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# The American Antitrust Institute

## *Texas Pacific Group Capital and Northwest Airlines Proposed Acquisition of Midwest Airlines*

## *An Antitrust White Paper*

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## Introduction

The American Antitrust Institute (AAI) has conducted an independent review of the proposed acquisition of Midwest Air Group Inc. (Midwest) by private equity firm TPG Capital L.P. (TPG Capital) and Northwest Airlines Corp. (Northwest). The $450 million deal would give TPG Capital a 53% ownership share of Midwest while Northwest would have a 47% ownership share.

The AAI's review of the proposed acquisition has been informed by discussions with industry personnel and a review of publicly available data and information. The AAI has not had access to any confidential company information and our analysis and recommendations are therefore limited accordingly. Based on information available to us, the AAI believes that the proposed acquisition of Midwest by Northwest and TPG Capital may tend substantially to lessen competition under Section 7 of the Clayton Act, to the detriment of consumers.

The combination proposed by Midwest, TPG Capital, and Northwest has a number of dimensions that are relevant to antitrust analysis. The AAI believes that the linchpin of any competitive analysis in this case is the combination of actual and potential ownership created by Northwest's minority interest in Midwest, coupled with its option to buy out TPG Capital once the latter decides to "cash out." This combination could fundamentally change the intensity of rivalry between Northwest and Midwest, despite assurances by Northwest's management that the brands will continue to compete. The buyout option

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also stands to chill existing competition and block entry into markets in which Northwest and Midwest currently and potentially compete.

Northwest's strategic ownership plan allows it to "test" the value of Midwest in implementing a potential strategy of locking up certain markets before a full acquisition. If cast over the affected markets, the competitive "pall" created by this strategy cannot possibly serve the interests of healthy competition and consumers of air travel, either in markets defined by specific city-pairs or the broader regional market that Northwest and Midwest could come to dominate. Moreover, the competitive problems potentially raised by the proposed acquisition cannot, for a variety of reasons, be tempered by claims of countervailing efficiencies or entry. The AAI therefore encourages the Department of Justice (DOJ) to carefully scrutinize the proposed transaction, giving full weight to how the structure of the transaction creates or enhances the ability and/or incentive of the parties to exercise market power.

## Background on the Transaction and the Parties

On August 16, 2007, Midwest Air Group Inc. announced an agreement with TPG Capital for $450 million ($17/share in cash) in which the latter would purchase a 53% stake in Midwest. The offer trumped an original, competing offer from AirTran Holdings, Inc. that--at a lower $16.25/share offer—failed to win the deal. AirTran had been pursuing Midwest for almost a year before TPG Capital and Northwest stepped in. Midwest opposed AirTran's hostile bid and sought out alternative buyers.[2] For Northwest, the deal keeps AirTran at bay. According to AirTran's President and CEO, "They [Northwest] did not want a strong, low-cost carrier in their back yard."[3] If shareholders do not approve or regulators block the deal, the agreement provides that Midwest will pay TPG Capital $13.5 million in breakup fees.

TPG Capital is the global buyout group of its parent company, a private equity investment firm. TPG Capital has $30 billion in assets under management with an extensive global reach and a diverse portfolio. TPG Capital was involved with Northwest in the 1998 partial ownership acquisition of Continental Airlines. The DOJ challenged that transaction on the basis that it would tend to substantially lessen competition and required Northwest to divest its majority voting interest in Continental.[4] The deal was never completed.

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[2] Emily Fredrix, *SEC Filings: Midwest Sought Other Buyers*, ASSOCIATED PRESS. ONLINE. Available http://www.usatoday.com/money/economy/2007-09-27-4292914661_x.htm. Last visited on November 15, 2007.

[3] Liz Fedor, *NWA Protects Turf With Midwest; Northwest Pushed Aside Hostile Bidder AirTran Airways and Will Keep a Strong Business Advantage in the Important Milwaukee Market*. STAR TRIBUNE (August 14, 2007).

[4] See, *U.S. v. Northwest Airlines Corporation and Continental Airlines, Inc.*, Amended Complaint, Civil No. 98-74611, U.S.D.C. (E.D. Mich.) (December 18, 1998).

