DEPARTMENT OF JUSTICE

Competition in the Air

Remarks by

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Thank you, Bob McGeorge, for the invitation to speak here in Istanbul. I had the pleasure of working with Bob when he too was an antitrust enforcement official at the DOJ Antitrust Division. We miss Bob, whose expertise in airline matters was invaluable, when he was on our side.

Lately I have been thinking a lot about airline competition, and not only because a number of U.S. air carrier mergers have been proposed. I left Washington on Friday, at the conclusion of one more session of the second round of negotiations between the United States and the European Union on a new Open Skies agreement for the two jurisdictions. I flew via Frankfurt first on United and then its partner Lufthansa, codesharing within the Star Alliance, which by the way enjoys antitrust immunity in the U.S., the EU, and elsewhere. The interline transfer of me and my bag was handled smoothly, thanks in part I assume to IATA protocols. I benefit from the procompetitive efforts of airlines worldwide.

These musings on competition suggests topics for my remarks today, which will cover how the U.S. Justice Department views international liberalization, consolidation among air carriers, alliances and antitrust immunity, and the antitrust risks of trade associations. I'll also mention criminal antitrust enforcement against cartels. Although the only criminal I encountered on my flights to Istanbul was the two year old who kicked the back of my seat for six long hours, this is a serious topic for this industry and others.

I. Open Skies

I'll start with the international liberalization of air transport rules. The U.S. has been campaigning since the late 1970s to persuade governments to stop regulating price, frequency, entry, marketing, and other features of the international air transport business. Our first Open Skies Agreement was formed with the Netherlands in 1992. This reinvented the framework

governing international air services and allowed new competition to enter on inter-nation routes. Today many countries around the world have negotiated Open Skies agreements with each other; and the U.S. enjoys more than 70 Open Skies relationships with trading partners.

The Open Skies framework is a big step forward from the protectionist model that preceded it, and the benefits of the Open Skies revolution to travelers and shippers have been enormous. Our studies found that in the late 1990s these agreements helped fuel a significant increase in traffic – about 30 percent – between the U.S. and Europe. This increase was driven at least in part by a substantial reduction in average fares. During that time, average fares decreased by twice as much in Open Skies transatlantic markets – 20 percent – than in non-Open Skies markets – 10 percent.

A. EU/U.S.

Hoping to go beyond Open Skies, the EU and U.S. have, since 2003, been negotiating a comprehensive agreement on civil air services, which in part will replace the various bilateral agreements between the U.S. and EU member states. Under discussion are how we can further liberalize rules restricting access to each other's markets, enhance aviation safety and security, reduce administrative burdens, take into account certain labor and environmental interests, and provide for ongoing consultations. This agreement would be an extraordinary improvement both for the Europeans (who will shed restrictions under a system that treats each of their carriers as a national carrier rather than a European carrier with broader rights) and for the Americans (who hope to clear away particular obstacles, such as limitations on flights to Heathrow).

Of course, not in our near future is a change to permit carriers to operate "cabotage" services, that is, the so-called "ninth freedom" for foreign carriers to fly city pairs within

another's territory on service with no connection to the home territory. For example, with Open Skies Lufthansa could fly from Istanbul to Milan to New York, with onward service to Houston, but it would not be permitted to operate solely between New York and Houston. Similarly, while United can fly from New York to Paris to Berlin, it would not be permitted to fly just between Berlin and Frankfurt. There has been some discussion of expanding "seventh freedom" rights: Lufthansa flies passengers or cargo from Houston to Mexico City.

To give you the latest gossip on the EU-U.S. discussions: Delegations from the two jurisdictions have met numerous times in Brussels and Washington. We thought we had an agreement in November 2005, but the text did not satisfy the EU transport ministers. The talks then stalled as the EU waited to see if the U.S. could liberalize its own rules on foreign ownership of U.S. carriers – more on that in a minute – but since that did not happen, the two sides have been brainstorming on new ways to expand foreign access to each other's markets.

We met this past week in Washington and will meet again in Brussels in a few weeks. The next month will be critical to the talks. I am hopeful we will reach an agreement that will be just the first stage in efforts further to liberalize rules in these markets.

B. Foreign ownership

As I mentioned, the EU-U.S. negotiations could have been furthered by commitments to allow more foreign investment. The laws of most jurisdictions limit foreign investment. By statute U.S. carriers must be 75% owned by Americans; some jurisdictions require more, some less. Speaking generally, if jurisdictions were to allow additional investment in their airlines by foreign carriers, this would facilitate creation of cross-border airline networks, not to mention expand access to capital. The Bush Administration supported a 2005 proposal by the

Department of Transportation to, without changing the 75% statutory limitation, allow foreign investors from Open Skies countries to assume control of commercial decisions of U.S. carriers, although not decisions related to safety, security, and the like. This would have given U.S. airlines access to capital outside the U.S., and joining ownership of complementary networks of U.S. and non-U.S. carriers could have allowed procompetitive scheduling and pricing coordination.

