BEFORE THE
DEPARTMENT OF TRANSPORTATION
WASHINGTON, D.C.

Joint Application of	)	
ALOHA AIRLINES, INC. and HAWAIIAN AIRLINES, INC.	)	**Docket No. OST-2002-13002**
under Section 116 of the Aviation and Transportation Security Act of 2001 for approval of and antitrust immunity for agreement	)	

PUBLIC

COMMENTS OF THE DEPARTMENT OF JUSTICE

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Joint Application of ALOHA AIRLINES, INC. and HAWAIIAN AIRLINES, INC. under Section 116 of the Aviation and Transportation Security Act of 2001 for approval of and antitrust immunity for agreement	Docket No. OST-2002-13002

COMMENTS OF THE DEPARTMENT OF JUSTICE

Aloha Airlines and Hawaiian Airlines have applied under Section 116 of the Aviation and Transportation Security Act for antitrust immunity for an agreement to coordinate capacity in Hawaiian inter-island markets. The coordinated capacity reductions proposed by the carriers will result in serious harm to consumers through higher fares and poorer service in some of the most heavily traveled city pairs in the United States. There has been no showing that such collusion on capacity is necessary to preserve air service in the inter-island markets.

The proposed agreement is not in the public interest and the Department of Justice ("DOJ") urges the Secretary to deny the Aloha/Hawaiian application.

I. Background

A. The Inter-Island Markets

Aloha and Hawaiian are the only two significant competitors in the Hawaiian inter-island markets, with over 95% of the traffic in these city pairs.[1] Both carriers have served the inter-island markets for over 50 years. In addition to inter-island service, both Aloha and Hawaiian provide Mainland-Hawaii service. Both carriers also codeshare with other domestic and international carriers serving Hawaii.

The inter-island routes include some of the most heavily traveled city pairs in the United States. Honolulu-Kahului is the eighth largest domestic city pair with over 6000 passengers per day.[2] (By comparison, Chicago-Washington averages about 3000 passengers per day.) Three other city pairs -- Honolulu-Lihue/Kona/Hilo -- are among the 35 largest US city pairs. Aloha and Hawaiian carry over 96% of the passengers in each of these city pairs.

The volume of inter-island traffic has declined over the last several years, largely due to declines in tourist traffic from the Mainland and Japan. In addition, the inter-island routes have been affected by the post-September 11 decline in air travel. Between January 2000 and January 2002, traffic on the four largest inter-island routes declined by about 12%.[3] As traffic has declined both Aloha and Hawaiian have reduced flights in the inter-island city pairs.

B. The Immunity Application

The Inter-Island Cooperation Agreement filed by Aloha and Hawaiian applies to routes between Honolulu and Kahului, Lihue, Kona and Hilo, which are served by both carriers. Under the agreement, the two carriers would agree on the total available seat miles (ASMs) to be

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[1] The remainder is accounted for by Pacific Wings, a scheduled carrier offering service with Cessna aircraft, primarily in smaller markets not served by both the Applicants, and a number of small air taxi operators offering non-scheduled service between the islands.

[2] Aviation Daily (November 29, 2001) at 8.

[3] T-100 data.

offered monthly in the covered routes. Each carrier would operate half of the agreed upon ASMs, but would be free to allocate the capacity among the routes, provided that at least one carrier continues to offer service in each city pair. The total ASMs for each month would be established by agreement between the carriers 75 days prior to the beginning of the month. The agreement does not provide for any agreement on schedules or fares.

At the end of each month, each of the carriers will certify the number of ASMs and revenue passenger miles (RPMs) operated during the month. If one of the carriers has operated more than its allocated share of inter-island RPMs during the month (as determined by the formula in Article 2 of the agreement), it must pay the other carrier a penalty ("RPM Transfer Payment"). The level of the penalty increases as the variance from allocated ASMs increases, to a maximum transfer payment of 40¢ per RPM where a carrier exceeds its ASM allocation by 3.1% or more. If one of the carriers fails to operate at least 98% of its allocated ASMs there is no penalty payment required from the other carrier, even if it exceeds its allocation.

