DEPARTMENT OF JUSTICE

STATEMENT

of

JOHN M. NANNES

Deputy Assistant Attorney General
Antitrust Division
U.S. Department of Justice

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Concerning

International Aviation Agreements
and Their Antitrust Implications

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Mr. Chairman and members of the Subcommittee, I am pleased to appear before you today to discuss important antitrust issues in today's airline industry. My testimony focuses on how we analyze international aviation agreements.

Antitrust Enforcement in the Airline Industry

Beginning in the 1970s, our nation has in several key industries acted on the recognition that competition serves consumers far better than economic regulation. In particular, the Airline Deregulation Act of 1978 moved the domestic air transportation industry from government regulation to a new era of competition.

Antitrust enforcement is critical to ensuring that the benefits of airline competition sought by Congress are realized by consumers. The Antitrust Division has maintained an active antitrust enforcement program in the airline industry for many years. During the 1980s, the Division recommended that the Department of Transportation (which had authority over airline mergers until 1989) disapprove two mergers, TWA/Ozark and Northwest/Republic, which involved the merger of the only two hub carriers at St. Louis and Minneapolis respectively. The merging carriers were the only airlines providing nonstop service between the hub city and smaller cities in the surrounding region (such as Bismarck, North Dakota and Cedar Rapids, Iowa).

The Division has also moved aggressively to block acquisition of gates or slots that would eliminate existing or potential hub competition, including Eastern's proposal to sell eight gates to USAir at the gate-constrained Philadelphia

International Airport and Eastern's proposed sale of slots and gates at Reagan Washington National Airport to United, which operated a significant hub out of nearby Dulles airport.

The Division has also challenged transactions involving international route authority. For example, with respect to the 1991 investment agreement between British Airways and USAir, the Department brought a civil action under Clayton Act § 7 after we concluded that the transaction threatened competition in gateway city pairs and certain connecting city pairs (in particular, service between Northeast and Mid-Atlantic cities and London).

In addition to challenging transactions that adversely affect the structure of the airline industry, the Division's record demonstrates a commitment to detecting and challenging collusive practices. In 1992 we sued Airline Tariff Publishing Co. and eight major airlines, alleging that the airlines used the ATPCO electronic fare submission and dissemination system to fix prices. The consent decrees ultimately entered into banned improper signaling of future pricing intentions, which had cost consumers up to $2 billion in travel expenses.

Other conduct that we have challenged includes agreements on international fares undertaken outside the scope of the International Air Transport Association[1] and the solicitation by American President Robert Crandall of a price increase from one

[1] See, e.g., United States v. Air Florida, Crim. No. 84-260 (D.D.C. indictment filed July 11, 1984).

of his chief rivals, which we challenged as attempted monopolization.[2]

In addition to the law enforcement efforts that I have described, the Antitrust Division engages in competition advocacy in various matters before the Department of Transportation. Because DOT retains significant authority over competitive issues raised by agreements between U.S. and foreign carriers and has the authority to grant antitrust immunity to agreements between such parties, the Division often brings our expertise to bear in comments to DOT. Overall, we have developed an excellent working relationship with the Department of Transportation.

International Code Sharing Agreements

As you can see, the Department of Justice has been working aggressively for many years on a number of fronts to preserve competition in the airline industry since deregulation. But let me turn now to the principal focus of today's hearing: the competitive implications of international aviation marketing alliances which, for the sake of simplicity, I will refer to as "code sharing." The term "code share" can mean as little as one airline allowing another airline to use its computer reservation system codes to sell seats on its planes on routes in which the second airline cannot compete, or as much as comprehensive integration of marketing and operations that involves joint

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[2] See United States v. American Airlines, Inc., 743 F.2d 1114 (5th Cir. 1984), cert. dismissed, 474 U.S. 1001 (1985).

decisions on price, capacity, schedules and other competitively sensitive matters.

The antitrust laws fully apply to all domestic code-sharing agreements and, absent an express grant of antitrust immunity by the Department of Transportation, the antitrust laws apply fully to international code shares as well. To antitrust law enforcement officials, code-sharing agreements are simply forms of corporate integration that fall somewhere between outright merger and traditional arm’s length interlining agreements. Like mergers and acquisitions, code-share agreements have the potential to be procompetitive--they can create new service, improve existing service, lower costs and increase efficiency, all to the benefit of the traveling public. By the same token, code sharing arrangements can be anticompetitive. They can result in market allocation, capacity limitations, higher fares, or foreclosure of rivals from markets, all to the injury of consumers. The ability to distinguish the latter from the former is crucial for aviation policy makers and antitrust enforcement authorities.

