Testimony of

# Dr. Darren Bush

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DARREN BUSH, Ph.D., J.D.
ASSOCIATE PROFESSOR OF LAW
UNIVERSITY OF HOUSTON LAW CENTER
HOUSTON, TEXAS

"An Examination of the Delta-Northwest Merger

BEFORE
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## INTRODUCTION

Mr. Chairman, Ranking Member Hatch and other distinguished members of the Judiciary Committee Antitrust Subcommittee, I want to thank you for giving me the opportunity today to speak about the potential anticompetitive effects inherent in a new wave of consolidation that may be spurred by the proposed merger of Delta and Northwest Airlines. My remarks here today are my own: I do not represent anyone. I speak today based upon my experience as an Antitrust Division trial attorney focused on deregulated industries, as an economist, and as a law professor whose research and writing has focused on antitrust issues arising in the context of regulated/deregulated industries, including airlines.

My testimony is divided into three parts. The first part of my testimony examines what I think are the potential anticompetitive harms of the transaction. This section should be treated not as an indictment of the transaction, but as a guide to issues I think key in determining whether the effect of such merger "may be substantially to lessen competition, or to tend to create a monopoly." The second section addresses believe what I believe are the key potential benefits of the transaction. This second section cautions against interpreting the antitrust laws as allowing mergers because of a wrongly yet widely held belief that efficiencies generally, even if not fully evidenced, somehow should be a trump card which enables a proposed merger to fly under the radar of antitrust review even whether the transaction raises serious anticompetitive issues. The third section offers speculation as to the reason behind the transaction, and the problems associated with the mindset that mergers and acquisitions resolve issues caused by uncertainty in input markets and economic factors as a whole.

WHAT ARE THE ANTICOMPETITIVE EFFECTS OF THE MERGER?

a. Nonstop Competition Is Potentially Injured

Cutting to the chase, the first question that must be addressed is whether the proposed merger will be beneficial to consumers. The standard antitrust answer to this question is a complicated analysis that purports to determine the relevant market in which the merging parties overlap, the concentration within that market, the likely anticompetitive effects that arise due to the proposed merger within the relevant market, and whether entry mitigates the injury to consumers caused by those anticompetitive effects or whether efficiencies outweigh the anticompetitive effects to such a degree as to justify the transaction. This classic analysis embedded in the Department of Justice/Federal Trade Commission Horizontal Merger Guidelines is the standard tool of antitrust analysis within the agencies.

The relevant market traditionally examined in airline mergers is typically the non-stop city-pair market. These routes are usually examined first in any merger of major carriers because hub-to-hub routes between competitors are commonly duopoly routes served only by the merging parties, or, in some circumstances, the routes are served by an additional nonstop competitor such as a low cost carrier. Witness, for example, the Department of Justice's Press Release discussing the threatened challenge of the United acquisition of U.S. Airways. The proposed merger was abandoned due in large part to the Department of Justice's threatened suit. The press release noted that these two carriers, the second and sixth largest at the time, would create "a monopoly or duopoly on nonstop service on over 30 routes." More addition, "US Airways is United's most significant competitor on densely-traveled, high revenue routes between their hubs, such as Philadelphia and Denver, as well as for nonstop travel to and from Washington D.C. and Baltimore, and on many routes up and down the East Coast."

Similarly there are issues with respect to nonstop routes served by Delta and Northwest. For instance, at the very least, the Antitrust Division will obviously examine the overlap between Northwest and Delta on nonstop hub to hub routes. In particular, the routes that are problematic are Salt Lake City-Minneapolis/St. Paul, Cincinnati- Minneapolis/St. Paul, Cincinnati-Detroit, and potentially Salt Lake City-Detroit (depending upon commencement of nonstop service by Northwest). In these routes, nonstop air passenger service faces a monopoly. In other routes, there is likely to be a reduction in service from three to two.