Either carrier can terminate the agreement on 75-days written notice. The carriers have requested that DOT grant immunity for the agreement until October 1, 2003, the maximum period allowed by the statute.

II. Legal Standards

A. Section 116

Section 116 of the Aviation and Transportation Security Act of 2001, Pub. L. 107-71, 115 Stat. 624 (Nov. 19, 2001), states that air carriers providing air transportation on intrastate flights may file an application for antitrust immunity for an agreement to coordinate operations on those flights upon a declaration by the governor of the affected state that the agreement is necessary to ensure the continuing availability of air transportation within the state. Section 116 provides that the DOT *may* approve such an application if the DOT determines that (1) "the State to which it relates has extraordinary air transportation needs and concerns; and (2) approval is in the public interest."[4]

Congress, in passing the Aviation and Transportation Security Act, rejected calls for much broader antitrust immunity provisions for the airline industry, and instead included only the very limited exemption in Section 116. It is clear from the legislative history of Section 116 that Congress intended that the exemption be construed narrowly and that the aim of the statute is to prevent the loss of service. The Conference Report stated that the purpose of Section 116 is "to ensure continued viability of air service within a state." H.R. Conf. Rep. No. 107-296 (2001). Statements about the provision during hearings on the bill consistently indicate that the purpose of the exemption is to protect against the complete loss of service. As Senator Hutchinson stated, the purpose is to "assure, as much as possible, that a community wouldn't lose *all* service." Financial State of the Transportation Industry: Hearing on S. 1447 Before the Senate Comm. on Commerce, Science and Transportation, 107th Cong. (2001) (emphasis added). Senator Inouye similarly stated that the provision was a "very narrowly drawn antitrust exemption." Id.

Given this legislative direction, DOT must construe Section 116 narrowly. This is consistent with the general rule that exemptions from the antitrust laws must be construed narrowly, see Group Life & Health Ins. Co. v. Royal Drug Co., 440 U.S. 205, 232-33 (1979),

[4] Under the statute immunity granted under Section 116 expires on October 1, 2002. The Secretary may, upon a public interest finding, extend the grant up to October 1, 2003.

and DOT's longstanding policy that it does "not routinely grant applications for immunity." Docket OST-95-618, Order 96-6-33 (June 14, 1996) at n.53.

B. The Governor's Declaration

As required by the statute, the carriers have submitted a declaration signed by Hawaii Governor Benjamin J. Cayetano stating that the cooperation agreement "is necessary to ensure the continuing availability of air transportation which both originates and terminates at points within the State of Hawai'i." The Governor's declaration, while meeting the legal requirement to trigger DOT review of the immunity application, cannot support a finding by DOT that the application is in the public interest.

The Applicants misrepresent the Governor's declaration as endorsing their claims about why the coordination agreement is necessary to preserve service on inter-island routes. Application at 7. The Governor does nothing of the kind, and is in fact quite careful to indicate that many statements in the declaration are based entirely on the Applicants' representations. Applicants drop the italicized phrases from their quotations of the declaration: "*Hawaiian and Aloha have reported* that neither carrier has earned a net profit on their respective interisland services for many years . . .;" "*Hawaiian and Aloha have stated* that there is excess capacity in interisland services but that they have no ability to conform capacity to actual demand;" "*Hawaiian and Aloha expect* implementation of their proposed Cooperation Agreement to substantially reduce the persistent losses experienced by the carriers, eliminate the short-term threat to interisland air transportation, and establish a stable base for continued interisland service." Declaration at 2-4.[5]