When we conduct an antitrust investigation of a code share, whether wholly domestic or international, we always analyze the specific terms of each agreement on a case-by-case basis. In assessing the effect on competition, the first necessity is to define the relevant market and measure that market in terms of its participants and concentration. For any proposed code share, we ask whether the code-sharing partners are actual or potential horizontal competitors. From an antitrust viewpoint, the greatest threat to competition comes when two of very few airlines that compete in a market enter into a code-sharing agreement in that market. The same concerns would be present if the two carriers were planning to merge. Any time two of very few airlines in a market act jointly, whether in a domestic U.S. market or an international city pair, we are concerned about the effect on competition.

Having defined and measured the relevant market, the next issue we examine is the potential adverse competitive effects of the code share. Here we consider whether the code-share partners will both operate flights in the market and whether their capacity, scheduling, and pricing decisions will remain independent. And by independent I mean that the agreement is structured in a way that gives each carrier the strongest possible incentive to sell seats on the flights it operates rather than on those of its code-share partner, and to cut its prices and increase its operating capacity to gain market share.

Thus, one characteristic of a code-share agreement that can reduce antitrust concerns is independent pricing and marketing of seats on the shared flights. This is often accomplished with block-seat arrangements where the non-operating carrier purchases a fixed number of seats and bears the risk of loss if those seats are not sold. This is far from ideal, however, because the cost of these seats to the non-operator, which is the key determinant of the ultimate fare to the consumer, is set by agreement between competitors. On the other hand, we recognize that compared to joint sales and marketing, a block seat arrangement can create some additional incentive for each partner to market its seats aggressively. Finally, it is also preferable from an antitrust perspective if any block seat agreement is non-exclusive and the time period of the agreement is not unreasonably long.

If independent operations are not contemplated, such that the code-share agreement will reduce or eliminate competition in city-pair markets between the code-share partners, we must consider the extent to which entry into these markets by new competitors is likely to occur in response to anticompetitive behavior of the code-share partners. If sufficient and timely entry can be expected, then the code-share agreement would not be likely to create or facilitate the exercise of market power by the code-share partners. In this regard, an important factor we consider is whether an “open skies” bilateral exists in the market. Open skies means that new entry by a carrier is possible, and we will investigate how likely such entry would be in the event the code-share partners attempted to raise fares or reduce service. On the other hand, where entry is governed by a restrictive bilateral, the threat to competition of a code share on that city pair, particularly if the only two authorized carriers are involved, may be substantial.

And finally, if independent operations by the code-share partners in the relevant city-pair markets are not contemplated and sufficient and timely entry is not likely, we look for evidence that one of the partners is likely to exit the market absent the code share, or that significant transaction-specific procompetitive efficiencies in serving other city pairs on a code-share basis outweigh the potential competitive harm in the overlap city pair.

In sum, we examine all of the facts and circumstances surrounding each code-share agreement and make our competitive assessment on a case-by-case basis.

How have we applied this analysis to proposed code-share agreements that we have reviewed? The majority of proposed agreements present no horizontal competitive concerns and can be readily approved. Others we have reviewed combined certain horizontal overlaps with significant end-to-end efficiencies. The Department's policy is to seek to exclude from a proposed alliance those city pairs on which the proposed alliance partners are two of very few current or likely future competitors.

For agreements where antitrust immunity has been sought from the Department of Transportation, we have recommended that DOT "carve out" certain unrestricted fares involving these city pairs from the order granting antitrust immunity for the alliance agreement, provided that the carve out can reasonably be done without sacrificing important consumer benefits created by the alliance. Thus, we recommended that seven city pairs be carved out of the Delta/Swissair/Sabena/ Austrian alliance (Atlanta-Zurich, Atlanta-Brussels, Cincinnati-Zurich, New York-Brussels, New York-Geneva, New York-Vienna, and New York-Zurich), one for the American/Canadian Air alliance (New York-Toronto), two for the United/Lufthansa alliance (Washington-Frankfurt and Chicago-Frankfurt), and two for the United/Air Canada alliance (Chicago-Toronto and San Francisco-Toronto).

