Before the
Committee on the Judiciary
United States Senate

"The Southwest/AirTran Merger and its Impact on M-7 Businesses, Consumers and the Local Economy"

Testimony of Diana L. Moss
Vice President and Director, American Antitrust Institute

February 25, 2011, 10:15 am
Waukesha County Technical College
Pewaukee, Wisconsin

I. Introduction

I would like to thank Presiding Member Senator Kohl, Chairman Senator Leahy, Ranking Member Senator Grassley, and the members of Senate Committee on the Judiciary for holding this hearing on the first major merger of low cost carriers (LCCs) in the U.S. airline industry. 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 in large part on a White Paper issued on December 24, 2010 by the AAI: "Airline Mergers at a Crossroads: Southwest Airlines and AirTran Airways." The White Paper is available on the AAI website.[2] That analysis takes up a number of questions regarding the competitive issues raised by the proposed merger of

---

[1] For more information on the American Antitrust Institute, please visit www.antitrustinstitute.org.

[2] Diana L. Moss, "Airline Mergers at a Crossroads: Southwest Airlines and AirTran Airways." American Antitrust Institute (December 24, 2010). Available http://www.antitrustinstitute.org/sites/default/files/SouthwestAirTran%20White%20Paper.pdf.

Southwest and AirTran. My testimony argues – without drawing any conclusions about the legality of the proposed transaction – that these questions deserve consideration in an antitrust review.

II. Summary of Major Points

The role of the LCCs in the domestic airline industry is an important one. LCCs have brought benefits to consumers in the form of lower prices, increased choice through penetration of markets dominated by legacy airlines, and innovative business models and service offerings. Arguably, LCCs have challenged their legacy counterparts to become more efficient and competitive. But significant merger activity among the legacy airlines such as Delta/Northwest and United/Continental, executed largely for the purpose of bulking up to become global competitors, has fundamentally changed the U.S. industry.

An antitrust challenge of the Southwest/AirTran deal could be viewed as punishing two very effective LCCs – Southwest and AirTran – for having played their role so well, whereas their larger legacy competitors were allowed to gain the benefits of merger in part because they had not done better individually. However, the first major merger of LCCs in the U.S. airline industry raises questions that may not have arisen in past mergers of legacy airlines reviewed by the U.S. Department of Justice (DOJ).

First, how will the merger potentially change Southwest's and AirTran's price discounting and entry strategies? Second, how will the merger affect short-run output decisions and longer-run capacity decisions at cities or airports where both Southwest and AirTran offer service? Third, will combining the Southwest and AirTran networks produce a result that looks and acts more like a legacy hub-and-spoke model than the hybrid and point-to-point systems maintained by each LCC independently? What are the implications for competition if this occurs? Fourth, how will the proposed merger affect competition and

consumers at Milwaukee, where both AirTran and Southwest have a significant presence? Before addressing these questions, however, it is useful to summarize the results of the standard origin-destination pair analysis that is likely to be the basis for an antitrust analysis of the proposed merger.

III. Origin-Destination Pair Analysis of the Proposed Merger

Evaluating the city-pair and/or airport-pairs affected by the Southwest/AirTran merger is fairly stock analysis. We do not offer an in-depth assessment, other than to report that the 18 airport-pairs *most* affected by the merger (i.e., where the merger will eliminate one of the merging carriers) originate either at Baltimore-Washington or Orlando. At Baltimore-Washington, for example, AirTran and Southwest will have a post-merger market share of just over 60 percent. At Orlando, that share will be almost 40 percent.[3]

In six of the 18 airport-pair markets, the merger would produce a monopoly.[4] In six airport-pair markets, post-merger concentration would be in excess of 9,000 HHI. In the remaining six markets, post-merger concentration is between 5,000 and 9,000 HHI. Pre- to post-merger changes in concentration in the 18 airport-pair markets are in the range of almost 1,000 to almost 5,000 HHI.[5] These levels exceed the thresholds for potential danger specified in the recently revised Department of Justice/Federal Trade Commission Horizontal Merger Guidelines. If other airports in the Baltimore-Washington D.C. area (e.g., Washington Dulles and Reagan National) are considered by consumers to be good substitutes for Baltimore-Washington, then the concentration statistics cited above could be lower.

