Follow-up Questions of Senator Klobuchar
Subcommittee on Antitrust Hearing on
"The American Airlines/US Airways Merger: Consolidation, Competition, and Consumers"

<u>For Dr. Diana Moss</u>

1. According to a USA Today report on February 22, 2013, there were seven major price increases in 2012. More recently, only five days after American and US Air announced their proposed merger, Delta announced price increases which were immediately followed by American, US Air and United; and a day later by Southwest. The new price increases, $4 to $10 for tickets purchased within seven days of domestic travel, mostly apply to tickets popular with busy business travelers. Will increased consolidation make it easier for airlines to tacitly coordinate price increases like that?

2. At the hearing, Mr. Parker said that barriers to entry into the airline industry are low, but that entrepreneurs weren't entering the market because it is so fiercely competitive. What's your response? How would the DOJ interpret that in its antitrust analysis?

3. Do you believe that the DOJ should look beyond simply overlapping non-stop routes as part of their antitrust analysis?

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The AAI believes that consolidation in the airline industry could increase the possibility of anticompetitive coordination, both at the national level and in airport-pair or city-pair markets where the two carriers compete. Should the proposed merger between US Airways and American be approved, the reduction in competition would result in the "Big 4" carriers (US Airways-American, United, Delta, and Southwest) nationally. At the route-specific level where the merger would significantly increase concentration, shares on US Airways-American overlap routes are concentrated largely among a few legacy carriers. A number of factors could facilitate explicit or tacit collusion at the national and route-specific levels, including high levels of price transparency, relatively homogeneous products within fare classes, and visible cost structures. With fewer national competitors, rivals would likely find it easier to signal each other and come to tacit agreement on fares or other key variables such as capacity cutbacks, which would keep fares higher than under more competitive market conditions. The same would be true at the route level. Moreover, LCCs face the key decision in increasingly concentrated markets of whether to price aggressively or to follow the pricing and capacity strategies of the dominant legacy carriers at the hub. LCCs can price their services barely below the oligopoly "umbrella," without providing the type of sharp maverick's spur needed to discipline coordinated behavior.

At the hearing, Mr. Parker said that barriers to entry into the airline industry are low, but that entrepreneurs weren't entering the market because it is so fiercely competitive. What's your response? How would the DOJ interpret that in its antitrust analysis?

The AAI believes that in regard to the proposed merger, the relevant point is not whether a potential entrant can secure financial capital and physical capital (e.g., aircraft) to engage in "greenfield" (i.e., new) entry. Rather the relevant consideration is whether existing participants in the industry find it more difficult with higher concentration and hub dominance to access the inputs (e.g., hubs, slots, gates, etc.) needed to enter and compete on airport-pair or city-pair routes that are adversely affected by the US Airways-American merger.

2. Do you believe that the DOJ should look beyond simply overlapping non-stop routes as part of their antitrust analysis?

Yes. The AAI believes that a broader view is as important at the route-specific analysis typically performed by the DOJ, for a variety of reasons. First, the merger would combine the fourth (American) and fifth (US Airways) largest airlines nationally, making US Airways-American the largest U.S. carrier with a combined share of over 20 percent, followed by Southwest with 18 percent, United Continental with 17 percent, and Delta with 16 percent. The Big 4 would therefore control over 70 percent of the national market. The dwindling stock of LCCs after maverick AirTran was eliminated by Southwest consists of JetBlue, Frontier, and Spirit Airlines. With fewer competitors with national footprints, anticompetitive coordination is easier and more likely. Rivals would likely find it easier to signal each other and come to tacit agreement on key variables such as capacity cutbacks, which would keep fares higher than under more competitive market conditions. Second, the merger would facilitate the metamorphosis of an industry in which hubs were designed to be open access facilities at which multiple, competing airlines provided service, to only a few mammoth, closed systems that are virtually impermeable to competition and provide a hostile environment in which LCCs and regional airlines have difficulty thriving and expanding.

Third, the network configuration of a merged US Airways-American has important implications for control over both connecting service and intra-regional service in the U.S. The networks of US Airways and American do not appear to be particularly complementary. There is relatively little “white space” in each network footprint that could be filled by the other carrier. Instead, combining the two networks could create regional and functional strongholds throughout the U.S. For example, the merged carrier would have a strong presence at a number of major airports on the eastern seaboard –Philadelphia (PHL), Reagan National (DCA), Charlotte (CLT), and Miami (MIA). The merging carriers would also have a presence at key Midwestern and western airports – Phoenix (PHX), Dallas Fort-Worth (DFW) and Chicago O’Hare (ORD) – that are important for providing connecting service to eastern and western destinations. Indeed, there is a resemblance to the United-US Airways merger of 2001, which was challenged by the DOJ on the basis of “solidifying control” over hubs.