Northwest Airlines operates the sixth largest airline in the world. It has hubs in Detroit, Minneapolis/St. Paul, and Memphis. It also has international route systems, a transatlantic joint venture, a large domestic and international alliance, membership in a global airline alliance, agreements with domestic regional carriers, and an air cargo business.

Midwest serves locations in the U.S. with hubs in Kansas City and Milwaukee. Midwest offers a differentiated product that includes premium passenger jet airline service, a high-volume economy service, and regional scheduled service. Midwest has had a long-term codesharing arrangement with Air Midwest and in 2007 agreed to code share with Northwest. The agreement reportedly "expands the networks of both carriers by opening up 250 city-pairs and more than a 1,000 new flight options for customers."[5]

## Competition and Markets in Airlines Mergers

Airlines provide perhaps one of the best examples of a physically networked industry. The hub and spoke organization of airline networks highlights a number of important features. One is that there are significant operating cost economies at the hub level resulting from increased density. These economies lower unit costs as the carrier pushes more traffic through routes that connect through a hub.[6]

Airlines also exhibit network effects to the extent that the more routes an airline adds to its system, the more connecting flights it creates at hub airports, increasing the value of the enhanced network to all customers.[7] Codesharing between airlines can facilitate network effects to the extent that they expand routes, coordinate scheduling, and enhance the value of frequent flyer programs and airport amenities. The self-reinforcing process of network effects, when coupled with strategic consolidation that expands the size of the network, however, can create dominance at certain hubs.

The DOJ/FTC *Horizontal Merger Guidelines (Guidelines)* provide guidance in defining relevant product and geographic markets for merger analysis.[8] Section 1 of the *Guidelines* asks whether consumers would switch to competing products or products produced by sellers at different locations in response to a price increase by a hypothetical monopolist. In other words, would a small but significant (e.g., 5%) and nontransitory

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[5] *Northwest Air, Midwest in Codeshsare Agreement*, REUTERS (September 14, 2007). Online. Available http://www.reuters.com/article/tnBasicIndustries-SP/idUSN1345674320070914. Last visited November 30, 2007.

[6] See, e.g., Severin Borenstein and Nancy L. Rose. *How Airline Markets Work...Or Do They? Regulatory Reform in the Airline Industry*, Working Paper 13452, NBER WORKING PAPER SERIES (September 2007), at 20.

[7] See, e.g., Christopher Mayer and Todd Sinai, *Network Effects, Congestion Externalities, and Air Traffic Delays: Or Why Not All Delays Are Evil*, 93 AMERICAN ECONOMIC REVIEW 1215 (2003), at 1195.

[8] Department of Justice/Federal Trade Commission, 1992 *Horizontal Merger Guidelines*. Online. Available http://www.usdoj.gov/atr/public/guidelines/hmg.htm. Last visited December 3, 2007.

price increase over prevailing price levels by all firms in the proposed market be enough to induce consumers to switch in sufficient numbers such that the price increase would be unprofitable? If so, then those products and locations should be included in the relevant product and geographic market, respectively. When no more substitute products or locations can be included in the market due to customer switching in response to a price increase, then the relevant market has been identified. Market shares and merger-induced concentration are then calculated based on sellers in the relevant market(s).

A number of relevant product markets are typically defined in airline mergers. These include, for example, the markets for: scheduled airline passenger service, nonstop scheduled airline passenger service, and scheduled airline service for time-sensitive travelers. Consumers typically shop for air travel from an origin city to a destination city, assessing alternative fares offered by various airlines that typically provide service from the same hub. Thus, competition in city-pair markets is relevant for an antitrust inquiry. Certain city-pair markets may also be hub-to-hub markets.

Publicly available information indicates that both Midwest and Northwest are direct competitors in a number of city-pair markets. Many of these pairs originate at Midwest's Milwaukee hub--General Mitchell International Airport. Midwest's market share in Milwaukee is 51% and Northwest's is 18%. If combined, Northwest/Midwest would dominate the Milwaukee hub with a 70% share.[9] In Kansas City, Midwest's other hub, the shares of Midwest and Northwest are about 11% each, for a total of 22%.

