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The American
Antitrust Institute

November 8, 2002

The Honorable Norman Y. Mineta
Secretary of Transportation
U.S. Department of Transportation
400 Seventh Street, S.W.
Washington, D.C. 20590

The Honorable Charles James
Assistant Attorney General for Antitrust
U.S. Department of Justice
Washington, D.C. 20530

Re: Review of Proposed Alliance of Delta, Northwest, and Continental Airlines

Dear Secretary Mineta and Assistant Attorney General James:

The American Antitrust Institute is an independent education, research, and advocacy organization that supports a positive role for antitrust in the national economy.¹ We are taking the liberty of transmitting to you several questions that we believe need to be answered in the course of a thorough evaluation of the proposed alliance of Delta, Northwest, and Continental (“the DNC Alliance”). We emphasize that these are illustrative rather than exhaustive and that we have not reached an overall conclusion, which we believe must be dependant on an assessment of information that is not currently available to us. We will comment on the following four questions:

1. What is the proper framework for analyzing the DNC Alliance?
2. What are the likely effects of the combination of frequent-flier programs?
3. Given the cyclical nature of the airline industry, what will be the effects of the DNC Alliance when the industry once again enters an expansionary phase?
4. Will the Alliance moderate Northwest’s ‘maverick’ influence on pricing?

¹ Information about AAI is available at www.antitrustinstitute.org. While members of the AAI Advisory Board were consulted in the course of preparing this letter, there should, of course, be no implication that all would necessarily agree with everything contained herein.

1. WHAT IS THE PROPER FRAMEWORK FOR ANALYZING THE DNC ALLIANCE?

The first thing to note about the DNC Alliance is its effect on the structure of the airline industry. Obviously, an alliance is something less than a full-scale merger, but it is also more than simple code sharing or a set of multilateral contracts for essentially marginal activities.² It appears from available, heavily redacted, documents that the DNC Alliance Agreement provides for:

- Reciprocal frequent-flier programs³
- Coordinated 'inventory management'⁴
- Division of revenues on previously competitively separate routes⁵
- Coordination and alignment of schedules⁶
- Coordination of airport facilities⁷
- Coordination of corporate and travel agent discounts⁸

² Codesharing was originally conceived as a way of dealing with foreign ownership issues and initially involved coordination among *potential* competitors to create end-to-end routes. As the list below demonstrates, it has evolved in some cases to incorporate a broader range of coordinated activities among actual competitors that facilitates their operation in a highly interdependent manner.

³ It would appear that the three carriers' individual frequent flier programs and executive lounge programs would effectively be merged.

⁴ It would appear that the three carriers will cooperate in a system to manage and sell each other's inventory so as to maximize total sales. Price competition among hub airlines occurs importantly through the management of the number of seats available at a particular price, as well as through published price levels, so this seems to be competitively significant.

⁵ This is not clearly set forth in the redacted Agreement, but it seems to be implicit.

⁶ The three carriers say they will 'align' their flights in unspecified ways to enhance connecting opportunities among them. They will even exchange new schedule data in advance, synchronize the filing of new schedules, and use "best efforts to advise each other at least [redacted] days prior to Load Date of ad hoc schedule changes." The implication would seem to be that the three carriers will not only pervasively coordinate their existing schedules but also signal each other as to future, planned schedule changes.

⁷ It appears that the carriers intend to relocate ticket counters, gates, flight operations and related airport facilities to be contiguous or close to each other on a 'high priority basis' at certain airports. We note that hub airlines have previously been accused of using airport facilities as competitive weapons to deny effective access to competing airlines, and so insulate themselves from competition in markets where they have a dominant position. It is possible that this relocation of gates and counters could allow an alliance member to discourage new competition by shifting any underutilized airport capacity to its alliance partner, which may have less incentive to compete aggressively with it, rather than to a more aggressive rival not in the alliance.

⁸ If, as it would appear, joint selling of corporate discount fares is intended, competition between the partners for lucrative business fares used by larger customers, and depended upon by full-service competitors, would be effectively terminated.

- Joint passenger processing⁹
- Coordinated reservations displays¹⁰
- Coordinated sales and marketing¹¹
- Code-sharing in domestic markets¹²
- ‘Seamless service’,¹³

The initial question is whether the DNC Alliance is sufficiently analogous to a merger that the government should apply the tests of the Horizontal Merger Guidelines.

