The American Antitrust Institute

Before the Senate Judiciary Committee
Subcommittee on Antitrust, Competition Policy and Consumer Rights

"The American Airlines/US Airways Merger:
Consolidation, Competition, and Consumers"

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I. Introduction

I would like to thank the Chair, Senator Klobuchar, Ranking Member Senator Lee, and the members of Subcommittee for holding this hearing on the proposed merger of USAirways and American Airlines (USAir-AA). I appreciate the opportunity to appear here today. The American Antitrust Institute (AAI) is a non-profit education, research, and advocacy organization. Our mission is to increase the role of competition in the economy, assure that competition works in the interests of consumers, and sustain the vitality of the antitrust laws.[1]

My testimony today is based largely on a White Paper issued on August 8, 2012 by the AAI and Business Travel Coalition (BTC): "The Proposed Merger of US Airways and American Airlines." The White Paper is available on the AAI website.[2] The analysis

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[1] Diana Moss is Vice President and Director, American Antitrust Institute (AAI). AAI's mission is to increase the role of competition, ensure that competition works in the interests of consumers, and challenge abuses of concentrated economic power in the American and world economies. See www.antitrustinstitute.org for more information. This testimony has been approved for publication by the AAI Board of Directors.

[2] Diana L. Moss and Kevin Mitchell, "The Proposed Merger of US Airways and American Airlines," American Antitrust Institute (August 8, 2012). Available http://www.antitrustinstitute.org/~antitrust/sites/default/files/AAI_BTC_USAir-AA_White%20Paper_8-7.pdf.

takes up a number of questions regarding the competitive issues raised by the proposed merger of USAir and AA. My testimony concludes that based on analysis using publicly-available information, the proposed deal raises significant competitive issues that could result in harm to consumers.[3]

II. Overview

A USAir-AA merger would combine the fourth (AA) and fifth (USAir) largest airlines nationally, making USAir-AA the largest U.S. carrier with a combined share of over 20 percent, followed by Southwest with 18 percent, United-Continental with 17 percent, and Delta with 16 percent.[4] The "Big 4" would therefore control over 70 percent of the national market. The dwindling stock of LCCs collectively account for less than 10 percent of the market, with only modest growth in share since 2007. The proposed deal, which comes in the wake of six major mergers in recent years, will hasten a metamorphosis of the domestic airline industry from one in which hub airports were designed to accommodate multiple competing airlines to a few large systems that will be largely impermeable to competition. In this environment, LCCs and regional airlines would have difficulty thriving and expanding.

The merger of USAir-AA will contribute to increased concentration at the national or systems level, increasing the ease with which the airlines can tacitly coordinate on system-wide capacity tightening – a key mechanism for maintaining fares.

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[3] An antitrust investigation will rely also on non-public information that will bear on conclusions regarding the competitive effects of the proposed transaction.

[4] U.S. Department of Transportation, Bureau of Transportation Statistics, *Domestic Market Share: May 2011 – April 2012*, *available at* http://www.transtats.bts.gov/. Shares are measured by revenue passenger-miles.

Moreover, it is questionable whether "legacy-like" Southwest, after its acquisition of AirTran, still exerts any reliable significant competitive discipline in the market. The proposed merger of USAir-AA also shares much in common with previous legacy mergers such as Delta-Northwest and United-Continental. Several route-level markets would be dominated by the merged carrier, while others would feature tight oligopolies with few carriers that may well find it in their economic interest to agree on strategic variables such as fares and capacity. Post-merger effects such as fares, availability, and choice have come under strong public scrutiny in the wake of the Delta-Northwest and United-Continental mergers. Similarities between these and USAir-AA support the case for why the merger deserves careful scrutiny.