These issues have traditionally been well-handled by the Department of Justice and my friends and colleagues at the Transportation, Energy & Agriculture Section of the Department of Justice's Antitrust Division.

b. Competition on a Connection Basis is Potentially Injured

The next issue typically raised by airline mergers is whether or not the combined firm will operate the bulk of hubs providing connecting service between cities in the Midwest and the Eastern United States. As you know, only certain connections make sense depending on geography. The more circuitous the route, the more expensive the ticket and the less likely that option will be chosen even among passengers who do not have the ability to enjoy nonstop service. For example, connections from origins or destinations east of Colorado in the Midwest

to East coast destinations may only have as reasonable connections options the hubs of the merging firms and Chicago O'Hare, an airport which is seriously congested and constrained.

In other markets, Delta and Northwest may be potential competitors in hub to hub routes. One example might be the Salt Lake City to Detroit market where Northwest might have provided service. In addition, there are numerous potential competition opportunities in connection markets.

c. Competition for Contracts may be injured.

As the government stated in its press release concerning United/U.S. Airways, major airlines bid for high volume contracts with large corporations, "negotiating discounts to their airfares in return for a corporation's commitment to concentrate travel on the airline." Northwest and Delta may compete vigorously with each other for these contracts, particularly when the corporation requires significant travel on nonstop routes where the companies compete.

d. Air Passenger Service Concentration may be diminished.

Northwest's merger with Delta may create or enhance dominance at many cities throughout the United States, including New York/La Guardia, Atlanta, Detroit, Memphis, and Minneapolis/St. Paul. Competition for the millions of passengers traveling to and from these cities may decrease, resulting in higher fares and reduced service.

e. The combination may foreclose downstream and upstream markets

Airlines may be less vertically integrated than in the past, with airlines outsourcing maintenance and other items not core to their business. However, there are still vertical implications for any merger in the airline industry. Specifically, care must be taken to examine the nature of any contract vital to the core function of providing air passenger service. In particular, contracts between the merging parties and vendors and suppliers should be examined to determine whether there is the potential that the combined firm could foreclose competitors from obtaining vital services.

f. Follow-on mergers may lead to further anticompetitive issues

Northwest's merger with Delta may lead to follow-on mergers. The one most contemplated in the popular media is a merger between United and Continental. Follow-on mergers occur because the competitors of the merging parties perceive that there is some potential advantage to merger and consolidation, regardless of the veracity of that notion.

Follow-on consolidation raises serious issues, including further reduction in nonstop and connect service along the lines as described above. While this hearing is not explicitly about mergers not yet announced, it is important to keep in mind that such mergers are likely.

Follow-on mergers raise other concerns not previously addressed in this statement. For example, a merger between Continental and United in a number of markets may potentially reduce alliance competition.

It is important that the Department of Justice and anyone wanting to understand antitrust law understand the plans and motivations for follow-on mergers. Follow-on mergers in times of industry distress (perceived or actual) are almost inevitable. Such an understanding is particularly important where the industry in question is a network industry such as airlines, where firms not only compete head to head on a nonstop basis, but where the systems as a whole serve the basis of competition. I offer an axiom and a question: The more systems serving the nation, the greater the number of choices for the traveling public. If six systems is not giving us very good service, will four likely improve the situation?

## WHAT ARE THE BENEFITS OF THE MERGER?

Proponents of the merger might suggest that efficiencies related to the transaction counsel in favor of approving the transaction. Benefits that potentially could be discussed include: 1. Rationalization of aircraft utilization between the combined companies; 2. Reduction in duplicative management and personnel; and 3. Enhancement of "presence" on a system basis. Before addressing each of these "efficiencies," it is important to understand the nature of antitrust efficiencies in merger cases. As the Department of Justice/ Federal Trade Commission Horizontal Merger Guidelines wisely state,

The Agency will consider only those efficiencies likely to be accomplished with the proposed merger and unlikely to be accomplished in the absence of either the proposed merger or another means having comparable anticompetitive effects. These are termed merger-specific efficiencies. Only alternatives that are practical in the business situation faced by the merging firms will be considered in making this determination; the Agency will not insist upon a less restrictive alternative that is merely theoretical.