Fourth, many mid-size communities have seen flight frequencies reduced, equipment downgraded or service lost altogether. Scores of airports are expected to lose scheduled service in the immediate years ahead as well as attendant local and regional economic benefits that flow from connectivity to the world’s important business centers. Evidence from the Delta-Northwest and United-Continental mergers indicates that merged carriers have adjusted capacities on overlap routes where they are dominant to drive more traffic to large hubs, with the possible side effect of starving routes involving smaller cities. Similar fact patterns across these mergers and US Airways-American raises the possibility that smaller communities could be harmed by the proposed merger. Loss of consumer choice that forces consumers to use less convenient connecting service or travel longer distances to other airports represent legally cognizable adverse effects of a merger.

[Note: Many of the answers provided here are based on analysis contained in the AAI White Paper by Diana L. Moss and Kevin Mitchell, “The Proposed Merger of US Airways and American Airlines,” (August

8, 2012), available http://www.antitrustinstitute.org/%7Eantitrust/sites/default/files/AAI_BTC_USAir-AA_White%20Paper_8-7.pdf]

Questions for the Record: The American Airlines / US Airways Merger

For Dr. Moss from Senator Blumenthal

Fares

As the witnesses noted, the overlap in exact routes is not large, but competition for direct flights between several major cities would decrease in the wake of the merger.

Mr Horton noted in the hearing, "…airlines are a network business, as you know. So even where we don't have a direct overlap, of course we're competing via connections over hubs."

Mr Parker similarly noted, "We absolutely are competitors today. We compete vigorously against each other. But we have two route networks that independently aren't as capable of competing against the larger carriers as we will be together. So I think by putting us together we create a stronger competitor to the rest of the industry."

After this merger four major airlines would control 70 percent of the US market.

> **Dr Moss, can you please report what AAI has found with regard to the city-pairs that will be most impacted by this merger? What has your analysis of price comparisons of high and low fares on the top routes found? Can low-cost carriers provide the necessary competitive discipline to keep prices in check?**

Based on AAI's analysis of publicly available data, there appear to be just over 20 routes that are potentially the most affected by the proposed merger of US Airways and American, i.e., where the merger would eliminate one of the merging carriers and result in a substantial loss of competition. These routes involve US Airways and American hubs or focus city airports, including: Charlotte (CLT), Miami (MIA), Los Angles (LAX), Philadelphia (PHL), Phoenix (PHX), Dallas-Ft. Worth (DFW), Chicago O'Hare (ORD), and Washington Reagan National (DCA), and New York La Guardia (LGA). In all cases (summarized in the table below), changes in market concentration and post-merger concentration exceed the thresholds specified in the Department of Justice/Federal Trade Commission HORIZONTAL MERGER GUIDELINES and would be presumed to lead to adverse competitive effects, including increases in fares, reduction in service, and loss of choice.

Post-Merger HHI	Pre- to Post-Merger Change in HHI			
	500-1,999	**2,000-2,999**	**3,000-3,999**	**4,000-4,999**
3,000 - 3,999	PHX-LAX, LAX-PHX			
4,000 - 4,999	DCA-ORF			
5,000 - 5,999				
6,000 - 6,999		PHX-ORD, ORD-PHX PHL-ORD, ORD-PHL		
7,000 -7,999				
8,000 - 8,999	LGA-CLT, CLT-LGA	CLT-ORD, ORD-CLT		
9,000 - 9,999		CLT-MIA	MIA-CLT	PHL-MIA, MIA-PHL, PHL-DFW, DCA-BNA, DFW-PHL
10,000				CLT-DFW, PHX-DFW, DFW-CLT, DFW-PHX

AAI also looked at routes on which US Airways and American are the high fare and low fare carriers on top airport-pair routes. It is important to note that the high/low fare data does not show rivals (or their fares) on top routes that are not the high fare or low fare carrier. Nonetheless, the data reveal potentially useful observations. Of the total number of top routes reported, about 40 percent involve US Airways and American as high and/or low fare carriers. On 44 percent of routes involving the merging carriers, either American is *both* the high fare and low fare carrier or US Airways is *both* the high fare and low fare carrier. On these routes there is therefore no difference between the high and low fares. The pricing data also indicate that the merging carriers are infrequently in situations where they aggressively undercut each other. For example, American is high fare on only 2 percent of routes when US Airways is low fare and US Airways is high fare on 10 percent of routes when American is low fare.

