to codeshare. And, while the DOT has been reviewing thousands

of comments regarding the guidelines submitted by interested persons, the guidelines have not yet been finalized.

I would suggest to you, however, that such temptation should be resisted. There have been important developments over the past twelve months that warrant review. While they may not have been the developments that people were anticipating, they were important, nonetheless.

I. Significant Developments During the Past Year

In the past year, there have been three developments that I think are worth reviewing: the DOT proceeding on the BA-American alliance, the Department of Justice suit against Northwest and Continental, and the Department of Justice suit against American Airlines.

Last year, right about this time, parties in the DOT proceeding considering the BA-American alliance submitted their reply comments. Everyone -- including BA and American -- accepted at the outset that no alliance could be approved without substantial modification of the bilateral agreement between the United States and the United Kingdom. The critical

question quickly became, though, how many Heathrow slots and facilities would have to be made available for new entrants. While the Department of Justice expressed substantial concerns about the competitive effects of the alliance even assuming an open-skies bilateral agreement, it commented that the DOT could find that the alliance was in the public interest if slots and ground facilities sufficient to allow for 24 daily round trips by other entrants were made available. Other governmental and private parties offered their own assessments of conditions necessary to ensure opportunities for competitive service.

The DOT proceeding was suspended in the fall after the United States determined that the U.K. was not prepared to come forward with meaningful proposals for an open-skies agreement. Resumption of bilateral negotiations seems to be more in doubt every day. Even at this date -- three years after the alliance was first announced -- substantial doubts remain about whether it will get off the ground in anything approaching the form originally envisioned by the parties.

What is clear, however, is that we have passed the point where entry analysis, even in the international arena, is confined to statutory or regulatory barriers to entry. Whatever the parties may have thought at the time the alliance was announced, it did not take very long for people to recognize that liberalization of the bilateral agreement would not be sufficient to ensure that other carriers could and would provide service to the United Kingdom. Meaningful entry into airline markets is dependant not only upon the absence of governmental restrictions, but also upon the presence of other factors -- including competitive terminal and gate facilities and, if airports are slot constrained, adequate appropriately-timed slots -- that are necessary to provide service. As the Department of Justice Merger Guidelines make clear, it is the timeliness, likelihood, and sufficiency of entry -- not the theoretical possibility of entry -- that comprise the relevant inquiry. This proposition is an important one that now seems well-accepted by antitrust agencies and regulatory agencies around the world. In this sense, the significance of the BA-American alliance lies in what didn't

happen: without conditions conducive to entry, the alliance has not been approved.

Last November, though, something did happen. The Department of Justice filed suit to challenge Northwest's acquisition of voting control of Continental Airlines. The transaction has some characteristics that make it unusual. As a result of Continental's various reorganizations, a shareholder group owned a class of common stock that controlled a majority of the voting interest but a minority of the financial interest, and it was this block of stock that Northwest acquired. Northwest and Continental also entered into a series of agreements that purport to restrict Northwest's ability to exercise full control over Continental for a period of years. The Department contends that the acquisition violates Section 7 of the Clayton Act. The trial is scheduled for fall next year.

The Northwest-Continental transaction represents the first acquisition of a major domestic air carrier by another since sunset of the DOT's jurisdiction over carrier acquisitions ten years ago. While Northwest and Continental do not have any hubs in common, the complaint alleges that

passengers traveling between the carriers' hubs will be harmed by the lessening of competition caused by the transaction. Northwest and Continental dominate their respective hubs and generally are the only carriers providing nonstop service between the hubs. We believe there is little prospect that another carrier would initiate meaningful nonstop service between these hubs in response to noncompetitive fares or service. The Department is also concerned about the impact of the transaction on passengers traveling via a Northwest or Continental hub in city pairs dominated by those carriers. Here, too, the prospect of entry is unlikely to deter anticompetitive behavior.