Certain city-pair markets are potentially problematic. For example, Northwest and Midwest compete for nonstop scheduled passenger service between Milwaukee and Minneapolis-St. Paul and Milwaukee and Atlanta.[10] Northwest plans to add service on a number of other routes in which Midwest also provides service, including Milwaukee-Newark and Milwaukee-Cleveland. Clearly, the DOJ is in the best position to identify the extent of the actual and potential overlaps between Midwest and Northwest in city pair markets for various relevant products. Each of those markets should be evaluated in light of the theories of competitive harm discussed below.

**<u>Northwest's Partial Ownership of Midwest, Coupled with an Option to Buy it, Could Potentially Harm Competition and Consumers</u>**

Northwest and TPG Capital have made a number of claims regarding Northwest's ownership interest in Midwest. First, when the Midwest/TPG Capital/Northwest deal was announced in mid-August, Northwest pledged that it would "remain competitors" with Midwest.[11] Second, Northwest and TPG Capital have claimed that the former will retain

[9] Based on all passengers boarded.

[10] Northwest also has an alliance with Delta Airlines and Continental Airlines and codeshares with them on various domestic flights.

[11] Fedor, *supra* note 3 and James Ott, *Midwest Muddle: Midwest Airlines Takeover Debated; AirTran Renews Bid for Midwest Airlines After Board Accepts TPG/Northwest Offer*, 167 AVIATION WEEK & SPACE TECHNOLOGY (August 20, 2007), at 47.

rights “typical of minority investors.” [12] However, those rights are not known in any detail at this time, as are other terms of Northwest’s “passive” ownership such as voting, veto, and other shareholder rights.

Third, the parties claim that Northwest will have no seats on Midwest’s new board and thus not participate in the management or control of Midwest.[13] Importantly, however, Northwest has the option to buy all shares of Midwest at some unspecified future date.[14] TPG Capital noted that it “. . .see[s] various means to cash out of Midwest, including a sale to the public and a sale to Northwest. He [Richard Shifter] said that any of those outcomes probably will occur ‘several years out’ but could happen sooner.’ It is clear that Northwest potentially could be interested in acquiring Midwest in the future and our agreement with them contemplates that.”[15] In the past, TPG Capital has cashed out of investments within a period of just a few years.[16]

The foregoing mix of substantial partial ownership and a buyout option highlights the complexity of the proposed transaction and therefore the need for close antitrust scrutiny. This complexity points to two key factors—control and incentives--that could bear materially on the post-acquisition intensity of rivalry (1) *between* Northwest and Midwest and (2) between an acquired Midwest *and other* competitors in the affected markets.

***Northwest’s Plan of Acquisition for Midwest Could Undermine Competition Between the Two Carriers***

The AAI urges the DOJ to consider all the mechanisms by which the proposed transaction creates or enhances the ability and/or incentive of all parties to the acquisition to undermine competition between Northwest and Midwest. Collusion between the airlines would likely result in supra-competitive pricing, or a failure to offer promotional fares for leisure travel or volume discounts to businesses. A lack of competition could also produce less choice on routes, lower service quality (e.g., on-time performance,

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[12] Statement of Richard Shifter (TPG Capital), August 17, 2007 conference call.

[13] See *Northwest Says Passive Investor In Midwest Takeover Bid*, REUTERS (August 12, 2007). Online. Available http://www.reuters.com/articlePrint?articleId=USWEN038120070813. Last visited November 29, 2007 and *AirTran Scales Down Growth Plan*, ATLANTA JOURNAL CONSTITUTION (August 14, 2007) See also Susan Carey, *TPG Might Sell Midwest to Northwest*, WALL STREET JOURNAL (August 18, 2007), at A.3, and Schifter, *supra* note 12.

[14] Shifter, *supra* note 12.

[15] Carey, *supra* note 13.

[16] TPG Capital cashed out of Oxford Health Plans, which it bought in 1998 and sold in 2000-2001 with a return of about 28%. See *TPG Cashes Out of Oxford*, THE DEAL (March 9, 2002). Online. Available http://www.tpg.com/news/articles/deal03.09.02.pdf. Last visited November 30, 2007. TPG Capital cashed out of Beringer Wine Estates with about a 9% return after about four years. See *Texas Pacific Group Gives Farewell Toast to Beringer Wine Estates*, BUYOUT (November 6, 2000). Online. Available http://www.tpg.com/news/articles/Buyouts110600_farwell.pdf. Last visited November 30, 2007.

ticketing, customer service), and fewer amenities.