The Governor's declaration does not reflect any independent investigation by his office, or purport to constitute a finding that the statements made by Applicants as to the necessity of the coordination agreement are true. Nor does the Governor purport to have reviewed any evidence supporting these statements beyond the representations of the Applicants. DOJ understands that the only material provided by the Applicants to the State of Hawaii in support of their claims is a one-page letter signed by the Applicants' CEOs stating that "each of our companies believes that the Inter-Island Cooperation Agreement is necessary to ensure the continuing availability of air transportation within the State . . . . Please be assured that each company confirms and ratifies that the representations, statements, beliefs and agreements attributed to them in the form of the Declaration we have provided for the Governor's signature . . . should be relied upon by the Governor in determining whether to issue the Declaration pursuant to Section 116." A copy of this letter is attached as Exhibit 1. Moreover, as discussed below, not only does the Governor's declaration fail to provide evidentiary support for the Applicants' claims, the Applicants themselves fail to provide DOT with evidentiary support for their claims.

C. DOT Public Interest Standard

The statute requires that the Secretary make a finding that approval of the agreement is in the public interest. DOT is not a rubber stamp under Section 116, but must independently assess the evidence, as it does with respect to other immunity applications, to determine whether the

[5] The Governor also details the undisputed importance of inter-island air service to the state's economy and the lack of alternative inter-island transportation. Given the importance of inter-island service it is all the more critical that DOT protect competition in these markets.

agreement is necessary to advance the aim of the statute -- in this case ensuring continued air service in the inter-island markets. DOT has stated that it may not approve an agreement "without finding that the proposed operations are in the public interest. . . . The Department examines judiciously each proposed [agreement] on its individual merits based on the particular facts and circumstances of each case."[6]

Contrary to the Applicants' claim that there is "nothing novel about granting antitrust immunity for the coordination of capacity or RPM balancing by two or more carriers," DOJ is aware of no post-deregulation proceeding in which DOT has granted immunity to such a deeply anticompetitive agreement. The DOT orders concerning discussions about airport congestion cited by Applicants specifically state that the carriers are <u>not</u> authorized to discuss capacity, fares, or schedules.[7] Similarly, in granting immunity for fare and capacity coordination to international alliances, DOT has repeatedly carved-out city pair markets monopolized by the applicants from the immunity grant.[8] A finding by DOT that the type of anticompetitive agreement proposed by Hawaiian and Aloha is in the public interest would be unprecedented, and Applicants have provided no justification for DOT to take this step.

Applicants have provided no evidence beyond the bald assertions in the application to support their claim that the grant of immunity is necessary to preserve inter-island service. The

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[6] Order 96-11-12, Docket OST-96-1700 (Nov. 18, 1996).

[7] *See, e.g.*, Order 91-9-39, Docket OST-47751 (Sept. 18, 1991); Order 87-3-39, Docket OST-44634 (Mar. 11, 1987). These orders allowed carriers to meet <u>in the presence of representatives from antitrust enforcement agencies</u> to discuss ways to reduce airport congestion at peak times.

[8] *See, e.g.*, Order 96-5-27, Docket OST-96-1116 (May 21, 1996) (carving out the Chicago-Frankfurt and Washington, D.C.-Frankfurt routes from the United/Lufthansa immunity grant).

statements in the Governor's declaration regarding the necessity of immunity are likewise based on the Applicants' completely unsupported representations. The Applicants have provided DOT with no evidence on traffic, capacity, fares, financial condition, or their inability to unilaterally reduce capacity that would support a finding that approval of the application is in the public interest. As discussed below, the available evidence shows that approval of the agreement will seriously harm consumers and is not necessary to preserve service in the inter-island markets. Accordingly, DOT must reject the application.

III. Coordinated Capacity Reductions Will Harm Consumers

The Applicants make the incredible assertion that the proposed agreement is relatively benign because they will "only" coordinate on capacity. But an agreement among carriers to reduce capacity is likely to reduce the number of passengers carried, harming consumers. An agreement among carriers to reduce capacity also harms consumers by reducing the number of scheduled flights and thus the options available to them.