Moreover, merger specific efficiencies do not arise from anticompetitive reductions in output or service, are cognizeable, and do not arise from anticompetitive reductions in output or service. If the efficiencies "likely would be sufficient to reverse the merger's potential to harm consumers in the relevant market, e.g., by preventing price increases in that market," there are relevant for purposes of determining the net effect of the transaction. However, "the Agency will not simply compare the magnitude of the cognizable efficiencies with the magnitude of the likely harm to competition absent the efficiencies."

This recitation of the Horizontal Merger Guidelines is important because it has recently been the case in much of antitrust law that efficiencies have been a trump card, allowing transactions to proceed and anticompetitive conduct to continue even where efficiencies are speculative at best. It should not be the case that given the serious potential for anticompetitive harm in these markets that the purported efficiencies are taken at face value. Any purported efficiencies should meet the requirement that they are cognizeable, verifiable, merger-specific, and not obtainable by any other means.

The first potential efficiency arises from the potential rationalization of the Northwest and Delta fleets. It might be argued that the nature of Delta and Northwest's aircraft size are different, with Delta having more mid-range capacity and NW having low and large capacity aircraft. With

complementary fleets, the merged firm could "right-size" aircraft on routes, allowing the proper capacity to meet demand.

More questions must be asked concerning this proposed efficiency. Have the airlines been buying the wrong size of equipment such that they have been mismanaging capacity on their routes? Is it not possible for the airline companies to rationalize their fleets absent the merger? In which routes are capacity mismatched with demand? With respect to the last question, one might argue that the greatest benefits might arise from international route capacity rationalization. However such an efficiency gain does not cure a loss of competition in United States nonstop and connect markets.

A second potential efficiency arises from airline industry specific phenomenon. It could be argued that network airlines are trying to reach optimum scope or "presence" not yet achieved in their already enormous size: Having more cities to serve (increased presence) allows them to broaden their network in any given market so they can provide more of what is highly valued by business travelers. I suppose the argument suggests both a gain in terms of presence within particular routes and over the system as a whole.

The problem with this assertion is manifold. First, to the extent that such a presence seeks to attract greater levels of business traffic (the purpose of presence typically), it begs the question as to why that is such a good strategy given the changing nature of the traveling public. To the extent that leisure passengers are a growing segment of the traveling public and to the extent that they are not as schedule sensitive, one could argue that a presence focus is not a wise management strategy. That is not necessarily a discussion for today, as antitrust law does not purport to second guess management decisions unless those decisions have as their foundation anticompetitive purpose or effect. Second, it is not entirely clear how this strategy translates to any efficiencies or cost savings, apart from the fleet rationalization argument described above. In short, the efficiency argument here requires greater specificity. It currently at best is illusory and ephemeral.

But the real concern is that the presence relates to the dominance of the combined entity post merger. With a reduction in network carrier competition, the only competitors capable of mitigating potential monopoly power on particular city-pair routes are low costs carriers. The problem is that the very "efficiencies" described by this theory are in fact serious barriers to entry for any non-network competitor. In other words, that which purportedly makes the airlines stronger only kills competitors, and thus are not efficiencies in the Department of Justice/Federal Trade Commission Horizontal Merger Guidelines sense of the term.

Thus, as with all mergers, unless more concrete and tangible information is provided, the only realistic efficiency is the reduction in management and staff. The problem is that there is a rich history of airline mergers. There is little history of, in spite of these transactions in the past, the airline industry getting better. The default position for the government, therefore, should be that efficiencies must be proven, not merely asserted.

WHAT IS THE REAL REASON FOR THIS MERGER?