The complaint illustrates that entry analysis has become quite sophisticated and substantially more factual than in the past. In the 1980s, the DOT approved a number of transactions involving carriers with high shares of city-pair traffic, reasoning that other carriers could easily enter those city pairs and discipline fares if the merging carriers began to act noncompetitively. Often, this rationale was based on little more than the assumption that other carriers, particularly those already serving both points

of the affected city pairs, could initiate service without much difficulty. Little consideration was given to whether new entry would be economically feasible given traffic flows and hub economics. The Northwest-Continental action serves notice that the Department will look carefully at any transaction involving major domestic carriers and will not be deterred from taking enforcement action by entry assumptions that are not supported by the facts.

Two months ago, the Department filed suit against American Airlines alleging unlawful monopolization by American in Dallas/Ft. Worth city pairs. The complaint charges that American used a combination of low fares and capacity expansions to drive start-up carriers out of DFW markets. This is the first government antitrust suit challenging predatory behavior in the airline industry since deregulation in 1978.

Much has been written about this case already. For those of you seriously interested in this area, I urge you to read the complaint. The conventional wisdom is that predation is usually implausible. Companies rarely engage in predatory conduct, it is said, because any attempt by the

predator to “recoup” the financial costs of predation in the form of higher prices after the prey is driven out will be defeated by new entrants undercutting those higher prices. Obviously, the prospect of entry is important to a determination of the plausibility of predation. Thus, the complaint alleges principles of hub economics that the Department believes create barriers to entry. And the complaint explains how a reputation for predation can itself be a barrier to entry.

American has recently answered the complaint. No trial date has yet been set.

II. Prospect of Entry as the Common Theme

If you detect a common theme to these proceedings, you are not alone. In each of them -- whether foreign or domestic, merger or non-merger, multiple firm or single firm -- entry conditions are central to antitrust analysis. And each of these proceedings demonstrates how far we have come from the entry analysis so characteristic of the early deregulation days.

In the aftermath of deregulation, some prominent economists and industry observers suggested that vigorous antitrust enforcement to preserve

actual competitors in specific airline markets might not be necessary. Potential competition, it was said, could be relied upon to discipline carriers, even those with dominant market shares: if a dominant carrier(s) sought to raise fares above competitive levels or reduce service below competitive levels, new carriers could easily enter, especially if they already had a presence at the affected airports. Airplanes were the quintessential mobile asset, and ground facilities could be leased. Knowing that noncompetitive behavior would attract entry, it was claimed that dominant incumbents would price competitively. Hence, market shares -- and the presumptions of market power that accompany them -- were of relatively little use in airline merger analysis. The DOT approved many airline mergers on this basis. The airline industry became the foster child for contestable market theory.

A funny thing happened on the way to contestable markets. Airlines established hubs to concentrate traffic. Over time, hub carriers came to dominate markets served from their hubs. The same pattern emerged at hub after hub. The hub carrier dominates city pairs it serves directly from its

hub, except to other cities that are also hubs for other carriers, in which case the two carriers providing hub service dominate.

Entry by a major carrier on a point-to-point basis into another carrier's hub has become very much the exception. A hub carrier has significant advantages in its markets. By combining local and connecting passengers, a hub carrier can offer more flights than a point-to-point carrier. By offering more flights, a hub carrier can attract passengers to its frequent flyer programs and travel agents to its commission override programs. In these circumstances, carriers with comparable cost structures to the hub carrier understandably find it unattractive to take the hub carrier head on. And without substantial actual competition, hub carriers are free to charge high fares to local passengers lacking competitive alternatives.

These factors explain the importance of start-up carriers. With lower operating costs than the majors, start-up carriers may be in a position to provide competition in precisely the markets that suffer currently from the absence of competition. It is in this context that the Department of Justice

has been investigating claims that hub carriers have engaged in predatory practices to protect and extend their market power in hub markets.