In this case, consumer harm will be exacerbated because the agreement is explicitly structured to discourage price or service competition. While the agreement allows the Applicants to agree on capacity (ASMs), the penalty provision is based on passengers carried (RPMs).[9] If one of the airlines carries a disproportionate share of passengers on the inter-island routes, it will be required to pay a penalty to the other carrier. As the agreement is written, such a payment is required even if neither of the Applicants exceeds its allocated 50% of the capacity. This system will create a powerful disincentive for the carriers to reduce fares or improve service in order to attract additional passengers. Indeed, since the carrier with higher fares will get at

[9] Inter-Island Cooperation Agreement, Article 2.

least partial compensation for any passengers lost to its competitor, each carrier will have a unilateral incentive to raise prices above current levels.

Even if a carrier deviates only slightly from its allocated capacity the penalty paid to the other carrier can be quite large. A carrier operating 2.1% more than its allocated capacity will pay its competitor 30¢ for each RPM above its proportionate share.[10] At this level, a carrier 200 RPMs over its allocated share (the equivalent of one roundtrip between Honolulu and Kahului) would pay a penalty of $60 (200 x 30¢). The carrier receiving the penalty payment will have every incentive to actively push passengers back to its competitor by raising fares and reducing service levels.

The agreement at issue here is of the type that (absent a grant of immunity) would likely be considered a *per se* violation of the antitrust laws. As the Supreme Court has stated, "Horizontal price fixing and output limitation are ordinarily condemned as a matter of law under an 'illegal *per se*' approach because the probability that these practices are anticompetitive is so high." National Collegiate Athletic Ass'n v. Board of Regents, 468 U.S. 85, 100 (1984). It is difficult to predict the amount of consumer harm from the proposed agreement (in part because it is unknown what the level of capacity cuts will be), but it is certain that passengers in the inter-island markets will suffer immediate harm if the immunity application is granted. Given the clearly anticompetitive nature of this agreement, DOT should carefully scrutinize it under the statute.

The anticompetitive effects of the coordination agreement may well be felt beyond the

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[10] Under the penalty provision, a carrier operating 2.1-3% above its ASM allocation would pay its competitor 30¢ for each RPM over 50% of total Aloha/Hawaiian RPMs in the affected markets (assuming its competitor operated at 100% of its allocated ASMs).

end of the immunity period. While the carriers will no longer be permitted to expressly coordinate, once they have reached an anticompetitive but more profitable arrangement, it may persist for some time even in the absence of the express agreement, causing continued consumer harm. Having managed to raise prices, the carriers may find it profitable to maintain them at this higher level, particularly given their ability to observe and respond immediately to one another's future initiatives.

Claims that any anticompetitive effects of the agreement will be quickly ameliorated by new entry, see Application at 12-13, are unconvincing. The Applicants' central argument is that under current market conditions two independent carriers cannot survive. If entry by a third carrier is not attractive today, it is hard to understand how it would become attractive during the term of the agreement given that the entrant would know that it would be facing two well-established independent competitors when the immunity expires. Moreover, since the Applicants will adjust capacity on a monthly basis they will have the ability to respond to entry even during the term of the agreement. On the other hand, if the market is indeed sufficiently robust to support a third carrier in the face of a price increase or output reduction by the two incumbents, it is difficult to credit the Applicants' assertion that the market cannot presently support even two firms under competitive conditions.

IV. Immunity is Not Necessary to Preserve Service

A. Neither Carrier is a "Failing Firm"

Financial hardship should justify what would otherwise be deemed an anticompetitive agreement only in rare circumstances when one of the parties is in imminent danger of financial failure. Under those circumstances, competition is not substantially harmed because the failing firm's assets will not be used to provide independent competition in the market anyway. Because claims of financial hardship are so easily made, parties asserting such a defense should be held to a high standard of proof.[11] The Applicants make dark predictions about their financial future absent the coordination agreement. Although, like the rest of the industry, Aloha and Hawaiian have seen better times, the available evidence shows that neither is in imminent danger of failing. And to meet the standard required by § 116, the Applicants would have to show that both carriers are failing firms and their assets likely to exit the market, leaving no air service in the Hawaiian inter-island routes.

