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"The United/Continental Merger: How Will Consumers Fare?"

BEFORE
THE SENATE JUDICIARY COMMITTEE
SUBCOMMITTEE ON ANTITRUST, COMPETITION POLICY AND CONSUMER RIGHTS

SUPPLEMENTAL QUESTIONS AND ANSWERS

1. United and Continental argue that there is very little "overlap" between the two airlines – that is, they compete on very few routes. Is this true? Are there any markets where the Justice Department should order divestitures as a condition of the merger?

No, it is not true that there is very little overlap between the two airlines. While the airlines are arguing that they only compete on a non-stop airport-pair basis—and therefore there is minimal overlap—in fact airlines compete on numerous other bases.

First, the importance of competition in these "few" airport-pair markets should not be denigrated. These overlaps are typically hub to hub overlaps as well as other business markets. Substantial consumer harm can occur even in this "small" area of overlap.

Second, airlines compete on network and connection bases, not just airport-pair connections. As I stated in my written testimony, 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 or the hubs of Northwest/Delta. In other words, after the merger of Northwest and Delta, consumers in the Midwest may face increasingly limited choices—mainly between Northwest/Delta and United/Continental in terms of connecting from the Midwest heading eastbound. These two entities would have hubs at O'Hare, Cleveland, Cincinnati, Minneapolis/St. Paul, Memphis and Detroit.

The potential injury to connection markets is also potentially true on the eastern seaboard, where reasonable connections up and down the east coast are potentially reduced to three airlines (U.S. Airways out of Charlotte and Philadelphia, United/Continental out of Newark and Dulles, and Delta/Northwest out of New York). If one were to place an overlay of the Continental system with that of the United system, one would discover there is a tremendous degree of competitive overlap, with few choices for consumers in the Midwest and along the east coast.

* The views expressed herein do not purport to reflect the views of the University of Houston.

Third, there are at least some markets where the companies do not overlap, but could. This is called in antitrust parlance "potential competition." One example might be Los Angeles – Houston, where United might have provided nonstop service. The threat of that potential nonstop service may in some cases be sufficient to provide a competitive response on the route even though United is currently not providing the service. In addition, there are numerous potential competition opportunities in connection markets. Therefore, there is numerous potential for overlap between the two carriers.

Fourth, the merging parties could leverage monopoly power to foreclose competitors from obtaining vital services upstream or downstream.

Finally, there are few competitors who could compete with the large network carriers in terms of corporate contracts. United and Continental may compete vigorously with each other for these contracts, particularly when the corporation requires significant travel on nonstop routes where the companies compete. Moreover, the sheer size of the combined system may make it more difficult for smaller carriers to compete for those contracts

2. After the merger United and Continental will operate a total of eight hubs in the continental United States. Some industry observers believe that this is too many full-fledged hubs for the combined airline, and fear that it is inevitable that some will be closed or downsized once the merger is completed. Continental's Cleveland hub is thought by many to be in jeopardy, being relatively close to United's hub at Chicago. Do you think some hub cities will be eliminated or significantly reduced in scope after this merger? If so, which ones?

If one takes as the guidepost the Northwest/Delta merger and the American/TWA merger, one would expect that Continental's Cleveland hub would be substantially reduced to a "focus city" or perhaps reduced even further.[1]

The hint that Cleveland is in jeopardy can be taken from the testimony of the United and Continental CEOs. The companies claim in their press release that the merger will create $800 to $900 million in incremental annual revenues. The CEOs claimed that this will occur without necessarily causing an increase in revenues all the while attracting greater numbers of business travelers. I have testified that this is highly improbable absent fare increases, reductions in capacity, the elimination of lower-priced fare buckets, and the substantial reduction or elimination of the Cleveland hub.

Nonetheless, taking the CEOs at their word, we can foresee the probably future of Cleveland. The CEOs have suggested that they are seeking to target a greater share of business passengers via an increased presence globally. If that is true, then the focus of the merged company has to be the larger business destinations, of which Cleveland is not one. Instead, other hubs destinations fare better under the merger as larger business

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[1] According to the Congressional Research Service, Airline Industry Mergers: Issues of Congressional Interest,June 9, 2010, at 6, Delta has already reduced the role of Cincinnati, where domestic emplaned passengers dropped by more than 50%, from 10.3 million in 2005 to 5 million in 2009

destinations. If the CEOs are right and they are able to miraculously cull $800-$900 million from increased business traffic, one would expect greater presence and capacity on business routes out of Chicago, San Francisco, Los Angeles, Houston, and Newark.

3. I am very concerned about air service to smaller markets outside the large hubs, such as many smaller communities in Wisconsin and the upper Midwest. How might this merger, or future airline consolidation, affect air service to smaller communities? And even if these communities have air service, will passengers have any choice of carriers?

As I stated in my supplemental answers to my testimony in the Northwest/Delta merger, the ability of smaller and midsized communities to attract air passenger service is complicated. It is a function of the amount of traffic the market will bear. In many instances, such communities face only one option with respect to air passenger service. In those instances, customers must elect to fly and pay the monopoly price or drive.