First, let us be clear that this proposal appears to differ from the code sharing alliance between Northwest and Continental and the similar alliance between United and US Airways. Why? (1) In size and scope, it is more encompassing. (2) It involves the collaboration of not two but three previously independent airlines. (3) It comes at a time after the industry structure has already been materially changed by the United/US Airways collaboration, so that it is the combined effect not merely of this alliance but of the other as well that must be appraised.

While it would be an overstatement to say that the two alliances taken together will reduce the number of major airlines from six to three, it does not seem too much to say they could alter the competitive strategies that will drive this important industry. The purpose of an alliance is to cooperate with one’s competitor and henceforth five of the six major airlines would be in an arguably compromised competitive status with respect to some of their most significant rivals.

The proposed DNC Alliance may be distinguished from a full-scale merger in the following ways: (1) The three companies remain financially independent. (2) They remain under separate ownership and direction. (3) They retain separate management. (4) Except with respect to matters covered by the Alliance Agreement, they remain free to

⁹ The carriers apparently intend to have very wide access to each other’s passenger sales information and inventory. The Agreement states that they will “jointly develop passenger processing and check-in procedures” (including reciprocal electronic check-in kiosks and Internet check-in procedures) at stations that at least two of them serve.

¹⁰ It appears that the carriers intend to integrate their internal reservations systems to display each other’s codeshare flights. It is possible that any overloading of screens that may result would make it more difficult for travel agents to identify competitive alternatives, and so drive consumers toward the collaborators and away from rivals.

¹¹ The carriers intend to coordinate their sales and marketing programs. This may mean that they will aggregate their travel agency commission override and corporate incentive programs. The carriers agree “to meet and confer to discuss opportunities to use technology to improve codesharing, sales and marketing, customer service and passenger handling...”

¹² It appears that the carriers intend to codeshare on all or substantially all of each other’s U.S. flights, including those operated by their regional carrier affiliates.

¹³ It is not clear what this means, although it would seem to call for additional types of cooperation planned by the carriers regarding facilities, operations, and passenger handling, with the objective of appearing to the public essentially as a single, combined entity.

pursue independent strategies. (4) The duration is, formally, for ten years rather than permanent.

On the other hand, with respect to the actual operations and marketing of the three airlines, it appears that virtually all functions other than flying and maintaining the planes are subject to the Agreement and the airlines will operate in a highly coordinated way, much as an integrated firm that operates under several different brand names.

In terms of antitrust law enforcement, the Alliance cannot be analyzed under the Clayton Act, the usual vehicle for merger evaluation, because there is no transfer of stock or assets. However, it would be subject to Section 1 of the Sherman Act: does the Agreement constitute a combination in unreasonable restraint of trade? The guiding analytical principles for the DOJ are set forth in the Antitrust Guidelines for Collaborations Among Competitors.¹⁴ With the possible exception of the sharing of frequent-flier programs (to be dealt with in the following section of this letter), it would appear that the Rule of Reason would apply, requiring a weighing of the anticompetitive potential against the benefits for competition and consumers. Under the Collaboration Guidelines, a ten-year duration (as in the DNC Alliance) is generally long enough to warrant consideration of the collaboration among rivals as analogous to a merger.¹⁵

The effects of airline alliances on competition were studied at the request of Congress by a blue ribbon committee of the Transportation Research Board of the National Research Council in 1999.¹⁶ The resulting report, Entry and Competition in the U.S. Airline Industry, recommends that

[A]ll collaboration plans among major U.S. airlines be subject to traditional, economic-based merger analyses by DOJ, and that these plans – even if they do not involve exchanges of equity or transfers of assets—be subject to advance notification requirements similar to those required under the Hart-Scott-Rodino process.¹⁷

In reaching this conclusion, the committee noted that alliance affiliations can be irreversible and possibly precursors of de facto mergers.

¹⁴ DOJ and FTC, Antitrust Guidelines for Collaborations Among Competitors (available at <http://www.ftc.gov/os/2000/04/ftcdojguidelines.pdf>).

¹⁵ *Id.*, at note 10.

¹⁶ Two authors of this letter, Alfred E. Kahn and Jonathan B. Baker, served on the eleven member committee carrying out this study. The views expressed in this letter are not necessarily those of their colleagues on the TRB Committee.

