DEPARTMENT OF JUSTICE

STATEMENT

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BEFORE THE

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U.S. HOUSE OF REPRESENTATIVES

CONCERNING

ANTITRUST ANALYSIS OF AIRLINE MERGERS

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Mr. Chairman and members of the Committee, I am pleased to appear before you today to discuss recent developments affecting competition in the airline industry and the role that our antitrust laws play in assuring that consumers receive the benefits of competition. Today's hearing has been sparked by recent reports regarding possible transactions involving some of our nation's largest airlines. While the Antitrust Division cannot comment on the specifics of any transaction that it is currently investigating, we fully understand the committee's interest in knowing how the Division analyzes airline mergers generally. Thus, it is my hope to provide you with a full picture of the procedures and standards the Division brings to this task. I propose first to address the circumstances that have brought us to the present state of competition in the airline industry, then the procedures that the Division uses to obtain information necessary to review proposed mergers between air carriers, and, finally, the standards that the Division utilizes in evaluating such transactions.

I. Evolution of Competition in the Airline Industry

During the Great Depression, Congress enacted a number of statutes that subjected major industries to substantial governmental regulation. Building largely upon the statutory regime first enacted in 1887 to regulate railroads, various industries, including other transportation industries such as trucking and airlines, were subjected to restrictions with respect to markets they could enter or exit, prices they could charge, and acquisitions they could make. In most instances, those decisions were subject to prior review and approval by an administrative agency, such as the Interstate Commerce Commission or what became the Civil Aeronautics Board ("CAB").

While the premise of such regulation was that regulatory agencies could restrain anticompetitive behavior by regulated industries and thereby protect the public interest, regulated industries and the public became dissatisfied with regulation. Regulated companies balked at having to obtain regulatory approval every time they wanted to change service or alter price, and consumers complained that agencies often seemed to reflect the views of the industry they regulated, rather than the public interest.

This dissatisfaction culminated in a series of regulatory reform initiatives in the 1970s that reflected a congressional determination that consumer welfare could be enhanced by reducing regulation and allowing consumers -- through their buying decisions in the marketplace -- to identify products and services they desired and the price that they were willing to pay. Thus, Congress enacted a number of deregulatory statutes that curtailed regulation and allowed formerly regulated industries far greater latitude in determining markets to serve and prices to charge.

Following on the heels of a number of deregulatory experiments conducted by the CAB, Congress enacted the Airline Deregulation Act of 1978, which moved the domestic air transportation industry from government regulation to a new era of competition. Carriers were permitted to enter and leave domestic markets without governmental authorization and to set prices and conditions of service. Such behavior would thereafter be subject to the antitrust laws, but the CAB retained jurisdiction over mergers and acquisitions and its authority to prohibit unfair practices.

Industry responses to deregulation were swift. While the prior regulatory regime had resulted in carriers largely providing point-to-point service, with deregulation they began to consolidate their operations at airports, forming what came to be known as hubs. With a hub system, carriers could combine "local" passengers (those originating at or destined to the hub) with "connecting" passengers (those not originating at or destined to the hub but traveling via the hub) on the same flight. In this manner, carriers found they could serve more cities from their hubs (known as "spoke" routes) and offer greater frequency of service with their fleet of aircraft than had been possible with point-to-point service.

During the first years following deregulation, antitrust jurisdiction was divided between the Division and the CAB. The Division could -- and did -- prosecute airlines for price fixing and other violations of the Sherman Act, but it did not have jurisdiction to review mergers and acquisitions. The CAB, which had this jurisdiction, reviewed a number of proposed mergers in the late 1970s and into the 1980s. When Congress sunset the CAB in 1985, it temporarily transferred merger review authority to the Department of Transportation ("DOT"). In ensuing years, the Division submitted comments to the DOT in some merger proceedings and supported many of the DOT's decisions. But the DOT approved two mergers that the Division opposed: the acquisition of Ozark by TWA in 1986 and the acquisition of Republic by Northwest in the same year. Both of those transactions involved carriers that operated hubs at common airports; the merging carriers in each transaction thus provided the only nonstop service in many city pairs. The DOT predicted that entry or the threat of entry by other carriers into the affected markets -- potential competition -- would prevent non-competitive performance by the merged entities. A subsequent study by Division economists found that potential competition had not prevented fare increases and service reductions.