CID MATERIAL

[12]

REDACTED [13] **REDACTED** [14] **REDACTED** [15]

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[11] The Supreme Court, within the context of merger analysis, has delineated strict standards for applying a failing firm defense. Citizen Publishing Co. v. United States, 394 U.S. 131, 137 (1969). Attempting to avoid such strict standards, some companies have argued that they are "weakened" competitors. This argument, as recognized by the Seventh Circuit, is "probably the weakest ground of all for justifying a merger." Kaiser Alum & Chem. Corp. v. FTC, 652 F.2d 1324, 1341 (7th Cir. 1981).

[12] **CID MATERIAL**

[13] **CID MATERIAL**
Operating cash flow is the actual cash generated by the carrier's airline operations.

[14] **CID MATERIAL**
Liquidity is a measure of a company's ability to meet its obligations as they come due in the ordinary course of business.

[15] **CID MATERIAL**

REDACTED [16]

Hawaiian had positive profits and cash flows in 2001.[17] Hawaiian also has a good liquidity position, as it had cash and cash equivalents of over $81 million as of June 30, 2002.[18] Additionally, Hawaiian has received almost $25 million in compensation pursuant to the Air Transportation Safety and System Stabilization Act.

The actions of both carriers cast serious doubt on any claim that they are near financial failure. Both carriers have added flights from Hawaii to the Mainland during 2002, and both have taken significant actions to reduce costs. Hawaiian, for example, is in the midst of a fleet renewal program to replace its wide body transpacific aircraft with new Boeing 767s and its narrow body interisland fleet with new Boeing 717s -- both of which Hawaiian has stated "are specifically engineered to insure efficient, cost effective service."[19] In discussing the addition of service to Sacramento, Paul Casey, then-Chief Executive Officer of Hawaiian, stated: "We are encouraged by the steady increase in bookings through the first quarter of this year and feel

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[16] **CID MATERIAL**

[17] 2001 Form 10-K at 19, 24.

[18] Second Quarter 2002 Form 10-Q at 17.

[19] *Meet the 767ER*, at http://www.hawaiianair.com/about/767.asp.

confident that traffic in our markets should return to full strength by summer."[20]

In another sign of confidence about its financial future, Hawaiian's Board of Directors approved a Stock Repurchase Program in March 2002, spending $3.1 million until the program ceased on May 7, 2002 -- not something a company normally does if it does not expect to have cash to spare.[21] On May 31, 2002, Hawaiian commenced a tender offer to purchase additional shares, spending $25 million for the tendered shares on July 8, 2002.[22]

B. No Showing Both Carriers Will Exit Inter-Island Routes

There is no evidence beyond the statements of the Applicants that both carriers (or even one of them) will exit any inter-island route if they are not allowed to coordinate capacity. In fact, with regard to the short term, the application says exactly the opposite: "Without the ability to coordinate capacity, Aloha and Hawaiian will continue to maintain excess capacity." Application at 15. The Applicants go on to claim that this will result in losses and that at some undefined point in the future "one or both carriers may be unable to sustain those routes." Id. (emphasis added). The Applicants have presented no evidence that they actually would exit any of the routes where they would coordinate. Nor is there any evidence that either carrier has ever considered exiting any of these routes. The prospect that both carriers would exit is entirely implausible and lacks any evidentiary support whatsoever.

The Application on its face thus fails to establish the basic predicate for immunity under Section 116 -- that immunity is necessary to preserve service. If it is the case, as Applicants

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[20] Sacramento Bee, April 23, 2002.

[21] Second quarter 2002 Form 10-Q at 7.