Opposition from interest groups and Congress caused DOT to back away from this proposal. In the long run, this may require a legislative change, but liberalization of these rules seems right to enhance competition in cross-border and domestic airline markets.

The Justice Department strongly supports efforts to liberalize international air transport rules, which should enhance competition and benefit U.S. consumers.

II. Consolidation

A question frequently asked in U.S. airline boardrooms is, "Will we see, and when will we see, industry consolidation?" The usual answer is that consolidation is inevitable and necessary, and this often is followed by, "But will the Justice Department allow consolidation?"

When I tell you my answer, "I do not have an answer to that question," you may ask, "Why are you here?" But you should not be surprised that DOJ has not answered this question. And this is not meant to sound contrarian. The DOJ Antitrust Division is responsible for enforcing the federal antitrust laws. We have the authority to review any particular proposed merger worldwide to determine if it may lessen competition in U.S. markets. You should be pleased that the Justice Department does not have an aviation grand plan. As for most U.S. industries, and for aviation since deregulation, the organizing principle is competition.

Therefore the market should identify good merger partners, produce winners and losers, and of course decide what airlines fly where and how much they charge. The government antitrust role is to protect consumers, maintaining competitive markets by seeking to block anticompetitive mergers in court, and otherwise to stay out of the way.

That said, inferring from DOJ's policy focus on competition and consumers, you could make some general predictions:

First, if consolidation or any particular merger is designed to join complementary networks, reduce costs, and create efficiencies, thereby resulting in a stronger, more competitive combined carrier, DOJ probably applauds it. A case in point is the recent combination of America West and US Air. The practical point for antitrust counsel is to focus on the efficiencies and the procompetitive rationale for the combination.

Second, if a particular merger has little effect on U.S. markets, then DOJ is unlikely to challenge it. DOJ has the burden of proof, and a tie goes to the runner. This largely explains our view of the Air France merger with KLM, in which the most significant effects were in Europe.

Third, if the best argument in favor of your otherwise competition-lessening merger is that consolidation leads to reduced capacity, less competition, higher fares and profits, and healthier industry participants – which benefits airlines and their stakeholders – then DOJ may say your merger still has an antitrust problem. If you also argue that a healthier industry brings investment and therefore long run benefits to consumers, then DOJ may ask you to substantiate the connection between the short term anticompetitive effects and long term procompetitive benefits – which may be hard credibly to substantiate – and DOJ may ask why it is better to rely on this mechanism, rather than a competitive market, to bring consumers what they need.

Finally, for some the policy problem is that the availability of bankruptcy reorganization keeps failing carriers and their assets in the market, at the expense of stakeholders, prevents the procompetitive destruction of mismanaged firms, which only return to the market with artificially low costs, and thereby keeps the whole industry poor. In light of the bankruptcy option, they argue, consolidation is the best way to bring profits and healthy investment. We could have a policy debate whether that's the best system, but changing that system requires either revising the bankruptcy code or cutting back the antitrust statute, and only Congress has that authority.

Yesterday one Brussels-based lawyer was telling me that, although he represents U.S. carriers, he won't fly them, because their chairs are too uncomfortable, which he attributes to their inability to invest in new equipment. The United States Justice Department supports finding this man more comfortable chairs for international flights, but only if the market finds the solution. (Although in another sense, from the way back seat a government fare secures, all those business class seats look pretty comfortable.)

III. Antitrust Immunity

So far I have discussed the enhanced competition that comes from Open Skies and the industry's hope for consolidation, which hope sometimes is in tension with the demands of competition law and sometimes is impossible due to cross-border ownership restrictions. Where a full merger has not been possible, some carriers have formed international alliances, to obtain some of the procompetitive benefits of merger by coordinating schedules and marketing for carriers with complementary networks. Most carriers in these alliances coordinate with the

protection of antitrust immunity, which in the U.S. can in certain circumstances be granted by the Department of Transportation.

The Justice Department often comments in DOT's immunity application proceedings. Since some of your clients may in the future seek antitrust immunity from DOT, I'll outline DOJ's view of when granting immunity is appropriate. We had the opportunity to give this some thought when commenting on the Skyteam alliance's recent application for expanded immunity, occasioned by the Air France/KLM merger.

Most competition law enforcement agencies are predisposed against competition law exemptions. Our economic model is vigorous competition, protected by the antitrust laws, and deviations from this successful model should be imposed only where critical to achieve some goal that competition cannot reach.

In the deregulated airline industry in particular, antitrust enforcement has been central to efforts to promote increased competition and its consumer benefits. DOJ believes there should be a presumption against immunity. To overcome the presumption, applicants for immunity must demonstrate (first) that their collaboration will generate significant benefits that outweigh any harm to competition, (second) that such benefits cannot be achieved without immunity, and (third) that the particular immunity proposed is narrowly tailored to achieve the benefits claimed.