¹⁷ Transportation Research Board, Special Report 255, Entry and Competition in the U.S. Airline Industry, Issues and Opportunities (Washington, D.C., 1999) at 143.

Although the committee noted that “it is plausible that consumers benefit from codesharing by major carriers on low-volume routes in which neither partner previously had offered service over the entire route and was not likely to do so,”¹⁸ it stated:

Less plausible, however, are the consumer benefits from codesharing that major carriers have claimed for single-connect or nonstop markets in which one or both of the partners already operates through-service. The concern is that such arrangements will reduce competition in these markets, because it is likely that the partners have—or had—competing flights in the market, or that they had the potential to become rivals in the market, because most nonstop and one-stop routes involve the partners’ hubs either as an end or transfer point.¹⁹

In accordance with this rather fundamental antitrust concern, we assume that government reviewers will insist upon a carve-out from the Agreement of codesharing on routes where there is already competitive overlap. The question is whether such a carve-out should represent the end of the competitive inquiry or — as we would urge — just the beginning.

In his letter to Secretary Mineta, dated October 18, 2002, Senator Herb Kohl noted that “The United/US Airways alliance and the Delta/Northwest/Continental alliance, when viewed together, represent approximately 60% of the market for domestic air transportation.” In many major city-pair markets--particularly between the respective hubs of alliance partners--the combined share is likely to be substantially higher. Relying on merger standards, the government’s investigation should consider the possibility of anticompetitive coordinated or unilateral effects, or anticompetitive exclusionary effects, and whether such possible effects would be either sufficiently minimized by the possibility of competitive entry or outweighed by cognizable efficiencies.

2. WHAT ARE THE LIKELY EFFECTS OF THE COMBINATION OF FREQUENT-FLIER PROGRAMS?

When the Transportation Research Board’s committee looked at shared frequent-flier programs, it observed,

It is unclear whether joint frequent-flier programs spur collaboration among partners in other ways [i.e., in addition to benefiting the participating airlines by making frequent-flier programs more enticing and more difficult to match] or cause them to compete less aggressively, or make them reluctant to compete directly. The net benefits to consumers depend on these competitive effects and

¹⁸ Id., 140.

¹⁹ Id., 142.

on the creation or enhancement of market power. Whether shared frequent-flier programs and limited codesharing relationships might evolve into more comprehensive and substantive relationships, undermining the partners' incentives to compete and increasing the potential of de facto mergers, deserves attention.²⁰

It appears from the redacted Agreement that the three carriers' individual frequent-flier programs would effectively be merged. While this would need to be confirmed through review of the unredacted Agreement, the possibility raises several concerns that should be assessed during a government review of the proposed collaboration and compared, in a reasonableness analysis, against any benefits from expanding frequent-flier programs.

First, frequent-flier programs can be viewed as a form of loyalty discount, intended not just to attract customers to a particular airline but also to keep them loyal. Frequent-flier points are valuable to the consumer even though they are not generally convertible directly into dollars because they reduce the cost of air travel much as does a discount. The combination of frequent flier programs could, in consequence, be understood as an agreement among horizontal rivals upon a term of competition that significantly affects price, which a court may treat as illegal per se.²¹

Second, even if the frequent-flier collaboration is not illegal per se, it may reduce or eliminate an important element of competition among the three airlines. The evaluation of this possibility requires an analysis of three scenarios that may result from the DNC Alliance: (1) Traveler makes reservation on Airline A, flies on Airline A and receives frequent-flier points for Airline A, (2) Traveler makes reservation with Airline A, flies on allied Airline B and receives frequent-flier points for Airline B, and (3) Traveler makes reservation with Airline A, flies on allied Airline B, and receives frequent-flier points for use on allied Airline C. The first scenario could result from independent, competitive decision-making, and would occur with or without the DNC alliance.²² The second scenario is also common, although it raises familiar questions about the possibility of diluting the competition between A and B, or insulating A and B from new competition by startup carriers. Over time, for example, alliance members may reduce or eliminate competition among themselves in the magnitude of the point award for flights of various distances.

²⁰ Id., 142.

²¹ See, e.g., Catalano, Inc. v. Target Sales, Inc., 446 U.S. 643 (1980) (per curiam).