[22] Id.

claim, that a coordination agreement that provides the carriers jointly with higher profits would allow both airlines to survive, it is hard to understand how a single carrier left with a monopoly after the other exits would be unable to survive. Given the large size of the markets covered by the agreements, it is difficult to imagine that they would not be able to support service by at least one carrier. The type of scenario presented by the Applicants in which the carriers slug it out until they suddenly and simultaneously collapse, leaving consumers with no service at all, is inherently implausible and provides no basis for approval of the application.

As noted above, the Applicants have not established that even one of them would stop serving the inter-island routes. But even if it were true that one of the carriers would inevitably exit "at some point in the future," an immunized cooperation agreement would still harm consumers. If the Applicants are granted immunity to coordinate capacity, competition will disappear and consumers will suffer immediate harm. Without the immunity grant, however, consumers will continue to benefit from competition between the two carriers at least until the time one of them exits.

C. Both Carriers Have Demonstrated the Ability to Make Unilateral Capacity Reductions

The claim that Aloha and Hawaiian are unable or unwilling to reduced traffic by making unilateral reductions in capacity is belied by the fact that both carriers have made significant reductions in capacity in the inter-island markets. Exhibit 2 shows the carriers' monthly passengers and seats for the period January 2000 to March 2002 on the inter-island routes covered by the agreement.[23] As this graph shows, Aloha and Hawaiian have been able to quickly

[23] All passenger and capacity figures in this section are from the T-100 data.

respond to changes in inter-island demand.[24] In the wake of September 11, inter-island capacity was reduced by 28% between August and October 2001, about the same percentage as the decline in passengers.

Over the entire period covered by the graph, the number of seats in the inter-island markets has declined faster than the number of passengers. Although the number of passengers in March 2002 was only 5.3% below March 2001, the number of available seats had declined by 16.9% from the previous year. Over the two-year period from March 2000 to March 2002, the number of inter-island passengers declined by 13.5% while the number of seats declined by 25.7%.

Not surprisingly, the decline in inter-island capacity relative to inter-island demand has had a positive effect on the load factors and yields of the carriers. In the first quarter of 2002, the load factors of Aloha and Hawaiian in the four routes covered by the coordination agreement were 71% and 81% respectively. By comparison, the industrywide load factor for domestic flights was 64%.

Hawaiian's 2001 inter-island yields were up 11.8% over the previous year.[25] In contrast, major airline yields for 2001 were 7.9% below 2000 levels.[26] Hawaiian's inter-island yields in

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[24] DOJ has no reason to doubt Applicants' statement that these capacity adjustments were the result of unilateral actions. If that is so, this contradicts Applicants' arguments that collusion and antitrust immunity are necessary to adjust capacity in response to changes in demand.

[25] 2001 Form 10-K at 20-21. Likewise, Hawaiian's 2000 inter-island yield was 7.3% over its 1999 yield. Id. at 22.

[26] Airline Quarterly Financial Review, DOT Office of Aviation Analysis (Fourth Quarter 2001) at 15.

the first six months of 2002 were 2.3% above the same period in 2001.[27] Aloha's first quarter 2001 yields were 2.1% higher than the first quarter of 2000, and its first quarter 2002 yields were up 10.9% year-over-year.[28]

CONCLUSION

The proposed Inter-Island Cooperation Agreement is manifestly not in the public interest. Allowing the only two carriers serving these routes to coordinate capacity will result in serious harm to consumers traveling in the inter-island city pairs. There is no evidence whatsoever to support the claim that immunity is necessary to preserve service on the routes. Accordingly, DOJ strongly urges that the Secretary deny the application.

Respectfully submitted,

"/s/"

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[27] Second Quarter 2002 Form 10-Q at 15. Hawaiian's inter-island yields declined slightly in the second quarter of this year (-0.4% year-over-year).

[28] Hub data base (Data Base Products).