With respect to those communities already served by major carriers, a major issue with respect to the United/Continental merger is whether the combined firm will operate the bulk of hubs providing connecting service between cities in the Midwest and the Eastern United States. In many instances in the Midwest, and particularly in Wisconsin, 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.[2] Thus, many communities will be limited to one or two choices, either United/Continental or Northwest/Delta. These airlines would have a lock on reasonable connection opportunities. Communities served predominantly or exclusively by the combined firms may find themselves faced with a reduction in service and increased fares.

Increased airline consolidation can only worsen the plight of smaller communities, as the choices for connection service become increasingly reduced. As stated in my written testimony, this is very much a concern in Midwest markets currently served by both Delta and Northwest.

4. Some airline industry critics argue that mergers such as United/Continental and Delta/Northwest make it very hard for smaller carriers to compete, especially for business customers. Among other things, they point out that the smaller carriers do not have extensive international route networks which therefore renders their frequent flyer programs less valuable. They also allege that large, networked carriers can use revenues from their lucrative international routes to "cross-subsidize" domestic routes. Revenue from international routes can be used to subsidize low fares on selected domestic routes in order to defeat smaller competitors.

[2] 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.

What is your view of these arguments? Do mergers of large, networked carriers make it hard for small carriers to compete?

All of the arguments described are precisely correct. Large network carriers are able to fend off low cost carriers for numerous reasons. First, as I stated in my written testimony, the empirical evidence suggests that low cost carriers (LCCs) will be unable to offer competitive products on many of the routes that would be subject to reduced competition and reductions in service due to the merger. First, LCCs typically avoid smaller markets because they typically lack the hub structure to feed traffic efficiently from smaller cities. Smaller cities simply are usually unprofitable for LCCs.

Second, the economics of LCCs makes it difficult for them to enter congested airports, typically choosing close-in substitute airports (e.g., choosing to operate out of Baltimore rather than Reagan-National). On high density routes at these congested airports, the proposed merger creates the most egregious increases in concentration, making entry on a viable scale by LCCs that do not currently operate in those markets even less probable (and less attractive). Because airlines with the greatest frequency receive a disproportionately greater share of traffic on any route, the merger makes it more difficult to achieve profitability.

Moreover and most importantly, any LCC entering a coveted premium business market would likely face predatory pricing and predatory capacity additions are well-recognized phenomena within the airline industry. Much academic literature[3] and many court cases have discussed the issue. Unfortunately, the courts have taken the position, without examination of any facts, that predatory pricing simply cannot take place in the airline industry because the incumbent carrier engaging in predatory behavior cannot recoup the losses incurred in engaging in the strategy.[4]

The basis of a predatory capacity and pricing attack lies within the system presence of the dominant carrier. The low cost carrier entrant predicts some response by the incumbent carrier. As the low cost carrier offers seats at lower prices, the incumbent carrier may offer a limited matching of the low cost carrier's fares in order to prevent its customers from switching. However, the incumbent is unlikely to match fully on all the entrant

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[3] For a small sampling of the literature, see, e.g., Robert G. Berger & Stephanie J. Mitchell, *Predatory Pricing in the Airline Industry: A Case Study--The Policies and Practices of the CAB*, 13 TRANSP. L.J. 287 (1984); Mark T. Clouatre, *The Legacy of Continental Airlines v. American Airlines: A Re-Evaluation of Predatory Pricing Theory in the Airline Industry*, 60 J. AIR L. & COM. 869 (1995); Einer Elhauge, *Why Above-Cost Price Cuts to Drive Out Entrants Are Not Predatory--and the Implications for Defining Costs and Market Power*, 112 YALE L.J. 681 (2003); Russell A. Klingaman, *Predatory Pricing and Other Exclusionary Conduct in the Airline Industry: Is Antitrust Law the Solution?*, 4 DEPAUL BUS. L.J. 281 (1992). For an innovative solution to predatory pricing, see Patrick Bolton, Joseph F. Brodley & Michael H. Riordan, *Predatory Pricing: Strategic Theory and Legal Policy*, 88 GEO. L.J. 2239 (2000). The U.S. Department of Transportation had proposed guidelines to regulate such practices, Enforcement Policy Regarding Unfair Exclusionary Conduct in the Air Transportation Industry, 63 FED. REG. 17,919 (Apr. 10, 1998), but these guidelines were never adopted.

[4] For a rare exception, see Spirit Airlines, Inc. v. N.W. Airlines, Inc., 431 F.3d 917 (6th Cir. 2005).

carrier's fares, because the incumbent relies upon higher fare customers to retain profitability. Still, some if not many of the higher-fare customers may opt to purchase lower fare tickets on the entrant carrier. The incumbent carrier seeks to prevent this using the limited matching strategy discussed above. Thus, a low cost carrier seeking to enter an incumbent's route expects to be matched on a limited basis.