²² This scenario is commonly viewed as procompetitive in most cases, and we do not question that presumption here. It is nevertheless possible that the establishment frequent flier programs could harm competition in some settings by raising barriers to entry to new competitors. As William G. Shepherd has explained, "When airlines give mileage bonuses for tickets it not only builds loyalty to the airline—it also ties the travelers to their local hub-dominant airlines. Travelers living near the hub naturally build up bonus holdings in the dominant airline. This raises entry barriers even further: Any new competitor must overcome the loyalty of these bonuses." Walter Adams and James Brock, *The Structure of American Industry* (10th ed.) (Prentice Hall, 2001) at 211.

The third scenario deserves particular scrutiny because it reflects elimination of an important element of competition among all three airlines, even when one of the three is not involved in rendering service to the consumer.²³ This scenario also increases the possibility that the three-way sharing of frequent-flier programs may harm competition by excluding smaller, non-affiliated rivals.²⁴

For example, suppose that a smaller, non-affiliated airline, X, competes on a route against Delta. Airline X has regular customers who have selected it over Delta, despite the fact that Delta offers an attractive frequent-flier program. Some of these customers may have accumulated frequent-flier points with Continental or Northwest but tend not to travel through a Delta hub and therefore do not desire Delta frequent-flier points. They might be inclined to fly with Continental or Northwest if those carriers competed on the same route as carrier X, but Continental and Northwest do not. Once the DNC Alliance is in place, these customers will be able to obtain frequent-flier points for Continental or Northwest simply by flying on Delta instead of on airline X. In effect, the consumer is offered a discount (the value of the frequent-flier points) to change carriers.

This may put the smaller non-affiliated carriers at a competitive disadvantage, with consequent impairment of competition. Given the costs of establishing a frequent-flier program and the impossibility of duplicating the scale with which the DNC Alliance could provide their combined one, there may be no practical way in which a smaller, non-affiliated carrier could counter by introducing its own competitive program. If the joint frequent-flier program damages the smaller and non-affiliated rivals, making them less effective competitors, consumers may eventually be deprived of desirable alternatives and the surviving large airlines may find themselves in a position to jointly reduce the value of their programs and otherwise raise fares.

²³ The combination of three frequent flier programs may benefit travelers by making it easier to earn frequent-flier points and expanding the routes on which awards can be redeemed, and any such benefits would have to be weighed against harms to competition in a reasonableness analysis. But an assessment of efficiencies must also account for the possible loss of efficiency from exacerbating the effects of an agency problem in the purchase of airline travel. If a traveler's air fare is paid for by an employer but the traveler personally acquires the frequent-flier points, as often occurs, the loyalty factor may lead the passenger to fly on a carrier that would not otherwise have been selected. By expanding the benefits of the loyalty program through merging the frequent flier programs of three carriers, the magnitude of this effect, and the resulting efficiency loss, is likely to be magnified.

²⁴ Throughout this letter, we use the term exclusion to mean more than the possibility that a firm is forced to exit the market (or kept from entering), but also to incorporate the possibility that a firm's costs have increased, or its access to the market has been limited, leading it to compete less aggressively than it otherwise would.

3. GIVEN THE CYCLICAL NATURE OF THE AIRLINE INDUSTRY, WHAT WILL BE THE EFFECTS OF THE DNC ALLIANCE WHEN THE INDUSTRY ONCE AGAIN ENTERS AN EXPANSIONARY PHASE?

The airline industry is currently in a very difficult time. Since September 11, 2001, demand has fallen off substantially. Today's circumstances are challenging and the causes are extraordinary, but the airline industry has historically tended to operate in cycles. As a general policy, policy-makers should strive to avoid accepting structural changes today that will unduly inhibit competition at a future date when the industry again enters an expansionary phase. Thus, it is important to ask: how will the DNC Alliance affect the incentives of its members in the future, when the carriers next see that it is in their interest to expand?

When an airline is independent, it will expand capacity and/or routes on the basis of its independent analysis. While it will take into account the likely counter-strategies of competitors and potential competitors, it would not have to take into account the likelihood that its competitor would withdraw from an alliance or suffer economic harm. Once in an alliance, however, the airline would be expected to pay some attention to the interests of its affiliates. At the extreme, if an affiliate is doing poorly, the airline may have an incentive to help it, since the affiliate's failure to survive would presumably undermine some of the value of the alliance to its partners.