First, a 47% interest in Midwest is arguably substantial enough to provide an incentive for Northwest to compete less aggressively with Midwest in city-pair markets in which both carriers currently, or plan to, provide service. The Northwest board has a fiduciary duty to its shareholders to pursue every means to ensure profitability, even if that means reducing rivalry with Midwest in markets where the two airlines possess enough market power between them to affect prices and service offerings. For example, sales that Northwest "steals" from Midwest through aggressive rivalry means losses for Midwest. After the acquisition, however, lower profits for Midwest also mean reduced profits for Northwest. Thus, Northwest's substantial ownership interest in Midwest may temper any incentive for Northwest to engage in aggressive, head-to-head competition.

Second, even if Northwest is deemed not to be represented on the Midwest board, there are still a number of mechanisms through which the airline can exercise control over Midwest decision-making. Ownership confers the power to exercise control, but in the words of two prominent economists, "control or ownership are never absolute."[17] As a result, analyzing competitive effects when control is a key question depends on evidence that bears on the ability of owners to influence decisions regarding output, pricing, innovation, and other strategic variables.

For example, the codesharing agreement recently entered into by Northwest and Midwest means that each acts, in effect, as the marketer of the other's products. By virtue of that relationship agreement, Northwest therefore may have some control over price-setting, promotions, and discounts offered on jointly-coded Midwest flights that could allow it to lower output and raise price (or, conversely, fail to lower prices). Moreover, it allows both carriers to discuss market issues. This is a particular concern in concentrated hub markets such as Milwaukee where Midwest has connecting flights and where it controls the majority of gates and facilities. How the Northwest/Midwest codesharing agreement would potentially act to enhance the ability of the parties to the transaction to adversely affect competition is independent of whether the codesharing agreement *itself* may be anticompetitive. DOJ must make that determination separately.

By virtue of its ownership interest in Midwest, Northwest could also have advance access to competitively sensitive information regarding Midwest or require that it be notified by Midwest/TPG Capital before it makes important strategic decisions. Such information could include advance information on prices, route offerings, expansion plans, costs, or strategic and marketing plans. If Northwest has access to such information, it could use it to make key economic decisions that would undermine competition with Midwest. The acquisition thus potentially facilitates the exchange of competitive information between two market participants--either directly or using TPG Capital as a conduit.[18]

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[17] Sanford J. Grossman and Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 JOURNAL OF POLITICAL ECONOMY 691 (1986), at 694.

[18] See, e.g., Laura A. Wilkinson and Jeff L. White, *Private Equity: Antitrust Concerns with Partial Acquisitions*, 21 ANTITRUST 28 (2007), at 30.

In light of the foregoing, the DOJ should carefully examine the competitive effects of the codesharing agreement between Northwest and Midwest *in light of* the changed ownership between Northwest and Midwest. Northwest's rights under the partnership agreement should also be scrutinized, including those pertaining to the control of critical business decisions and access to competitively sensitive information. Many of the partnership agreement questions that arose in the 1998 case involving Northwest's ownership interest in Continental clearly apply here. This includes how Northwest could also influence Midwest decision-making through discussions with Midwest directors, officers, or employees, or comments about Midwest performance or management.[19]

Third, as majority owner and with representation on the Midwest board, TPG Capital is well-positioned to make management decisions that favor higher profits for itself. The most logical source of higher profits would be reduced competition between Northwest and Midwest. TPG Capital's post-acquisition ability to control Midwest board decisions thus provides an additional mechanism that could promote collusion between Northwest and Midwest.