III. Lessons from the Delta-Northwest and United-Continental Mergers

The similarities between USAir-AA and the Delta-Northwest and United-Continental mergers make a strong case for why a *post-mortem* analysis of those mergers should inform decision-making in the present case. The results of a brief analysis of Delta-Northwest and United-Continental are included in the AAI/BTC White Paper. Several of the 21 routes affected by those deals are among the largest city-pair markets in the U.S. Both mergers substantially eliminated competition on hub-to-hub routes, more than doubling the number of routes on which there was limited competition (e.g., two or fewer carriers) before the merger. Moreover, several routes experienced the exit of LCCs and regional airlines after the mergers while entry occurred on a very limited scale. This lends some support to the notion that merged carriers' dominance at a hub also dissuades incumbent carriers from remaining in the market.

The White Paper analysis also shows substantial pre-to post-merger fare increases on some hub-to-hub overlap routes affected by Delta-Northwest and United-Continental. Fare increases are above average at the origin airport on 70 percent of routes affected by Delta-Northwest and on over 90 percent of routes affected by United-Continental. Pre- to post-merger fare increases of up to 30 percent and up to 20 percent are evident on routes affected by United-Continental and Delta-Northwest, respectively. These results highlight the general importance, as expressed in the (DOJ)/Federal Trade Commission (FTC) HORIZONTAL MERGER GUIDELINES), of considering such "direct evidence" from previous mergers in evaluating the USAir-AA merger.

IV. Probable Effects of a USAir-AA Merger on Route-Level Markets and Hubs

Similar to Delta-Northwest and United-Continental, a USAir-AA combination is likely to adversely affect a number of important route-level markets. Over one-half of the 22 overlap routes potentially affected by the proposed merger would thus be monopolized or nearly monopolized. [5] In all cases, changes in market concentration and post-merger concentration are presumed (under the HORIZONTAL MERGER GUIDELINES) to lead to

[5] In four markets involving hub-to-hub routes, the transaction would result in a monopoly. In seven additional airport-pair markets, post-merger concentration (as measured by the HHI index) is in excess of 9,000 HHI, with large pre- to post-merger changes in HHI. There are eight hub-to-hub markets where post-merger concentration is in the range of 6,000 to 8,999, with changes in the range of 500 to 2,999 HHI points. The DOJ/FTC Horizontal Merger Guidelines identify three tiers of post-merger market concentration and pre- to post-merger changes in concentration. The first is an "unconcentrated," market with an HHI below 1,500, in which a merger is unlikely to have adverse competitive effects. The second is a "moderately concentrated" market with an HHI between 1,500 and 2,500, in which an increase in HHI of more than 100 points potentially raises significant competitive concerns and often warrants scrutiny. The third is a "highly concentrated" market with an HHI above 2,500, in which an increase in HHI of 100-200 points potentially raises significant competitive concerns and often warrants scrutiny and an HHI of more than 200 points is presumed to be likely to enhance market power. See U.S. Department of Justice/Federal Trade Commission HORIZONTAL MERGER GUIDELINES (August 2010), at 19. Available http://www.justice.gov/atr/public/guidelines/hmg-2010.html.

adverse competitive effects, including increases in fares, reduction in service, and loss of choice.

In light of our earlier observations regarding fares and service in the aftermath of the Delta-Northwest and United-Continental mergers, the effect of USAir-AA on overlap routes should garner serious attention. Similar to previous legacy mergers, USAir-AA would substantially eliminate competition on important routes, creating a dominant firm that – acting unilaterally post-merger – could raise fares, degrade service, and eliminate consumer choice. This is particularly a concern since pricing data show that the carriers are likely each other's closest competitors, thus making a post-merger price increase more likely and profitable.

The merger could also increase the risk of anticompetitive coordination. Shares on USAir-AA overlap routes are concentrated largely among a few legacy carriers. Legacies in highly concentrated markets are unlikely to discipline post-merger increases. Moreover, LCCs face the key decision in an increasingly concentrated market of whether to price aggressively or to follow the pricing and capacity strategies of the dominant legacy carriers at the hub. Southwest can operate effectively by pricing its services just barely below the oligopoly "umbrella," without providing the type of sharp maverick's spur that it needed in earlier years as it entered new markets.