Commenting in the Skyteam proceeding, DOJ stated its view that the applicants had not met this standard. First, it seemed there could be net competitive harm. The expansion of Skyteam would be primarily an overlapping combination, in contrast to the largely end-to-end collaborations for which the original SkyTeam and Northwest/KLM alliances obtained immunity. The expansion joined two major U.S. airlines, risking a domestic anticompetitive

effect. And the claimed benefits attributable to immunity were modest. Second, the requested immunity did not seem necessary to achieve these benefits. The applicants already had begun to integrate their activities and could achieve a substantial portion of the claimed benefits through codesharing that presented minimal antitrust risks. And the threat of damages litigation, much less government prosecution, did not seem substantiable. Third, the parties had not yet defined material details of their proposed coordination, making it difficult to conclude that the purported benefits of immunity justified weakening antitrust protections.

I concede this not an easy standard, and therefore this may call for a more rigorous effort to justify the immunity application than has been thought necessary in the past.

To connect the previous topics, I'll note that liberalization of access and ownership rules could simplify defending mergers, because entry into cross-border and maybe domestic markets would be easier, increasing the number of potential competitors in city pair markets that before liberalization could have been problematic for the merger review. Liberalization also may ease the antitrust review of alliances, although undercut the need to use them as proxies for full mergers of airlines with cross-border networks.

IV. Cartels

We all know cartels are bad business. Price fixing, bid rigging, and output restriction agreements almost always are harmful and without justification. Therefore antitrust authorities worldwide generally regard cartel behavior as, in the words of the U.S. system, per se illegal, hard core violations, the "supreme evil of antitrust."

And it is a growing view that the wrongfulness of cartels calls for the deterrence of criminal punishment. In many jurisdictions, criminal fines and jail time have soared in the last

ten years. For many jurisdictions, our shared commitment to fighting those cartels has led to improved cooperation among antitrust enforcers. As Don Klawiter mentioned in his remarks this morning, authorities regularly coordinate dawn raids and other searches. In the U.S., DOJ will even in appropriate cases seek indictment and extradition of foreign nationals so they may be tried in U.S. courts and, if convicted, serve time in U.S. prison. This is not a pleasant duty, but justified for cartel conspirators in cross-border markets and decreasingly controversial even among the nations whose citizens have seen those prisons.

One of the best weapons in the U.S. arsenal for fighting cartels is our leniency program, which has parallels in dozens of other jurisdictions. Our program offers incentives to be the first cartel member to report the cartel and implicate other conspirators. For qualifying applicants, no charges are filed against the company, no charges are filed against cooperating employees, and no criminal or administrative fine is imposed. These incentives of the leniency programs are invaluable in undercutting cartels, by changing the cost-benefit calculation in these already unstable arrangements. This helps authorities detect cartels and collect the evidence necessary to obtain convictions.

I know some of you have airline clients under investigation by the U.S. and other jurisdictions, in which competition authorities are working together. As surely you already have told your clients, the existence of these ongoing investigations highlights the importance of antitrust compliance counseling for competitors and for trade associations.

V. Trade associations

Trade associations are an example of the antitrust paradox that sometimes coordination among competitors is procompetitive. For diverse products from train tracks to electrical plugs

to computer software, many trade associations have over the years advanced competition by standard setting, facilitating interoperation of complementary activities, and aiding customers that buy from competing networks. Antitrust law long has recognized that trade associations can help the economy by creating fora for such procompetitive coordination among competitors.

IATA itself has sponsored such procompetitive coordination. Most notably, IATA deserves credit for helping to create a multilateral interlining structure with the technical standards, passenger and bag transfer procedures, money transfers, and communications protocols needed to get passengers and their luggage around the globe more efficiently. We all are indebted.

On the other hand, history has proved that frequent gatherings of close competitors can tempt unlawful coordination. A favorite U.S. example is the coordination of output and price by the world's major lysine producers, accomplished during meetings of trade associations such as the European Feed Additives Association (sounds so benign). Three U.S. executives went to jail and their company was fined a then-record $100 million. Last year in Europe, the EC imposed €519 million in fines on members of the European Synthetic Rubber Association, which the EC said had formed cartel agreements just before or after official meetings of the trade association. And then there are the examples in which the trade association itself acted as the hub of the conspiracy.

The expert work of Bob McGeorge and his legal team gives me confidence that this trade association will work to stay on the pro-competition side of antitrust. This group can help prove untrue the warning of one skeptic, that trade associations are invariably "walking antitrust violations."

As I am sure IATA has advised you, advise clients: while they are enjoying a faraway city with IATA friends, do not have discussions about their future pricing decisions, bids on contracts, business plans, business relationships with travel agents or other third parties, the benefits of cooperation rather than competition, or why their IATA friends should compete in a particular way. Do not discuss these at a trade association meeting. Do not discuss these anywhere.

VI. Conclusion

Thank you again for the invitation to discuss the U.S. DOJ's views on competition in air transportation. I would be happy to answer questions in the time remaining and to answer individual questions anytime later in the conference.