---

[3] *Id.*, at 8. Market shares are based on total passengers enplaned by all types of carriers (legacies and LCCs).

[4] Market shares are based on passenger-miles flown by all types of carriers (legacies and LCCs).

[5] *Supra* note 2, at 8.

Under the foregoing circumstances, how would the proposed merger fare in a DOJ merger review? The answer may be informed by public closing statements issued by the DOJ in recent airline merger investigations. Obviously, while not all the information and analysis that goes into a merger investigation is revealed in closing statements, they do highlight a number of apparent themes. For example, the agency appears to put significant weight on claimed efficiencies from combining airline operations. Concerns over eliminating competition on overlap routes appear to be tempered if the number of routes is small, there is rivalry from LCCs and legacies on some of those routes, and entry is relatively easy at adversely affected airports. Nonetheless, the DOJ has required gate and slot divestitures in some cases.

A number of important factors that might inform the DOJ's analysis of the proposed merger, however, might not get significant weight in a standard city-pair and/or airport-pair analysis. The next section briefly summarizes those factors, which are described in detail in the AAI White Paper.

IV. Effect of the Merger on Price Discounting, Entry, Capacity, and Network Structure

A. Price Discounting and Entry

Relative to Southwest, AirTran appears to be a particularly aggressive discounter and market entrant. The merger could eliminate this source of competitive discipline. This observation is derived from an analysis of Department of Transportation fare data produced for the top 1,000 city-pair routes. Statistics on high fare and low fare carriers reveal a number of important features of competition between LCCs and legacies, between LCCs, and between Southwest and AirTran. As expected, we see that when LCCs are the low fare carrier on a route, they offer the deepest discounts off the high fare. And when LCCs compete against each other as the high fare and low fare carriers on a route, they produce the

lowest observed average fares.[6] These observations confirm the important role played by LCCs in the domestic industry.

The pricing data also reveals that AirTran's discounts are some of the deepest in the industry; in fact, higher than Southwest's, which has been considered the industry "maverick" for many years. Southwest's average discount as a low fare carrier on the top 1,000 city-pair routes is 12 percent off the high fare, while AirTran's average discount is 21 percent (the remaining LCCs' discounts are 20 to 26 percent). When the merging LCCs compete as the high fare and low fare carriers on a route, AirTran's discounts are 14 percent off the high fare. But when Southwest is the low fare carrier, its discounts are only 4 percent off the high fare.[7]

Thus, while Southwest and AirTran are probably each other's closest competitors (along with the other LCCs) relative to the legacy airlines, the two LCCs exhibit very different discounting behavior. How this discounting behavior might change as a result of the merger may not be captured by standard market share and concentration analysis. As one analyst summarized: "[T]aking AirTran, a particularly aggressive discounter, out of the mix will make matters worse, permitting Southwest to raise its prices and eroding whatever pricing discipline the low-cost carriers still exert over the legacy airlines."[8]

A brief analysis of Southwest's and AirTran's very different entry patterns also reveals important information. AirTran has pursued a far more aggressive expansion strategy than Southwest over the last five years. For example, AirTran's entry rate in markets where Southwest also offered service is about twice as high as the rate at which Southwest

---

[6] *Id.*, at 4.

[7] *Id.*, at 15.

