The American Antitrust Institute

November 9, 2015

The Honorable Anthony R. Foxx
Secretary of Transportation
U.S. Department of Transportation
1200 New Jersey Ave SE
Washington, DC 20590

The Honorable John F. Kerry
Secretary of State
U.S. Department of State
2201 C Street NW
Washington, DC 20520

The Honorable Penny Priztker
Secretary of Commerce
U.S. Department of Commerce
1401 Constitution Avenue NW
Washington, DC 20230

Re: The Open Skies Debate - Promoting Competition or Protecting a U.S. Airline Oligopoly? [In re: DOT-OST-2015-0082, DOS-2015-0016, and DOC-2015-0001]

Dear Secretaries Foxx, Kerry, and Priztker:

The American Antitrust Institute (AAI) has been active in supporting antitrust enforcement and competition policy in the U.S. commercial passenger aviation ("airline") industry. The unifying theme of AAI's advocacy is the importance of competition, innovation, and consumer choice and benefits.[1] AAI's advocacy has spanned all aspects of the airline industry on both competition and consumer issues, in numerous U.S. Department of Transportation (DOT) and Federal Aviation Administration (FAA) rulemakings and inquiries, and airline mergers reviewed by the U.S. Department of Justice (DOJ).

AAI does not write to opine on the specifics of the alleged Open Skies dispute, namely whether large U.S. carriers (i.e., Delta, United, and American (the "Big 3")) are harmed by the alleged subsidization of the Gulf carriers by their sovereign governments. That is a matter for adjudication by the appropriate agencies. Nor does AAI support the Gulf carriers over any other potential foreign entrant seeking to establish or expand service under Open Skies agreements. Rather, we

[1]The AAI is an independent non-profit education, research, and advocacy organization. Its mission is to advance the role of competition in the economy, protect consumers, and sustain the vitality of the antitrust laws. For more information, see www.antitrustinstitute.org. Many thanks to AAI Research Fellow Kyle Virtue, and former AAI Research Fellow Birzhan Batkeyev for research assistance.

believe it is important to highlight the major competition policy question raised in this proceeding. Namely, should the Big 3 use Open Skies as a way to maintain barriers to entry in order to protect their domestic oligopoly and dominance on international routes?

The first part of this letter outlines the benefits of Open Skies agreements to competition and consumers. The second section summarizes the fundamental change in the domestic U.S. airline industry that is the root of the debate over the entry that challenges the dominance of the Big 3. The final section highlights key competition policy issues raised by the Open Skies debate and suggests a number of questions that policymakers and competition enforcers should consider in moving forward.

I. Open Skies Agreements Have Generated Benefits For Competition and Consumers

Open Skies seeks to liberalize the international aviation market.[2] The agreements benefit U.S. and foreign carriers by increasing demand for air travel services and benefit domestic and international consumers by creating more choice and welfare gains associated with greater connectivity. The benefits of Open Skies to consumers and carriers, and economic development more generally, are well documented. For example, shortly after the U.S. signed its Open Skies agreements with India in 2005 and the European Union in 2007, Delta announced it would begin service to London Heathrow[3] and American Airlines announced nonstop service between Chicago and New Delhi, respectively.[4] Agreements have facilitated the ability of many U.S. cities (e.g., Detroit, Las Vegas, Memphis, Minneapolis) to participate in the global economy by providing travelers with international access.[5] The U.S. enjoys more route offerings, an increase in global trade, and more international traffic due to better connectivity between domestic and foreign origins and destinations.[6]

Economic analysis demonstrates that Open Skies agreements involving international routes flown by U.S. carriers have reduced fares, as compared to adjusted fares in markets that remain regulated.[7] Other analysis of major U.S. and non-U.S. international routes flown by leading airlines under Open Skies agreements indicates that fares have been reduced by 15%.[8] Further, other studies have found

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[2] U.S. Dep't of State, *Open Skies Partnerships: Expanding the Benefits of Freer Commercial Aviation*, State.gov (last visited Oct. 13, 2015), http://www.state.gov/e/eb/tra/ata/.

[3] *Air Transport Agreement Between United States and United Kingdom of Great Britain et al.* (2007), *available at* http://www.state.gov/documents/organization/114872.pdf; Alan B. Nichols, *Open Skies' Agreement Paves Way for Greater Access in Air Traviel,* Wash. Dipolmat (June 2007), http://washdiplomat.com/index.php?option=com_content&view=article&id=6722:open-skies-agreement-paves-way-for-greater-choices-in-air-travel-&catid=1002:june-2007&Itemid=279.