The foregoing discussion highlights the danger of the proposed transaction in creating or enhancing the incentive and ability for Northwest and TPG Capital to coordinate activities between the two carriers, otherwise undermine the ability of the companies to compete, and to avoid entering into any pro-competitive agreements with other carriers. A key question therefore is whether TPG should be viewed by the antitrust laws as effectively standing in the shoes of Northwest, such that statements that Northwest will not participate in management ought to be ignored. These issues are not new to the DOJ—even in cases where the acquirer has a minority interest.[20] A reduction in aggressive competition between Midwest and Northwest would be beneficial to both buyers, but not to competition and consumers.

***<u>Northwest's Option to Buy Out Midwest Could Chill Competition and Block Entry into Relevant Markets</u>***

A second major avenue by which the proposed acquisition could harm competition and consumers is through the signaling effect of the Northwest buyout option. Expectations about key economic variables such as the intensity of competition, number of rivals and impending consolidation, pricing, advertising, and entry play a large role in rivals' decisions.[21] The specter of a merged Northwest/Midwest could fundamentally change the

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[19] *Supra* note 4, at 5.

[20] See, e.g., *U.S. vs. AT&T Inc. and Dobson Communications Corp.*, Complaint, Civil No. 1:07-CV-01952, U.S.D.C. (D.C. Cir.) (October 30, 2007), at PP. 22 and *U.S. v. Commscope, Inc. and Andrew Corp.*, Complaint, Civil No. 1:07-cv-02200, U.S.D.C. (December 6, 2007).

[21] For discussion, see, e.g., Carlton, Dennis W. and Jeffrey M. Perloff, MODERN INDUSTRIAL ORGANIZATION, 4th edition (2005). Pearson-Addison Wesley, at 160.

calculus of existing and potential competitors, dampening incentives to compete aggressively or to enter certain markets.

If Northwest exercises its option to buy out TPG Capital and gains full control of Midwest, it receives a tremendous benefit. That is, if competition in the airline industry is viewed under a lens of broader, regional competition (as opposed to the microscope of city-pair markets), Midwest provides a southern buffer for Northwest in preventing encroachment into markets centered around its Minneapolis/St. Paul and Detroit hubs. This motive is perhaps the most evident in Northwest's desire to keep out lower cost rivals such as AirTran.[22] If the transaction is approved, it could make it significantly more difficult for lower-cost, competing carriers such as AirTran to gain a foothold into markets that would now be dominated by Northwest and Midwest. Entry of low cost carriers conveys significant benefits for competition and consumers. In the interim period, Northwest's partial ownership will serve as a mechanism for transmitting information on the quality of Midwest as a permanent investment prospect. More important, however, is that Northwest can "test" Midwest's effectiveness as part of a larger strategy of protecting its northern markets.

The AAI urges the DOJ to fully consider the effects of the buyout option on restraining competition and potentially closing the door to entry in markets in which Northwest and Midwest could wield market power. Moreover, the DOJ should reject arguments to delay an analysis of the competitive effects of a Northwest buyout of Midwest until the buyout actually occurs. Were this to happen, the potential competitive damage would already have been done. Failure to consider the effect of the buyout option on competition in relevant markets would also violate the incipiency standard that underlies Section 7 of the Clayton Act.[23] Under that standard, the government need not show that an actual restraint has occurred, only that it "may" occur.[24] This requires that DOJ consider *all* aspects of the proposed Midwest/TPG Capital/Northwest transaction that could affect competition, including the buyout option.

**<u>Entry is Unlikely to Rectify the Competitive Concerns Raised by the Acquisition and any Claimed Efficiencies Generated by the Acquisition Should be Disregarded</u>**

Under the *Guidelines*, merger-related and cognizable efficiencies may be considered in generating cost savings that could potentially countervail competitive harm. TPG Capital

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[22] Fedor, *supra* note 3 reports that Northwest management ". . . recognized an AirTran-Midwest merger would 'alter the competitive balance in Milwaukee.'"

[23] The language of Section 7 "was designed to cope with monopolistic tendencies *in their incipiency* and well before they have attained such effects as would justify a Sherman Act proceeding." *Cargill, Inc. v. Monfort of Colorado, Inc.*, 479 U.S. 104, 124 (1986) (emphasis added and citations and quotations omitted); cited in *United States of America v. Northwest Airlines Corporation and Continental Airlines, Inc.*, Plaintiff United States of America Motion to Strike Defendants' Efficiencies Defense. Civil Action No. 98-74611, U.S.D.C. (E.D. Mich.) (April 11, 2000).