The proposed merger has important implications for control over both connecting service and intra-regional service in the U.S. The networks of USAir and AA do not appear to be particularly complementary, as indicated by relatively little "white space" in each network footprint that could be filled by the other carrier. Instead, combining the two networks could create regional and functional strongholds throughout the U.S. For example, the merged carrier would have a strong presence at a number of major airports on the eastern seaboard –Philadelphia (PHL), Reagan National (DCA), Charlotte (CLT), and Miami (MIA). The merging carriers would also have a presence at key Midwestern and western airports – Phoenix (PHX), Dallas Fort-Worth (DFW) and Chicago O'Hare (ORD) – that are important for providing connecting service to eastern and western destinations. Indeed, there is a resemblance to the proposed United-USAir merger of 2001, which was challenged by the DOJ on the basis of solidifying control over hubs.

V. LCCs Cannot be Relied Upon to "Save the Day" for Legacy Mergers

The dwindling stock of LCCs makes them increasingly unreliable as a source of competitive discipline in the industry. LCCs may find it more difficult to enter and discipline prices in markets anchored by increasingly concentrated, legacy-dominated hubs. Based on the AAI/BTC's White paper analysis of routes affected by the Delta-Northwest and United-Continental mergers, LCCs may not be abundantly available as substitutes for legacy carriers that serve hub-to-hub routes. We could expect the same rationales to apply in the USAir-AA merger.

For example, several hub airports that could be affected by the proposed merger (DFW, DCA, ORD, MIA, and LGA) are located in cities with alternative airports where LCCs often have a larger presence. Whether secondary airports are good substitutes for consumers seeking to avoid post-merger price increases at major hubs is a function of consumer costs associated with traveling to more remote airports and the availability, frequency, and type (e.g., nonstop or connecting) of service. Indeed, not all routes affected by the USAir-AA merger are replicated by other carriers at alternative airports in major hub cities. For example, JetBlue has continued to focus on the leisure market in Florida and the Caribbean and may not provide a good substitute for business travelers. Southwest has a substantial presence at secondary airports such as Chicago Midway (MDW), Baltimore-Washington (BWI), and Dallas Love Field (DAL) but there is accumulating economic evidence that fare discipline wanes as LCCs (e.g., Southwest) gain market share at such airports.[6] Trading one route that might be adversely affected by a USAir-AA merger for another that uses an alternative airport dominated by Southwest is unlikely to rescue consumers from adverse competitive effects.

VI. Potential Loss of Service to Smaller Communities

Many mid-size communities have seen flight frequencies reduced, equipment downgraded or service lost altogether as the result of previous legacy mergers. Smaller airports are expected to lose scheduled service in the immediate years ahead as well as attendant local and regional economic benefits that flow from connectivity to the world's important business centers.[7] For example, a major outcome of the Delta-Northwest merger was the elimination of Cincinnati as a Delta hub. The state of Ohio's effort to prevent a similar outcome at Cleveland in the United-Continental merger was likely a response to this effect. Between 2001 and 2009, American cut flights at TWA's former

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[6] *See e.g.*, John Kwoka, Kevin Hearle, and Phillippe Alepin, *Segmented Competition in Airlines: The Changing Roles of Low-Cost and Legacy Carriers in Fare Determination*, working paper, presented at 10th Annual IIOC, Washington, DC (May 2012).

[7] *See, e.g.*, Boyd Group International, *Air Service Challenges & Opportunities For US Airports* (2012), *available at* http://www.aviationplanning.com/Images/AirServiceRealitiesFromBoydGroupInternational.pdf. *See also* Will Phase-Out of RJs Doom Small Airports? 81 AIRPORT POLICY NEWS (July/August 2012), *available at* http://reason.org/news/show/airport-policy-and-security-news-81.

hub Lambert-St. Louis airport by 85 percent.[8] And between 2005 and 2009, the merged US Airways-America West reduced flights at Las Vegas by 50 percent.[9] Once enough data are available, it will be important to understand how Southwest is adjusting capacity after their 2011 merger with AirTran.