The DOT's jurisdiction over mergers terminated effective December 31, 1988, after which time the Division assumed sole responsibility for airline merger review. Since then, there have been very few mergers proposed among the major airlines. However, in 1998, Northwest, then the fourth-largest U.S. air carrier, sought to acquire a controlling interest in Continental, then the fifth-largest U.S.

carrier. The Division has challenged the transaction. Our complaint alleges that the acquisition would lead to higher ticket prices and diminished service for millions of passengers, especially those traveling on routes dominated by the two airlines. Northwest and Continental are each other's most significant competitors -- and sometimes the only competitors -- for nonstop airline service between cities where they operate their hubs. The case is scheduled for trial later this year.

In addition to challenges to mergers and acquisitions of stock, the Division has also challenged acquisitions of assets that it concluded would be competitively problematic. The Division has moved to block acquisition of gates or slots when it thought such transactions would lessen competition, as demonstrated by its challenges to Eastern's proposal in 1989 to sell gates to USAir at the gate-constrained Philadelphia International Airport and Eastern's proposal in 1991 to sell slots and gates at Reagan Washington National Airport to United.

For the past decade, airline acquisition activity has centered on acquisition of international route authority. Here, the Division shares review responsibility with the DOT, which has jurisdiction over transfers of international route authority. Such authority is literally an "admission ticket," since many international bilateral aviation agreements limit the number of U.S. carriers that can provide service to a foreign country, and service cannot be provided absent such authority. Financially ailing domestic carriers with substantial international route authority, such as Pan Am, Eastern, and (at the time) TWA, sold route authority to other U.S. carriers. The Division reviewed these transactions as well and challenged some of them, such as the proposed sale by TWA of its London route authority to American.

In the past few weeks, attention has turned back to the domestic scene, with the announcement of a proposed acquisition by United of US Airways and speculation about transactions involving other major U.S. carriers. The Division has announced that it will review the United-US Airways transaction carefully, as it will any transaction between major U.S. carriers.

II. Procedures for Reviewing Airline Mergers

Major U.S. carriers seeking to merge or acquire another carrier must provide the Division and the Federal Trade Commission ("FTC") with notice of their proposed transactions pursuant to the Hart-Scott-Rodino Antitrust Improvements Act of 1976 ("HSR"). Although the Division and the FTC share merger enforcement responsibility as a general matter, the Division is the agency that reviews air carrier transactions. The initial HSR filing contains certain basic information, which the Division uses to determine whether more extensive review is appropriate.

The initial waiting period under HSR is usually thirty days. If the Division concludes during that period that the transaction is not competitively problematic, the HSR waiting period is allowed to expire or may even be terminated early. The parties are then free to proceed, subject, of course, to any other required regulatory approvals. However, if the Division cannot resolve its competitive concerns within that period, it can issue a request for additional information, known more commonly as a "second request," which defers the ability of the merging parties to consummate their transaction until twenty days after they have provided the Division with the requested information. During this time, the Division will frequently seek or receive information from other persons interested in the transaction; these may include suppliers, customers, and/or industry specialists. We work closely with the DOT, which obviously has substantial expertise with respect to the airline industry.

It is not uncommon during this process for the parties to have substantial contact with the Division. The process is confidential and, unlike the procedures in some administrative agencies, competitors do not have access to the merging parties' submissions. Sometimes parties are able to demonstrate that the transaction is not competitively problematic, in which case the waiting period expires or is terminated early; again, the parties may then proceed, subject to other required approvals.