The airline industry exhibits certain characteristics that make a predatory theory more than merely "plausible." First, hub carriers dominate hub markets, as demonstrated by market share. Second, hub carriers appear to be in a position to exact high fares, as demonstrated by hub premiums. Third, hub carriers can easily respond to entry by start-up carriers by increasing capacity and reducing fares in affected markets virtually overnight. Fourth, hub carriers have an incentive to act before start-up carriers develop a foothold in the hub: it is obviously easier to drive a carrier out before it gets established in the market. Fifth, a start-up carrier is likely to have limited capital and is thus vulnerable to predatory practices; this is not an instance like Matsushita where a court has to wait a long time to see whether competitors can be, or actually have been, driven out of business. Sixth, a hub carrier "defending its turf" against encroachment by a start-up carrier in a few markets can create a "reputation for predation" that deters start-up carriers from entering its many other hub markets; this can

significantly alter the "cost-benefit" predation calculation for a hub carrier in a way uncharacteristic of most other industries. In short, a "recoupment scenario" is not implausible at all.

To conclude that predation is "plausible" in the airline industry does not, of course, prove that a particular airline has predated in a particular instance. Only a court can make that determination, and that issue will be presented to the court hearing the Department's case against American.

III. Antitrust as Regulation

The Department's case against American has provoked some in the industry to charge that the Department of Justice is trying to re-regulate the industry through the back door. Let's take a look at that charge.

The "re-regulation" bogeyman is trotted out by some in the airline industry whenever the government suggests that there is or should be a limit on what the major carriers can do. Just last year, when the DOT proposed its guidelines, the major carriers cried out that DOT was trying to re-regulate air fares. To head off the DOT, major carriers claimed that the antitrust laws provided the appropriate policy response to concerns about predatory

behavior in the airline industry. Don't subject us to special rules, the carriers claimed. We're subject to the antitrust laws, like other industries, and that's enough.

Now that the Department of Justice has sued a carrier under the antitrust laws, some claim that this is simply another attempt to re-regulate air fares. They ignore their earlier calls for application of antitrust concepts to allegations of predation. Invoking the antitrust laws as a free-market alternative to regulatory rules was apparently a convenient argument to fend off the DOT. Now that the Department of Justice has filed such a suit, however, they are up in arms again. Sounds a little disingenuous to me. How about to you?

Now, please don't misunderstand me. It is certainly fair for those inside or outside the airline industry to contend that particular conduct is lawful or to debate what should be the appropriate antitrust standard. Some of that debate is taking place already, and certainly more will occur once the case against American gets going. But raising the specter of "re-regulation" as a way of avoiding a merits-based debate on the appropriate construction

and application of the antitrust laws is simply a diversionary tactic and should be recognized as such.

Claims of “re-regulation” also seem misguided to me. Surely everyone would acknowledge that there are significant differences between antitrust and the type of pervasive regulation, for example, that governed the airline industry prior to de-regulation, when domestic carriers could not enter markets or change fares without prior notice to and approval by the government. The fact that the antitrust laws may impose limits on certain kinds of carrier behavior does not mean that antitrust constraints constitute “regulation” as that term is ordinarily used. Applying the same standards to the airline industry as are applicable to other industries cannot be regulation in any meaningful sense of the term; under that definition, all industries are “regulated,” a proposition that deprives the term of any useful meaning. If differences in structure and conduct among industries make some susceptible to predation and others not, there may be a need for antitrust intervention in the former but the latter. But that surely doesn’t mean that

the former are “regulated” and the later are not. They are both subject to the antitrust laws.

Make no mistake about it. Regulation and antitrust are very different creatures. As more and more of the world’s economies are recognizing every day, antitrust is the most minimal form of government intrusion in business decisions. The history of this country demonstrates that regulation is often the legislative response to perceptions that the marketplace is not operating competitively. Appropriate antitrust enforcement offers the best prospect for avoiding both market failures and imposition of regulation by legislative bodies looking for a solution. Those looking to protect the airline industry from regulation should recognize that the best way to do so is through vigilant application of the antitrust laws that gives people confidence that they will receive the benefits of the competitive process. That is what we are endeavoring to do at the Department of Justice.