[4] *Air Transport Agreement Between United States and India* (2005), *available at* http://www.state.gov/documents/organization/114735.pdf; American Airlines, *American Airlines History* (last updated Mar. 2009), http://www.aa.com/intl/es/aboutUs/history_en.jsp.

[5] John R. Crook, Am. Soc'y of Int'l Law, *U.S. Open Skies Agreements Number More Than One Hundred*, 105 Am. J. Int'l L. 586, 587 (2011).

[6] The Gulf carriers carried 2.2 million passengers into the United States in 2014. These travelers spent an estimated $4.0 billion during their visits. Oxford Economics, *Gulf Carrier Traffic in the USA: An Analysis of the Competitive Landscape* 17 (2015), *available at* https://www.ustravel.org/sites/default/files/page/2009/07/USTA_Traffic_Analysis_Briefing_6_18_2015.pdf. (briefing provided to the U.S. Travel Association).

[7] *See* Anca D. Cristea et al., *Estimating the Gains from Liberalizing Services Trade: The Case of Passenger Aviation* 5 (2014).

[8] Clifford Winston & Jia Yan, *Open Skies: Estimating Travelers' Benefits from Free Trade in Airline Services*, 7 Am. Econ. J.: Econ. Pol'y 370, 371 (2015).

that full liberalization would increase passenger traffic worldwide by 5%.[9] Liberalization has also enhanced consumer welfare through more efficient baggage handling, reciprocal frequent-flier programs, greater flexibility in scheduling, and more direct connections.[10]

Extensions of the Big 3 carriers' global networks have generated gains to U.S. carriers, not only in terms of new international route offerings, but also from traffic coming into the U.S. from international origins. U.S. carriers pick up such traffic to provide service to U.S. destinations beyond domestic gateway hubs. One analysis finds that expansion by the Gulf carriers has increased passenger volumes, generating additional demand for U.S. service, and increased consumer welfare in U.S. and international markets.[11] JetBlue Airways notes that its international partners feed traffic into the U.S., which increases domestic competition, resulting in lower fares and increased demand.[12] Similarly, Hawaiian Airlines states that liberalization has permitted it to expand its operations outside the U.S., which allows "more people – both U.S. citizens and foreign visitors – to travel internationally."[13]

II. Protection of a Domestic Oligopoly is Driving the Current Open Skies Debate

The genesis of the Big 3's strategic opposition to the Gulf carriers under the current Open Skies dispute is their dominance in U.S. airline markets and strong incentives to control entry into the domestic market and on international routes. After 10 years of rapid consolidation, the Big 3 preside over a domestic market where capacity is kept tight and fares and ancillary fees high.[14] The Big 3 drive traffic to their large U.S. hubs (often at the expense of service to smaller U.S. communities) in order to extend their networks globally by offering service on international routes, under the umbrella of the three airline alliances (Star (United), SkyTeam (Delta), and oneworld (American)). Coordinated pricing, scheduling, and marketing involving these routes is largely immunized from antitrust scrutiny.[15] The three alliances alone carry about 75% of all passengers in the global market.[16]

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[9]Roberta Piermartini & Linda Rousová, *The Sky is not Flat: How Discriminatory is the Access to International Air Services?*, 5 Am. Econ. J.: Econ. Pol'y 287 (2013).

[10]*See* Anca D. Cristea et al., *supra* note 7, at 40 (concluding that liberalizing countries see expansions in route offerings, lower prices, and more direct flights, all of which consumers value highly).

[11]*See* Oxford Economics, *supra* note 6, at 9 (concluding that the arrival of Gulf Carrier traffic into the U.S. does not displace U.S. carrier flights). The study also found that 620,000 passengers who arrived on Gulf Carrier flights transferred to a U.S. airline to complete their journey. *Id.* at 14.

[12]Letter from JetBlue Airways to Dep't of State, Dep't of Transp. & Dep't of Commerce, No. DOT-OST-2015-0082, at 2 (June 17, 2015).

[13]Comment of Hawaiian Airlines, Inc., No. DOT-OST-2015-0082, at 6 (June 17, 2015).