The difficulty in an incumbent's response occurs when the incumbent offers increased capacity on the route. By increasing the supply of lower fare tickets, the incumbent may keep customers on board the incumbent's planes, sacrificing the profit that could have been achieved by utilizing those planes in a more profitable route (i.e., a route lacking in competition where passengers would experience higher fares). The benefit of this strategy is that it could cause the low cost carrier's passenger base to drop below break even load factors, making the route unprofitable for the low cost carrier. Once the low cost carrier withdraws from the route, the incumbent carrier reduces capacity by either decreasing the number of flights, the size of the aircraft on that route, or both, while raising fares.

The greater the system presence of the network carrier, the more difficult it is for the low cost carrier to attract passengers, even with the offering of lower fares. First, the low cost carrier may not be able to obtain business passengers associated with any corporate contract any company has with the incumbent carrier. Second, the use of frequent flier programs helps the incumbent carrier retain passengers who would sacrifice program benefits if they switched to a low cost carrier. Travel agents, to the extent they are used, may also receive benefits from keeping passengers on the dominant carrier in the form of higher commissions on booked travel. As the size of the incumbent carrier's network grows, so too do the disadvantages associated with passengers switching to low cost carriers.

Moreover, the greater the system presence, the greater the ability of the incumbent to respond without much sacrifice. It is a well-known network phenomenon in the airline industry that the dominant carrier on any route, or in any city origin, receives a disproportionate share of the traffic. In other words, increased network size can be an entry barrier to competition in any nonstop market. It can prevent low cost carriers from entering routes. The threat of a predatory campaign by the incumbent may also deter competition from low cost carriers.

Low cost carriers lack any serious recourse under the antitrust laws.[5] Any monopolization case involving the expansion of capacity and reduction of fares by a dominant carrier is quickly cast into a "predatory pricing" case. In that pigeon-hole of antitrust, plaintiff almost always loses.[6]

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[5] In at least one instance, legislation created a barrier to competition that allowed the perpetuation of monopoly power by a dominant carrier. *See* Shubha Ghosh and Darren Bush, *Predatory Conduct and Predatory Legislation: Exclusionary Tactics in Airline Markets,* 45 HOUSTON L. REV.293 (2008).

[6] The case law is replete with allegations suggesting that the major airlines have engaged in predatory conduct against entrants. See, e.g., Int'l Travel Arrangers v. NWA, Inc., 991 F.2d 1389, 1394 (8th Cir. 1993); Pac. Express, Inc. v. United Airlines, Inc., 959 F.2d 814, 815 (9th Cir. 1992); Cont'l Airlines, Inc. v. Am. Airlines, Inc., 824 F. Supp. 689, 692-93 (S.D. Tex. 1993); In re Passenger Computer Reservations Sys.

5. How likely do you believe further airline mergers are in the next few years? And do you believe that the Justice Department should analyze this merger on its own, or in light of other airline mergers likely to come in the future?

The difficulty in analyzing whether or not a merger will tend to lessen competition is that the question is typically answered in light of an existing competitive landscape. Within that landscape, government investigators seek to determine whether or not the combined company could exercise monopoly power. While a merger may increase the incentive of other firms in the marketplace to combine, further consolidating the industry and enhancing monopoly power within that industry, it is difficult for antitrust agencies to consider the potential for future consolidation unless specific deals are announced.

For that reason, follow-on mergers typically occur rapidly after an initial proposed consolidation. Otherwise, follow-on deals would likely be examined under a completely different market analysis than the initial merger, as the initial merger will have caused the market dynamics to change, decreasing competition.[7] Thus, savvy industry executives know that it behooves them to propose deals at the heels of any initial proposed merger.

As I stated in my written testimony, 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. There is little time to discern how effective the initial proposed merger will be. Thus, if the initial merger is efficient, it might have the effect of promoting further efficiencies within the industry. On the other hand, an anticompetitive merger may likely incite others to engage in defensive strategies to offset the monopoly power of the initial merging parties, further consolidating the industry.

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.

The difficulty is that the Department of Justice *cannot* address the issue of follow-on mergers in a vacuum. If they are not proposed or announced, speculation is unlikely to prove fruitful, and certainly cannot serve as the basis of a challenge to any transaction under Section 7 of the Clayton Act. Thus, the most credible line of investigation, absent

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Antitrust Litig., 694 F. Supp. 1443, 1451 (C.D. Cal. 1988), aff'd sub nom. Alaska Airlines, Inc. v. United Airlines, Inc., 948 F.2d 536 (9th Cir. 1991); Brian Clewer, Inc. v. Pan Am. World Airways, Inc., 674 F. Supp. 782, 784, 788 (C.D. Cal. 1986) (granting defendants' motion to dismiss plaintiff's claims that defendant airlines priced their tickets to drive a competitor affiliated with plaintiff out of business).

[7] For example, upon consummation of a merger, the market's "HHI", a measure of how concentrated a market is, will increase. Thus, a follow on merger announced after consummation of the initial merger will be examined in light of a more concentrated market, which may cause the enforcement agencies to challenge the follow-on merger even where the agencies did not challenge the initial merger.

another announced transaction, is to examine the effects of the proposed transaction under the existing competitive landscape.