Thus, the government needs to explore whether there may be a ratchet effect hidden in the DNC Alliance, such that future decisions of its members will be less intensely competitive than if they had remained independent. This concern would not be eliminated by the reviewing agencies merely requiring carve-outs making the alliance inapplicable to *preexisting* head-to-head routes, because the alliance may also induce its members to channel any future expansion away from going head-to-head against an affiliate. Why would either airline want to go directly against its partner as long as there are alternative areas for expansion? In short, the question is whether the alliance would harm consumers in the future, by preventing competition that otherwise would have occurred during the industry's next expansion phase.

4. WILL THE ALLIANCE MODERATE NORTHWEST'S 'MAVERICK' INFLUENCE ON PRICING?

One of the problems that merger enforcement seeks to control is coordination among horizontal competitors. The presence of a maverick firm in an oligopolistic market helps protect the public, because it constrains or limits anticompetitive coordination. For this reason, it is particularly important to protect the independence of such firms, and

scrutinize carefully changes in market structure that may operate to modify the incentives facing them.²⁵

Northwest has acquired the reputation of being a maverick within the airline industry, because other carriers have repeatedly attempted to raise system-wide prices but have retracted those increases when Northwest refused to go along.²⁶ Accordingly, in evaluating the DNC Alliance, the government should consider whether Northwest's reputation correctly reflects the facts today, and, if so, whether its incentive to constrain coordination will be altered through participation in the DNC Alliance.

CONCLUSION

The proposed DNC Alliance raises a number of substantial antitrust questions. To answer them with confidence, government reviewers will need to conduct a thorough investigation and careful analysis. This will probably take more time than has hitherto been provided by the Department of Transportation.

It is also important that the government approach a matter of this magnitude with a high degree of transparency. Members of the public, including consumers (who might be harmed by potential collusive or exclusionary effects) and - rivals of the member airlines (who stand to be damaged by possible exclusionary effects²⁷) should be provided with information about the Agreement sufficient to make it possible for them to assist the government's analysis. Regardless of the ultimate decision, moreover, the government's reasoning should be placed on the public record in as much detail as possible. A model for this might be the Federal Trade Commission's recent Statement (accompanied by a dissenting statement and followed by a staff speech further explicating the decision) when it decided not to stop a controversial merger in the cruise

²⁵ See generally Jonathan B. Baker, *Mavericks, Mergers, and Exclusion: Proving Coordinated Competitive Effects Under the Antitrust Laws*, 77 N.Y.U. L. Rev. 135 (2002).

²⁶ *Id.*, 166-73.

²⁷ It is sometimes contended that the government should pay little attention to complaints by competitors about a proposed horizontal collaboration, because if the collaboration would create market power potentially injurious to consumers—whose welfare alone is the proper concern of the antitrust laws—it would also be beneficial to its competitors because they could then raise their own prices as well. Hence, it is said, if rivals complain, it can only be because they fear that the collaboration will create a more efficient competitor. The argument clearly has some validity, except for its exclusivity. Where, however, the collaboration creates a potential for unfairly exclusionary effects—that is, where it may impair the competitive process itself, for example by raising rivals' costs or otherwise excluding them from the fair opportunity to compete on the basis of their relative efficiency—without generating significant efficiencies that outweigh those dangers—there is good reason to explore and weigh rivals' concerns. Consumers, of course, may find it in their interests to complain about a proposed collaboration for multiple reasons: because of its potential for making coordination more likely or more effective, because it may increase unilateral market power, or because it may harm competition through its exclusionary effect on competitors.

line industry.²⁸ We believe that the public deserves such full explanations when decisions are made that may dramatically alter the structure of an important industry.

Sincerely,

Jonathan B. Baker
Professor of Law, American University

Albert A. Foer
President, The American Antitrust Institute

Alfred E. Kahn
Professor of Economics, Cornell University

²⁸ See, In the Matter of Royal Caribbean Cruises, Ltd./P&O Princess Cruises plc and Carnival Corporation/P&O Princess Cruises plc, FTC File No. 021 0041, <http://www.ftc.gov/os/caselist/0210041.htm> and <http://www.ftc.gov/opa/2002/10/simonsantitrust.htm>