Evidence from the Delta-Northwest and United-Continental mergers indicates that merged carriers have adjusted capacities on overlap routes where they are dominant. One explanation for capacity increases is the strategy of driving traffic to large hubs, such as Delta's ATL and MSP and United's IAH. An increasingly symbiotic relationship between domestic U.S. consolidation and global antitrust immunized alliances drives this effect. Similar fact patterns across these mergers and USAir-AA raise the possibility that the merged carrier would also drive traffic to large hubs, with the potential side effect of starving routes involving smaller cities.

Choice and availability are important variables in the antitrust analysis of transportation networks, since consumers have limited flexibility over the points at which they enter (and exit) the network. Loss of choice that forces consumers in smaller communities to use less convenient connecting service or travel longer distances to other airports represent legally cognizable adverse effects of a merger. As air service evacuates a city and surrounding region, we not only lose the competition that once existed at the airport, but we lose competition that existed between airports. More important, if not

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[8] American Antitrust Institute, *Competition at a Crossroads: The Proposed Merger of Southwest Airlines and Air Tran* 20 (December 2010), *available at* http://www.antitrustinstitute.org/~antitrust/sites/default/files/SouthwestAirTran%20White%20Paper.pdf.

[9] Bill McGee, *When Airlines Merge, Consumers Usually Loose*, USATODAY.COM, April 29, 2010, http://www.usatoday.com/travel/columnist/mcgee/2010-04-28-airline-mergers_N.htm.

recognized in antitrust analysis, we lose competition in the regional market that depended substantially on being linked into the national transportation network.

VII. Efficiencies

The economic literature has hosted an ongoing debate over efficiencies in airline mergers, including empirical work showing that efficiencies dwindle as networks increase in size and the effects of increased “hubbing” on congestion and costs. An increasingly important factor in the efficiencies debate is post-merger integration. Protracted and unwieldy system integration scenarios can impose costs on the merged company that are passed on to customers in the form of inconvenience, flight delays, and even litigation involving contested issues. For example, US Airways-America West, Delta-Northwest, and United-Continental all experienced system integration problems, ranging from integrating computer systems, combining frequent flier programs, meshing work forces (particularly unionized employees), to problems with “cockpit standardization.”

The AAI/BTC White Paper analysis of Delta-Northwest and United-Continental highlights the fact that post-merger capacity adjustments can have a range of positive and negative effects that may be extraordinarily difficult to disaggregate and categorize as costs or benefits *at the time* a merger is reviewed. Moreover, in network industries, it is tempting to sell a merger on the basis of “out of market” efficiencies, or savings that may occur in a part of the system that is far removed from where competitive harm is inflicted. Given the magnitude of harm that could flow from a USAir-AA combination and the importance of protecting smaller communities from merger-related cutbacks, efficiencies should be tied directly to aversely affected markets.

VIII. Other Potential Competitive Problems

The proposed merger raises a number of additional issues that should be carefully scrutinized. The first involves ancillary fees and price transparency. For example, the latest round of airline industry consolidation has been accompanied by carriers aggressively unbundling their products (e.g., checked baggage, advance boarding, preferred seating, etc.) and charging fees for services previously included and paid for by consumers in the price of their tickets. While unbundling is generally pro-competitive, it is unlikely to be beneficial without accompanying price transparency. This is currently lacking in the domestic industry. Ancillary fees thus go largely undisciplined by market forces and prevent consumers from efficient comparison-shopping for air travel offerings across multiple airlines. Since rivalry creates incentives for sellers to fully inform consumers about the pricing, quality, and availability of their products, further consolidation (and the USAir-AA merger in particular) could dampen the merged carriers' incentive to disclose ancillary fee information. Moreover, the existence of fewer carriers in the market enhances the ease with which the airlines can tacitly agree on ancillary fees. Curbing or preventing such behavior is one of the major purposes of the antitrust laws, particularly merger control.

In sum, the merging parties bear a heavy burden in demonstrating that their merger would not be harmful to competition and consumers. Thank you for this opportunity to testify. I again refer you to the AAI/BTC White Paper for a more detailed discussion of the competitive issues raised by the proposed transaction.