[8] "Opposing View on Airline Mergers: A Bad Deal for Fliers," *USA Today* (Sep. 29, 2010), http://www.usatoday.com/news/opinion/editorials/2010-09-29-editorial29_ST1_N.htm.

attempted entry in markets where AirTran offered service. In markets where the rival airline does *not* offer service, AirTran has attempted entry with more than eight times the frequency than has Southwest.[9]

The reason for AirTran's maverick-like behavior on the entry front may be obvious, namely that Southwest – with a larger market presence – may be reaching saturation levels in terms of the airports it can serve using its hybrid system. This likely reflects the fact that Southwest, which is far larger and more mature than AirTran, has experienced nearly as much organic growth as possible. Merger may be the only way to extend this growth platform while AirTran may still be in expansion mode.

The evidence on entry may indicate a number of things. First, if entry is important in an antitrust analysis, then AirTran's experience may well indicate that entry is relatively "easy" for a similarly situated carrier. That is, other LCCs might be able to enter in a timely, likely, and sufficient manner so as to discipline any adverse price effects (e.g., price increases or less aggressive discounts) by a merged Southwest/AirTran. At the same time, however, with an aggressive AirTran out of the mix, entry that is effective enough to discipline post-merger competition must be accomplished by a much diminished set of players. Those players are likely to be the remaining LCCs. But the best markets for LCC entry will already have been entered by Southwest and AirTran which, when merged, will be a more formidable competitor for an entrant.

In sum, combining the new maverick, AirTran, with Southwest could change incentives for the merged company to discount and to enter new markets to serve U.S. consumers. The pro-competitive behavior by each firm independently has brought benefits to consumers over the years. With the ranks of the LCCs reduced through a Southwest/AirTran merger, effective the rivalry offered by the remaining LCCs may be relatively limited.

---

[9] *Supra* note 2, at 18.

B. The Potential for Post-Merger Output and Capacity Restrictions

Post-merger output restrictions and/or capacity reductions are demonstrated effects of airline mergers that have been largely overlooked in antitrust reviews. Hub cutbacks and closures raise local economic concerns such as job loss and weakening of the service sector that surrounds an airport and may undermine the economic viability of a city. The competition policy focus, however, is not on urban welfare generally but on the loss of choice for consumers in smaller communities who rely on hubs. The U.S. Midwest is particularly rich in consumers who rely on service, for example, at cities like Cincinnati, Milwaukee, Memphis, Cleveland, and Detroit to connect to other destinations. Fewer flights, higher fares, loss of choice, and discontinuation of nonstop service that forces consumers to use less convenient connecting service or travel longer distances to other airports represent cognizable, potential adverse effects of a merger.

There is evidence that capacity cutbacks are a real post-merger risk. For example, there have been significant reductions in flight frequencies following airline mergers. These include cutbacks at Lambert-St. Louis airport following the merger of American and TWA in 2001, Las Vegas McCarran airport following the merger of U.S. Airways and America West in 2005, and at Cincinnati following the merger of Delta and Northwest in 2009-2010. Anticipating the same fate in the wake of United/Continental, Ohio's Attorney General successfully obtained a commitment from the parties to maintain service at Cleveland's Hopkins airport.[10]

Mergers of LCCs should be no exception to a rigorous examination of the potential for post-merger output and capacity reductions. This is particularly true if the merger

[10] *Id.*, at 20.

eliminates competition on routes and the carriers are likely to be particularly adept at managing capacity – as a combined Southwest and AirTran might well be.

C. Effect of the Merger on the Combined Network

Legacy airlines such as United/Continental and Delta/Northwest operate hub-and-spoke networks, whereby traffic is routed through central hubs to the ultimate destination, which is often a smaller, behind-the-hub community. Many LCCs operate point-to-point networks, characterized by short- to medium-haul flights that are not routed through a central hub. Among other features, point-to-point networks create fewer congestion costs associated with the maintenance of hubs. Southwest's network is considered a "hybrid," displaying characteristics of both the point-to-point and hub-and-spoke systems. Combining the Southwest and AirTran networks will result in two changes. First, the network will contain a number of airports (e.g., Baltimore, Milwaukee) where the combined airline will offer a high volume of service. Second, the combined network will contain more cities where the airlines maintain sizeable ground operations.