We believe that this carve out approach permits U.S. air passengers to obtain the benefits of increased efficiency and enhanced beyond-gateway service provided by these code-sharing agreements, while avoiding possible diminutions in gateway-to-gateway service or increased air fares as a result of an alliance. Of course, should a proposed code-share present the potential for significant diminutions in gateway-to-gateway service while providing little likelihood for enhanced beyond-gateway service, we are fully prepared to recommend against the approval of the code-share proposal in its entirety.

I should make it clear that, although I have been discussing the way the Department of Justice evaluates international code shares, the Departments of Justice and Transportation share a common interest in protecting competition to ensure that consumers receive the best services at the lowest prices. To date, DOT has accepted all of the carve outs the Justice Department has proposed, with the exception of the four New York/Europe carve outs we sought for the Delta alliance. Even then, DOT required the alliance partners to report fare and other data that will allow us to review the effect of the alliance on price and service on these routes. If the data ultimately show that fares increase or service decreases on any of the four routes, DOT can remedy the harm by expanding the carve out accordingly.

In addition, DOT has prohibited alliance partners from participating in “fare coordination” activities under the auspices of the IATA. The Department of Justice has for years raised concerns to DOT about this type of international cartel activity, and we fully support DOT’s efforts in this regard, which will clearly benefit international airline passengers.

Let me conclude my remarks on international code shares by touching on two pending agreements. One is the proposed code-share agreement between American Airlines and the TACA group. We provided our comments concerning this code share proposal to the Department of Transportation on January 28th, and I can summarize our position for you here.

The TACA group is composed of six Central American airlines serving Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and the Republic of Panama. American and a TACA carrier operate overlapping nonstop flights on virtually all routes between Miami, the principal Latin American hub in the United States, and the Central American gateway cities in the countries just mentioned. Last summer, these flights accounted for all 21 of American’s daily nonstop U.S.-Central American flights, and seven of the TACA Group’s eight daily nonstop U.S.-Central American flights. Put another way, in the overlapping nonstop Miami-Central American city pairs, American and TACA have combined market shares ranging from a low of 88 percent to a high of 100 percent.

At the same time, the number of passengers traveling between the United States and smaller Central American cities beyond the Central American gateways served by American's nonstop flights or, conversely, the number of passengers traveling from the Central American gateways to cities beyond Miami served by TACA Group nonstop flights, is not only a small percentage of the passengers flying gateway-to-gateway, but these passengers can currently obtain on-line, beyond-gateway service simply by switching to existing TACA Group or American Airlines flights, respectively. Thus, the class of potential beneficiaries of the expansion of the American/TACA Group route network is largely limited to that very small fraction of passengers whose double-connect itineraries include end points both beyond Miami and beyond the Central American gateways. This almost exclusively horizontal agreement stands in stark contrast to the largely end-to-end international code-share agreements that we have previously reviewed.

We concluded that the claimed efficiency benefits that are specific to the transaction are very slight, while some potential risks to competition would inevitably persist despite the best efforts to eliminate them through imposing conditions. We believe that DOT should weigh these factors very carefully before making a determination that approval of this code-share agreement would be in the public interest under 49 U.S.C. § 40109.

Finally, let me briefly mention the pending American Airlines/British Airways proposal. The Department is carefully reviewing this proposal under the same analytical framework that I described earlier for all international code-share agreements, recognizing that the degree of competitive overlap--in terms of both the number and size of the affected city-pair markets--is much greater here than in any of the existing alliances. Not only do the two carriers compete in a number of large nonstop city-pair markets, but also, as was the case with USAir and British Airways in 1991, they compete for passengers traveling between interior U.S. points and the United Kingdom.

A key issue is whether and under what circumstances it is likely that “future competitors” will replace the competition lost as a result of the proposed alliance. With open skies, new entry might be likely on many of the overlapping city pairs in the absence of airport access constraints, but the fact is that constraints on new or expanded service at London’s Heathrow Airport are significant. Consequently, we are assessing whether there are any conditions that can resolve the Heathrow access problems to allow sufficient entry to replace the competition lost from an American/British Airways combination. You can be sure that, unless we conclude that effective conditions can be imposed to ensure competitive airline service between the United States and the United Kingdom, we will urge DOT to disapprove the alliance.

I hope that I have helped the Subcommittee understand the approach the Department of Justice is taking with respect to evaluating international code share agreements. I believe that the Division's analytical approach is sound, and that, to mix transportation metaphors, we are on the right track with respect to the manner in which we conduct our analyses in this area.

Mr. Chairman, this concludes my prepared remarks. I will be happy to answer any questions that you or other members of the Subcommittee may have.