[24] *FTC v. Proctor & Gamble Co.*, 386 U.S. 568, 577 (1967); *Lektro-Vend Corp. v. Vendo Co.*, 660 F.2d 255, 274 (7th Cir. 1981).

and Northwest argue that the combination with Midwest will generate efficiencies, including savings such as economies of scale in regard to supply agreements, volume fuel purchases, insurance, and distribution.[25] However, the standard *Guidelines* treatment of efficiencies in this case does not hold, for two reasons.[26] First, many of the claimed efficiencies listed above are clearly not merger-specific, as required by the *Guidelines*. They are obtainable through a properly structured joint buying arrangement of the sort the DOJ has blessed in many Business Review Letters over the past 20 years, but without the anticompetitive effects that accompany a merger or an equity investment of any kind.

Second, any actual merger-related, cognizable efficiencies that would result from Northwest's involvement as a partial owner of Midwest would be difficult to realize without full integration of control.[27] Statements by Northwest officials indicate that such integration of control is clearly not contemplated. Therefore, efficiencies cannot be balanced against the potential for competitive harm raised by the transaction. Northwest cannot play the game both ways, i.e., claim efficiency gains for a transaction they would apparently like an antitrust review to consider as stopping short of a merger. If, indeed, the parties to the transaction want genuine efficiencies to be considered as a defense, then they must admit that they will not move forward as independent carriers if the transaction is finalized.

Entry can also not be expected to win the day. In general, for example, new entry of nonstop service in hub-to-hub markets is unlikely unless the entrant has a hub at one end of the city-pair. Constructing new hubs requires long lead times and investment. Entry into airline markets is also made difficult by access to gates and facilities necessary to serve all relevant markets, frequent flyer programs, and the effects of travel agent incentive programs offered by large carriers that dominate markets.[28]

In the case of the proposed transaction, entry would be difficult for several additional reasons. For example, there are enough city-pair markets potentially affected that entry would not occur in time to discipline post-acquisition price increases (or a failure to discount prices). Northwest and Midwest also have significant cost advantages in offering services in the hub markets they dominate in the central and upper Midwest that serve as a barrier to entry. Moreover, the Milwaukee and Kansas City airports have facility limitations that--with Northwest and Midwest combined--would make it difficult for any other carrier to serve it with more than a few flights. Finally, it would be hard for a carrier to start service to Milwaukee from important New York and Washington hubs where Midwest has the only available government-issued slots.

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[25] Shifter, *supra* note 12 and statement of Tim Hoeksema (Northwest Airlines), August 17, 2007 conference call.

[26] There are arguably no cognizable efficiencies that a merger between a private equity firm such as TPG Capital and an airline could generate.

[27] See, e.g., 5 Phillip E. Areeda & Herbert Hovenkamp ANTITRUST LAW ¶ 1203d, at 283 (2d e. 2008).

[28] *Supra* note 4, at 11.

**Conclusion**

Based on the information available to us, the AAI believes that the proposed acquisition of Midwest by TPG Capital and Northwest raises potentially troubling competitive issues. These problems involve competition between Northwest and Midwest and between an acquired Midwest and other existing and potential rivals in relevant markets. The AAI therefore urges the DOJ to carefully consider all issues relating to how Northwest's minority interest/buyout option ownership plan creates or enhances the ability and/or incentive of the acquirers to adversely affect competition.

All of the foregoing analysis should proceed in light of relevant markets in which Northwest and Midwest currently and potentially compete. The DOJ—with better access to relevant information--is in the best position to identify these specific markets. At the same time, however, the strategic underpinnings of the proposed transaction highlight the importance of considering competition in the broader regional market in which Northwest and Midwest could leverage a dominant presence. Such a presence could contribute to the creation of a regional system that would be reinforced by network effects, codesharing agreements, and other mechanisms.

Finally, this case is important because of the increasing role of equity firms such as TPG Capital in key infrastructure sectors. Antitrust enforcers will have to be vigilant that the forms of investment made possible through such firms will not become a loophole through which anticompetitive mergers can be squeezed.