If the Division concludes, however, that the transaction violates the law, the Division can attempt to stop the transaction by filing a complaint in federal court and persuading a judge to enter an order prohibiting the parties from consummating it. It is not uncommon, however, for the parties to make a proposal to address the competitive concerns that the Division has identified, in which case some form of agreed-upon relief may resolve the problem while still allowing the parties to proceed with the overall transaction. In those circumstances, the Division ordinarily files a complaint along with a consent decree that embodies the relief in the form of an order entered by the court. There are times, however, when the competitive problem cannot be cured by any form of relief other than outright prohibition, in which case the Division is likely to seek a preliminary injunction to prevent consummation of the transaction pending completion of judicial proceedings and then a permanent injunction prohibiting the transaction altogether.

The Division looks for relief that will address fully the competitive problems presented by the transaction and will almost always seek some form of divestiture. Parties sometimes propose conduct remedies -- usually some form of behavioral restrictions -- but these are generally unsatisfactory for a number of reasons. First, they are often difficult to draft with precision. Second, they require continuing monitoring by the Division. Third, they cannot be enforced without resort to the court on a continuing basis. Finally, they have often proven to be insufficient to remedy the anticompetitive problems presented by a transaction.

The particular form of divestiture necessary to solve a competitive problem will vary from transaction to transaction and involves many inquiries. First, it is essential that the assets to be divested are sufficient to allow a purchaser to be an effective competitor over the long term, i.e. to replicate the competition that would otherwise be eliminated in the market(s) of concern. Sometimes the necessary assets are easy to identify as, for example, when a party agrees to divest a stand-alone business entity such as a subsidiary or a pre-existing operating division. In those instances, the sufficiency of the assets can be evaluated in light of historical performance of the business unit in the marketplace. In other instances, parties propose divestiture of specific assets, sometimes even combining some assets from each of the parties to the overall transaction. It can be difficult to assess whether such assets are sufficient to allow the purchaser to compete on a meaningful basis because there is no track-record to gauge the adequacy of the asset package. A recent study of antitrust divestitures by the FTC "suggests that divestiture of an on-going business is more likely to result in a viable operation than divestiture of a more narrowly defined package of assets," although "divestitures of selected assets can succeed."

Second, the Division will look carefully at the prospective purchaser. In most instances, the proposed purchaser is not selected until after the court has entered an order directing the nature and form of the divestiture, but occasionally parties to a transaction will identify a proposed purchaser to the Division during the course of the investigation. In either case, the Division will review the experience, financial resources, and business plan of the purchaser, all in an effort to determine whether the purchaser is likely to solve the competitive problem presented by the original transaction.

In performing this review, the Division considers the terms of the proposed contract and any other arrangements between the merged entity and the purchaser to determine whether the purchaser will be an independent competitor. The Division's form consent decree provides, for example, that the merged entity cannot finance the sale to the purchaser. Similarly, the Division is generally skeptical about supply contracts between the merged entity and the purchaser, as well as any other arrangements that tie the purchaser to the merged entity, although there may be circumstances in which such arrangements are warranted. Our concern is that, if the purchaser is dependent upon the merged entity for critical products or services, there are two risks: (1) the merged entity may seek to influence the behavior of the purchaser by manipulating price or supply of such products or services and (2) the purchaser may pull its competitive punches for fear of antagonizing the merged entity.

The Division has, on occasion, refused to approve a purchaser unless and until changes have been made in the terms of the divestiture to assure that the purchaser will be viable and independent. While the Division does not (and should not) seek to ensure the success of a purchaser, it must be confident that the divestiture will remedy the competitive problem that it is intended to fix.

III. Merger Enforcement Standards in the Airline Industry

In reviewing airline mergers, the Antitrust Division applies Section 7 of the Clayton Act, which prohibits the acquisition of stock or assets "where in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly." Section 7 reflects the congressional judgment that merger enforcement should be able to arrest anticompetitive transactions in their incipiency, to forestall the harm that would otherwise ensue but be difficult to undo. Thus, merger enforcement standards are forward looking and, while we often consider historic performance in an industry, the primary focus is to determine the likely competitive effects of a proposed merger in the future.