Such a combined network could stretch the limits of Southwest's and AirTran's efficient point-to-point and hybrid systems. Without trimming capacity and eliminating redundancies where both of the merging LCCs maintain operations, the combined airline's costs could be affected by changes in network structure and configuration. Those costs include, for example, maintaining larger operations at particular airports or increased congestion associated with the bunching of flights at airports. If costs increase, the combined company may be less able to inject competitive discipline through lower fares, more choice, and entry and expansion than each LCC alone has brought to the industry.

V. Focus on Possible Effects of the Merger in Milwaukee

Since this hearing is being held in Milwaukee, it is useful to consider some of the possible effects of the merger locally. As noted above, one of the often overlooked effects of

airline mergers is post-merger capacity cutbacks on overlap routes, or routes where the two merging airlines both offer service. Milwaukee's General Mitchell (MKE) airport is such a location. Even a brief analysis reveals how important LCCs are at MKE. For example, there are about 130 nonstop segments that originate or terminate at MKE. On those segments, LCCs account for 60 percent of total passenger miles. AirTran's share is about 40 percent and Southwest's is almost 10 percent, for a total share for the merged company of almost 50 percent.[11]

Some of the routes affected by the proposed merger are quite important. For example, 19 nonstop and connecting service routes originating or terminating at MKE make the Department of Transportation's top 1,000 city-pair rankings. Southwest and AirTran compete on almost 80 percent of the routes originating or terminating at MKE. Moreover, they are the low fare carriers on about 75 percent of these routes, accounting for about 55 percent of total passenger-miles.[12] These statistics illustrate the need to consider the merger's effect on Milwaukee, for several reasons.

First, passengers originating or terminating in MKE are clearly dependent on the LCCs for service. The competitive discipline injected by LCCs at MKE may be one reason why consumers traveling to and from this city have seen, incredibly, decreases in air fares based on the Airline Travel Price Index since 1995 (i.e., about -2.5 percent).[13] In light of the

---

[11] Statistics derived from "Air Carriers: T-100 Domestic Segment (U.S. Carriers)," Research and Innovation Technology Administration, Bureau of Transportation Statistics, http://www.transtats.bts.gov/DL_SelectFields.asp?Table_ID=259&DB_Short_Name=Air%20Carriers.

[12] "Domestic Airline Fares Consumer Report," Table 1 (2nd Qtr 2010), Office of Aviation Analysis, U.S. Department of Transportation, http://ostpxweb.dot.gov/aviation/X-50%20Role_files/consumerairfarereport.htm.

[13] The national change in the Airline Travel Price Index since 1995 is about 17 percent. See "Table 11: Top 85 Markets Ranked by Percent Change from 1995," Research and Innovative Technology Administration, Bureau of Transportation Statistics, http://www.bts.gov/programs/economics_and_finance/air_travel_price_index/html/table_11.html.

importance of LCCs at MKE, it is worth examining how the merger could change the competitive dynamics of rivalry.

Second, passengers traveling to and from MKE are dependent on Southwest and AirTran, in particular, for service. These two airlines have a significant presence on flights originating and terminating at MKE and they are head-to-head competitors on important, heavily-traveled routes. In light of the fact that AirTran has the larger share at MKE where it exhibits its characteristic aggressive discounting, it is also worth asking how the merger might change the price dynamics if AirTran is eliminated through the merger with Southwest, which is a less aggressive discounter. The merged airline will be in price competition against legacy carriers, but no longer against each other. While they may continue to be the low fare operator, their fares could edge closer to legacy fares and their influence on legacies' pricing could diminish.

Consumers undoubtedly have benefited from competition at MKE in terms of low fares, a variety of airlines to choose from, and the convenience of having flight frequencies and availability of nonstop and connecting service. It is an important competition policy goal to connect the vast swath of the population in the American Midwest that lives in smaller communities and in mid-size cities with the rest of the country.

Thank you for this opportunity to testify. I again refer you to the AAI's White Paper for a more detailed discussion.