[14]*See, e.g.*, Volodymyr Bilotkach & Paulos Ashebir Lakew, *On Sources of Market Power in the Airline Industry: Panel Data Evidence from the US Airports*, 59 Transp. Pol'y Part A: Pol'y & Prac. 288 (2014). The authors show welfare losses in over 30 small airports resulting from the Delta-Northwest merger. *See also* Diana L. Moss & Kevin Mitchell, Am. Antitrust Inst. & Bus. Travel Coal., *The Proposed Merger of US Airways and American Airlines* 11 (2012). *See also* John Kwoka, Kevin Hearle & Phillippe Alepin, *Segmented Competition in Airlines: The Changing Roles of Low-Cost and Legacy Carriers in Fare Determination* (2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2212860. Identical increases in fee revenues across the Big 3 U.S. carriers occurred from 2007–2010 and 2013–2014, with across-the-board flat or declining fees from 2010–2012. *See also* Jay Sorensen, IdeaWorks Co., *Ancillary Revenue Report for 2015: The CarTrawler Yearbook of Ancillary Revenue* 5 (2015), *available at* http://www.ideaworkscompany.com/wp-content/uploads/2015/09/2015-Ancillary-Revenue-Yearbook.pdf.

[15]*See, e.g.*, William Gillespie & Oliver M. Richard, U.S. Dep't of Justice, Antitrust Division, *Antitrust Immunity and International Airline Alliances* (Economic Analysis Group Discussion paper EAG 11-1, Feb. 2011), *available at* http://www.justice.gov/sites/default/files/atr/legacy/2011/02/23/267513.pdf.

[16]Volodymyr Bilotkach & Kai Hüschelrath, *Balancing Competition and Cooperation: Evidence from Transatlantic Airline Markets* 4 (ZEW Discussion Paper No. 15-059, 2015).

Five major mergers in the last decade have produced four large U.S. carriers that control about 70% of the national market (American with a share of 20%, Southwest with 18%, Delta with 17%, and United with 15%).[17] Members of this club have little incentive to reap promised cost savings and network benefits, or to minimize system integration costs—all problems that have dogged several major mergers.[18] Historical data for the four large carriers, across the hubs they have operated over the last decade, reveal this fundamental reshaping of the U.S. industry. For example, average real fares declined almost 12% from 2004–2009 (even as real fuel costs *increased* by 33%) with negative operating margins for much of that period.[19] By 2009–2014, things had turned around. Average fares increased by 15%, a rate that far outstripped that of fuel costs, which slowed to less than 5%. By 2014, operating margins were 8.6% and the airlines were strongly profitable.[20] It has been widely noted that despite flat or declining fuel costs for much of the last five years, fares have not also declined, suggesting that there is significantly less competition post-consolidation. These adjustments all occurred against the backdrop of highly concentrated hub markets.[21]

The foregoing clearly depicts the transformation of the domestic industry from several undisciplined and unprofitable carriers into an oligopoly with significantly more control over capacity, fares, and fees. The dramatic restructuring of the domestic industry has raised entry barriers to both domestic and foreign carriers seeking to enter or expand service involving U.S. international gateways or hubs. These barriers take several forms. For example, hub dominance resulting from past consolidation has myriad implications for entry, including hubbing diseconomies and uninternalized costs of carrier-caused delays. Slot allocation policies that favor, or can be gamed by, large incumbents at slot-constrained airports also make it more difficult for regionals, low cost carriers, and foreign carriers to compete effectively. Moreover, domestic carriers' ability to coordinate with alliance partners on pricing and schedules—immunized from antitrust scrutiny—poses barriers to entry to non-alliance partners.

It comes as no surprise, therefore, that the large U.S. carriers would bristle at any threat of entry or encroachment into a domestic market in which they are reaping the rewards of oligopoly. This has arguably been the reaction of the Big 3 to the Gulf carriers' and other foreign carriers' attempts to initiate service or expand capacity to serve international routes involving U.S. cities. While the Gulf carriers are the perceived international threat "du jour," there are potentially many others in line with

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17 Shares are measured by revenue passenger-miles. U.S. Dep't of Transp., Bureau of Transp. Statistics, *Airline Domestic Market Share: July 2014–June 2015* (2015), http://www.transtats.bts.gov.

18 *See generally* Diana L. Moss, Am. Antitrust Inst., *Delivering The Benefits? Efficiencies And Airline Mergers* (2013).