While I do not have an inside understanding of the Northwest or Delta management, allow me to compare mergers with marriages. People tend to get married for a variety of reasons. Many times, these reasons are bad. Often times, people do not want to be alone during the difficult times of their lives. I believe the airlines are similarly seeking to enter bad marriages out of fear and as a knee jerk reaction to increased difficulty.

It is difficult to see how two dysfunctional organizations combined make a better airline. In fact, in announcing their proposed merger, Delta and Northwest emphasized that no airport hubs would be closed and no compulsory pink slips would be issued. In other words, it would be "business as usual," albeit in a much-larger combined company. Business as usual has not been working, and it should not be incumbent upon the airline passenger to subsidize a potentially anticompetitive merger because a dominant carrier has the ability to extract dollars from the wallets of consumers.

The fear of the major carriers is understandable. Fuel costs are higher than ever, and a recession appears looming close by. However, it should not be the case that those factors are relevant to any antitrust analysis. These firms are not failing in any sense of the term, except perhaps failing to understand the nature of their own markets such that they continue to look towards consolidation as the answer to every challenge.

CONCLUSION

For many years now I have been greatly concerned about the role of antitrust laws in deregulated industries. It is not a lack of faith in my former colleagues at the staff level at the Department of Justice, as they are hard-working and dedicated public servants. Rather, my concern is about the role of antitrust in general, particularly where there are serious high-stakes mergers coming to the forefront, particularly in the airline industry.

First, antitrust law should take into account not only the obvious anticompetitive harms associated with a merger. In the case of airlines, nonstop competition is the obvious relevant analysis. However, other forms of competition are important in the airline industry, a fact that the Department of Justice attempted to teach us in its United/U.S. Airways press release. Other important factors include connect competition, alliance competition, competition for business contracts, and the overall level of concentration in particular origins and destinations. It is my hope that the Department of Justice is as thorough in its analysis of the Northwest/Delta merger as it was in that case.

The problem is that in recent times efficiencies analysis have become the end of the analysis. When efficiencies, real or imagined are present, it appears from recent antitrust lore, including some recent Department of Justice decisions, that antitrust should ignore the competitive issues underlying any transaction. That is not what antitrust law is about, it is not what the Horizontal Merger Guidelines teach us, and it is certainly not the way to run a competition policy. Efficiencies, even if proven, must mitigate anticompetitive harms caused in the relevant market due to the transaction's consummation.

This body can use the Northwest/Delta transaction to examine these issues and restore antitrust law to its rightful place as the magna carta of free enterprise. It can also use this merge to ask the

harder questions as to the nature of antitrust analysis, even as such analysis has been eroded partly by certain recent Department of Justice investigations, but also by recent Supreme Court decisions.

1. The term "deregulation" is a bit of a misnomer. See Harry First, Regulated Deregulation: The New York Experience in Electric Utility Deregulation, 33 LOY. U. CHI. L. J. 911 (2002)(noting that New York's electricity market was not deregulated, but in fact replaced "one regulatory system with another.").

2. 15 U.S.C. § 18.

3. U.S. Dep't of Justice & FTC, Horizontal Merger Guidelines (1992), available at http://www.usdoj.gov/atr/public/guidelines/hmg.htm.

4. Id.

5. http://www.usdoj.gov/atr/public/press_releases/2001/8701.htm.

6. Id.

7. See Darren Bush and Salvatore Mass, Rethinking the Potential Competition Doctrine, with Salvatore Massa, 2004 WIS. L. REV. 1035.

8. Id.

9. Horizontal Merger Guidelines, Section 4.

10. Id.

11. Id.

12. Id.

13. United States v. Topco Assoc., 405 U.S. 596, 610 (1972).

14. See, e.g, Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co., 127 S. Ct. 1069 (2007); Bell Atl. Corp. v. Twombly, 127 S. Ct. 1955 (2007); Credit Suisse Secs. (USA) LLC v. Billing, 127 S. Ct. 2383 (2007); Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 127 S. Ct. 2705 (2007); Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398 (2004)..