The Division and the FTC have jointly developed Merger Guidelines that describe the inquiry they will follow in analyzing mergers. "The unifying theme of the Guidelines is that mergers should not be permitted to create or enhance market power or to facilitate its exercise." Merger Guidelines 0.1. As suggested by the language of Section 7 itself, we usually start by seeking to define the relevant product or service ("line of commerce") and geographic ("section of the country") markets in which the parties to a merger compete and then determine whether the merger would be likely to lessen competition in those markets.

The purpose of this inquiry is to ascertain whether, with respect to a product or service offered by the merging parties, there are alternative products and services to which customers could reasonably turn if it were assumed that the merging parties were the only suppliers of the product or service and sought to increase prices. Once relevant markets are defined, we look at various factors in order to determine whether the transaction is likely to have an anticompetitive effect.

In performing this analysis, the Division considers both the post-merger market concentration and the increase in concentration resulting from the merger. As a yardstick for concentration, we utilize the Herfindahl-Hirschman Index ("HHI"), which is calculated by summing the squares of the individual market shares of all the participants. The Division will presume that mergers in highly concentrated industries that produce more than a small increase in concentration are likely to create or enhance market power or facilitate its exercise, unless other factors, such as the prospect of entry by other firms, make that unlikely.

We apply this basic approach to analysis of air carrier transactions. In this industry, the definition of product/service market and geographic market converge: 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. This market makes intuitive, as well as economic, sense. A passenger desiring to fly from Washington to San Francisco for a business meeting or a vacation is unlikely to regard a flight from Washington to Minneapolis as a reasonable alternative in the event the fare from Washington to San Francisco is increased. Thus, we should be concerned about a transaction that significantly raises concentration levels in city pair markets.

The relevant market may, however, be narrower than all scheduled airline service in a city pair. Carriers can serve a city pair market on a connecting basis or a nonstop basis. If the only available service offered by carriers in a city pair is connecting service, there may be various routes that passengers regard as reasonable alternatives and from which they will choose based on fare, elapsed travel time, and other factors. However, there are many city pairs that are served by some carriers on a nonstop basis and others on a connecting basis, which poses the following question: is a passenger having the ability to take a nonstop flight likely to regard connecting service as a reasonable alternative, such that he or she would switch from nonstop service offered by one carrier to connecting service offered by another carrier if the first carrier raised its fare? Chances are that passengers traveling for leisure -- on vacation perhaps -- are more likely to consider switching; their demand is said to be more elastic. However, passengers making business trips are significantly less likely to regard connecting service as a reasonable alternative -- they are often in a hurry and may place a higher value on getting to their destination in a hurry -- so that a carrier offering the only nonstop service has power to raise fares without losing these passengers to another carrier's connecting service. Thus, there may be circumstances in which a transaction will be competitively problematic because of its impact on nonstop service in city pair markets, even if other carriers provide service in those markets on a connecting basis.

Therefore, in considering the antitrust implications of a particular transaction, the Division looks at the effect in all city pair markets served by both of the carriers involved in terms of (1) nonstop service and (2) nonstop and connecting service. We have found, not surprisingly given the operation by carriers of hubs in the post-deregulation world, that the transactions most likely to be problematic are those that involve carriers with hubs at the same airport or at airports in the same metropolitan area. These carriers are likely to serve many of the same city pairs and, especially in spoke markets, they may be the only two carriers, or two of a very small number of carriers, providing service.

That is not to suggest, however, that transactions involving carriers that do not have overlapping hubs may not also present problems. Carriers with hubs in nearby cities are often the dominant carriers -- usually on a connecting basis -- for a significant number of city pairs in their region. And even when carriers' hubs are substantial distances apart, it is often the case that they are the only two carriers providing nonstop service between their respective hubs.