19 Fares obtained from U.S. Dep't of Transp., Bureau of Transp. Statistics, *Average Domestic Airline Itinerary Fares By Origin City, Ranked by Total Number of Domestic Passengers in 2014* (2015), *available at* http://www.transtats.bts.gov/AverageFare/. Operating margins were -1.1% in 2004, increasing to only 1.6% by 2009. U.S. Dep't of Transp., Bureau of Transp. Statistics, *U.S. Airline Industry Operating Margins: 2004-2010* tbl.3–9 (2010), *available at* http://www.rita.dot.gov/bts/sites/rita.dot.gov.bts/files/publications/transportation_statistics_annual_report/2010/html/chapter_02/table_03_09.html. Fuel costs derived from U.S. Dep't of Transp., Bureau of Transp. Statistics, *Air Carrier Financial: Schedule P-12(a)*, *available at* http://www.transtats.bts.gov/DL_SelectFields.asp?Table_ID=294&DB_Short_Name=Air%20Carrier%20Financial. Press Release, U.S. Dep't of Transp., Bureau of Transp. Statistics, *2014 Airline Financial Data* (May 5, 2015), *available at* http://www.rita.dot.gov/bts/press_releases/bts022_15.

21 Average market concentration across hubs from 2004–2014 was between about 3,400 to 3,750 HHI. Diana L. Moss & Kevin Mitchell, Am. Antitrust Inst. & Bus. Travel Coal., *The Proposed Merger of US Airways and American Airlines* 14–15 (2012). Moreover, significant increases in concentration (including some 3-2 and 2-1 mergers) were observed in the wake of airline mergers.

them, including carriers that have already entered, or will attempt to enter, U.S. markets under the auspices of Open Skies agreements.[22]

III. Entry Facilitated by Open Skies Threatens the Big 3's Domestic and International Turf

Capacity growth and potential entry puts downward pressure on fares in the U.S. markets, a decidedly negative effect if you are part of the domestic airline oligopoly. The Big 3's resistance to foreign entry is most visible in the current Open Skies debate, specifically their objection to the Gulf carriers. But the collateral effects of the debate are also potentially visible in delayed action on Open Skies requests, such as the languishing of Norwegian Air Inc.'s Open Skies application at DOT.[23] That agreement has awaited action for over a year—well beyond the time frame when action was both reasonable and expected.

In the matter of the Gulf carriers, the Big 3 cloak their objection to entry in a two-part argument that the playing field has become uneven. They argue that (1) U.S. Open Skies agreements with the Gulf governments run counter to the underlying assumptions of Open Skies policy and (2) the agreements, which are based on outdated assumptions, are being abused by the Gulf carriers.[24] The Big 3 claim, for example, that the Gulf carriers possess "artificial competitive advantages over foreign carriers" as a result of subsidies that enable those carriers to expand capacity at a rate that would be impossible to achieve on a level playing field.[25] They go on to note that certain players have expanded to the point where they can directly compete with U.S. carriers on international routes to the United States.[26]

The result of the alleged unlevel playing field is to divert passengers away from U.S. airlines' services and to the Gulf carriers.[27] For example, the U.S. airlines claim that they risk losing a substantial number of passengers that they flew between Orlando and Bangkok over the past year as a result to being "siphoned off via a subsidized Gulf hub."[28] In response to the concerns they raise over alleged subsides involving the Gulf carriers, the Big 3 carriers ask for a voluntary "freeze" on Gulf carrier capacity.[29]

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[22]Open Skies agreements place no pricing, flight frequency, and destination restrictions on the ability of non-U.S. carriers to provide direct service to the U.S. *See, e.g.*, *Air Transport Agreement Between United States and France* (1998), *available at* http://www.state.gov/documents/organization/114271.pdf. *See also* Anca D. Cristea et al., *Estimating the Gains from Liberalizing Services Trade: The Case of Passenger Aviation* 40 (2014). Cristea et al. also note that OSA signatories experience 18% growth in traffic, a third of which can be attributed to new routes. *Id.*

[23]*See, e.g.*, U.S. Dep't of Transp., *Answer of Federal Express Corporation*, in re Application of Norwegian Air International Limited for an Exemption Under 49 U.S.C. § 40109 and a foreign air carrier permit pursuant to 49 U.S.C. § 41301, Docket DOT-OST-2013-0304, at 1, 3.

[24]United Airlines, American Airlines & Delta Air Lines, *Restoring Open Skies: The Need to Address Subsidized Competition from State-Owned Airlines in Qatar and the UAE* 52–53 (2015) [hereinafter *Big 3 White Paper*].

[25]*Id.* at 6, 39.

[26]*See id.* at 52–53 (explaining that, at the time the U.S. signed Open Skies agreements with Qatar and UAE, neither had developed aviation policies). The Big 3 now fear that due to "unfair government subsidies" the Gulf Carriers are big enough to expand their operations into the U.S. *Id.* at 39–43.

[27]American Airlines, Delta Air Lines & United Airlines Comment, No. DOT-OST-2015-0082, at 2 (Apr. 17, 2015), *available at* http://www.regulations.gov/#!documentDetail;D=DOT-OST-2015-0082-0025. *But see* Oxford Economics, *supra* note 6, at 8–9. Oxford Economics found that the there was very little overlap between the Gulf carriers' routes and the Big 3's routes, suggesting that the Gulf carriers have not displaced Big 3 traffic. Far from displacing U.S. market share, the entry of the Gulf carriers has simply resulted in an increased volume of traffic.

[28]*Id.*

[29]*Id.* at 1.

IV. Any Government Resolution to Open Skies Disputes Should Not Facilitate Its Use to Maintain Barriers to Entry

In resolving the current dispute, the AAI respectfully suggests that the government consider two important objectives. One is to give consideration to the broader competition policy underpinnings of the Open Skies debate. The second is to resist any attempt by dominant U.S. carriers to use Open Skies as a way to maintain barriers to entry to the domestic and international markets in which they are dominant. A focus on two major questions would help guide resolution to the debate on Open Skies at this critical juncture.

First, to their credit, the Big 3 recognize that Open Skies has been successful in liberalizing the aviation industry. But their position on the Gulf carriers dispute reveals a stark contrast with the second goal of Open skies, namely that bilateral agreements are consistent with U.S. interests.[30] Entry into U.S. markets, facilitated by Open Skies, is decidedly in the interest of competition and the U.S. consumer, even if it may threaten the Big 3's private interest. There is substantive economic evidence that demonstrates that Open Skies agreements on the whole deliver benefits to competition and consumers, without displacing or impairing the ability of domestic carriers to compete. As noted above, the Big 3 have benefitted from Open Skies not only by expanding their global reach but also in serving those passengers domestically beyond the U.S. gateway hubs that anchor those international routes.[31]

Second, the Big 3 carriers enjoy protection from competition that is afforded by grants of antitrust immunity under Open Skies for coordinated operations with partners in the international airline alliances. Immunity is a powerful tool that extends the Big 3 carriers presence beyond the U.S. and to the international routes that are increasingly challenged by foreign carriers. Economic evidence on immunity presents a decidedly mixed picture. Any benefits gained from immunity come at not insignificant costs, including the elimination of competition on overlapping gateway-to-gateway routes and foreclosure of rivals' access to alliance-dominated hubs.[32]

The power wielded by the Big 3 on immunized international alliance routes, coupled with the significant barriers to entry that such immunity presents, shines the light on why the DOT should periodically re-evaluate grants of antitrust immunity. To our knowledge these reviews, if they have occurred, are not on the public record. This transparency vacuum is at odds with other important periodic regulatory reviews of privileges and freedoms granted to market participants. For example, the Federal Energy Regulatory Commission (FERC) grants market-based rate authority to generators selling electricity at wholesale. Such grants factor prominently into the competitiveness of wholesale power markets and are periodically reviewed by FERC in a transparent forum.[33] Likewise, any broader evaluation of Open Skies should more generally account for the role of antitrust immunity on competition and consumers, particularly as domestic consolidation has changed the competitive landscape domestically and internationally.

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[30] *Big 3 White Paper*, *supra* note 24, at 1.
[31] *See* Oxford Economics, *supra* note 6, at 14–16 (estimating that in 2014 feeder passenger traffic into the U.S. from Gulf Carriers alone generated 1 billion seat miles on U.S. carriers).
[32] *See* James Reitzes & Diana Moss, *Airline Alliances and Systems Competition*, 45 Hous. L. Rev. 293, 305–06 (2008) (outlining the costs and benefits of airline alliances).
[33] Fed. Energy Regulatory Comm'n, *Triennial Reviews*, http://www.ferc.gov/industries/electric/gen-info/mbr/triennial.asp (last visited Nov. 9, 2015).

V. Conclusion

In sum, three major questions are ripe for the asking in the current Open Skies debates. The AAI respectfully encourages the Departments of Transportation, State, and Commerce to take these up in their resolution of the matter.

1. **How has domestic consolidation over the past decade changed incentives for the Big 3 to protect their private economic interests, at the expense of the economic benefits from liberalization embodied in Open Skies to the U.S. a whole?**

2. **How should the demonstrated benefits of entry by foreign carriers to U.S. competition and consumers under Open Skies agreements factor into the government's assessment of disputes involving specific agreements, and more broadly into the approval of new Open Skies agreements?**

3. **Given the role of the Big 3 carriers in international alliances, and the powerful lever that such alliances provide the Big 3 in extending their market power into international markets, how can the DOT make a priority of transparent, regular, and periodic review of immunity grants?**

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Sincerely,

Diana Moss

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