Once overlapping city pairs have been identified, the Division looks at the number of other carriers serving each of the markets and at the nature of that service, often by resorting to data that carriers report periodically to the DOT. This allows the Division to calculate market shares and focus further analysis on those city pairs in which pre-merger concentration levels suggest post-merger structure conducive to the creation or enhancement of market power.

As the Merger Guidelines indicate, however, the analysis does not end there. Pre-merger market shares are a useful tool for predicting future market shares of the incumbents in a market, but they do not take account of the possibility of entry by additional competitors. The prospect of potential competition can constrain the ability of incumbents to raise price or reduce output below a competitive level. Indeed, the possibility of potential competition was the linchpin for many of the DOT's decisions approving mergers between carriers. Potential competition, it was said, could be relied upon to discipline carriers, even those with dominant market shares: if a dominant carrier sought to raise fares above competitive levels or reduce service below competitive levels, new carriers could easily enter, especially if they already had some operations at the affected airports. Airplanes were the quintessential mobile asset, it was said, and ground facilities could be easily leased or subleased. Knowing that noncompetitive behavior would attract entry, it was claimed that dominant incumbents would price competitively and offer competitive levels of service. Hence, the DOT reasoned that market shares -- and the presumptions of market power that accompany them -- were of relatively little use in airline merger analysis. The airline industry became the poster child for contestable market theory.

The Division does not subscribe to this entry analysis. It simply does not conform to the facts in a post-deregulation world consisting of hub airports. Hub economics are powerful. By combining local and connecting passengers, a hub carrier can offer more flights on a route than a carrier offering service on a point-to-point basis. Since a hub carrier offers more flights than any other carrier at the hub, the hub carrier can better attract passengers to its frequent flyer program and travel agents to its commission override program. As the dominant provider of air service in the area, the hub carrier is also in a unique position to enter into contracts with area businesses that require them to use its services.

In these circumstances, carriers with comparable cost structures to the hub carrier generally find it unattractive to take the hub carrier head on. Entry by a major carrier on a point-to-point basis into another carrier's hub has become very much the exception. Thus, 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. And without substantial actual competition, hub carriers charge higher fares to local passengers than they do in more competitive markets.

This does not indicate that entry into a carrier's hub is impossible. Carriers with low costs (known as low-cost carriers or "LCCs") may be able to enter profitably, even with point-to-point service, but such entry has tended to be gradual and limited. Under our Merger Guidelines, the Division considers whether entry into the affected markets is so easy, in the sense that it would be timely, likely, and sufficient in its magnitude, character, and scope, that it will likely deter or counteract the competitive effects of concern. With respect to transactions between major air carriers with substantial overlaps in markets in which they are the dominant providers of service, it is unrealistic to expect that the prospect of potential competition can fully address the competitive problems of concern.

Finally, the Division will consider and take into account airline-specific business practices and characteristics that can affect merger analysis, especially those that differ from most other industries. Airline fare data is available instantaneously not only to consumers, but also to the airlines themselves, which can act as a disincentive to fare reductions. Airlines frequently propose general or systemwide price increases, which may be more likely to "stick" as the number of major carriers diminishes. Carriers have developed loyalty programs that tie passengers and travel agents to them at their hubs, making entry into those hubs more difficult. And, airlines apply sophisticated computer modeling techniques and ticketing restrictions to identify passengers to whom they can charge higher fares, a form of price discrimination. The Division will consider these and other factors, in seeking to determine whether any proposed transaction threatens substantially to lessen competition.

IV. Conclusion

Mr. Chairman, competition in the airline industry is critical for the millions of people who depend on air travel in their business and their family life. If the Division concludes that air carrier mergers threaten to deprive consumers of the benefits of competitive air service, I can assure you that the Antitrust Division will take appropriate enforcement action.

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