These comparisons reinforce the observation that American and US Airways are dominant players in the industry. The fact that each carrier offers both the high and low fare on a sizable proportion of routes might reflect limited competition on those routes and thus the ability of each carrier to set prices. Given this pattern of high pricing, reinforced by evidence that the airlines rarely undercut each other, we could expect that on routes where the merging carriers *do* compete, they are more likely to be each other's biggest rivals. This lends support to the possibility that a price increase by one carrier could divert substantial sales to the merging partner, creating upward pricing pressure and increasing the probability of post-merger price increases.

Finally, the proposed merger would occur against an industry backdrop marked by a dwindling fringe of low-cost carriers (LCCs) and growing questions as to whether legacy look-alike Southwest Airlines-AirTran Airways exerts any significant competitive discipline in the industry. The merger could hasten the metamorphosis of the domestic airline industry from one in which hub airports were designed to accommodate multiple, competing airlines to a few large, closed systems that are virtually impermeable to competition and create a hostile environment in which LCCs and regional airlines have difficulty thriving and expanding.

Increasingly concentrated hubs resulting from previous legacy mergers have enhanced barriers to LCC entry. In concentrated oligopoly markets, small fringe competitors such as LCCs and regional carriers are also less likely to effectively discipline the pricing of the resulting four powerful systems, *or* they may walk away from the opportunity to gain market share by going along with the higher prices that often accompany diminished competition. Based on our analysis of routes affected by the Delta-Northwest and United-Continental mergers, LCCs may have a limited ability to induce price discipline among the legacy carriers that serve hub-to-hub routes. LCCs do not factor prominently on routes that could be adversely affected by a US Airways-American merger. Collectively, these factors make LCCs increasingly unreliable as a source of competitive discipline in the industry and in assuaging the concerns over adverse effects that could result from the proposed merger.

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Questions for the Record from Senator Mike Lee
"The American Airlines/US Airways Merger: Consolidation, Competition, and Consumers"
Tuesday, March 19, 2013 10:00 AM

Diana L. Moss (Director and Vice President, American Antitrust Institute)

1. In analyzing a proposed transaction's effect on consumer welfare, we sometimes look to see if the market includes a maverick—whether one or more companies serve to discipline the market by offering low prices or providing innovative services to consumers. Within the airline industry, low-cost carriers have often served the role of mavericks. For example, Southwest has traditionally been considered a maverick. But some contend that the airline industry is no longer served by any significant mavericks and that it is instead mostly characterized by large businesses with similar offerings.

    a. In your view, does USAirways function in some ways as a maverick?

Mavericks (i.e., firms that play a disruptive role in the market, to the benefit of consumers) typically exercise competitive pressure on rivals by pricing aggressively (or resisting efforts to coordinate), or offering a new technology or business model. Pricing data show that US Airways prices similarly to other legacy carriers. The AAI White Paper analyzes and concludes that American and US Airways tend to be the high-price carriers on top routes where the other competes and neither engages in aggressive discounting. On the basis of price comparisons, US Airways does not appear to play the role of maverick in the market.

    b. After this merger, will there be any remaining mavericks in the airline industry?

It is the AAI's view that after Southwest Airlines eliminated low cost carrier maverick AirTran in their recent merger, there are no other obvious mavericks remaining in the domestic airline industry.

Based on our discussion of this proposed merger at the hearing, are there factors beyond the usual route-to-route analysis that you believe are particularly important for DOJ to consider in its review of this transaction?

Yes. The AAI believes that a broader view is as important at the route-specific analysis typically performed by the DOJ, for a variety of reasons. First, the merger would combine the fourth (American) and fifth (US Airways) largest airlines nationally, making US Airways-American the largest U.S. carrier with a combined share of over 20 percent, followed by Southwest with 18 percent, United Continental with 17 percent, and Delta with 16 percent. The Big 4 would therefore control over 70 percent of the national market. The dwindling stock of LCCs after maverick AirTran was eliminated by Southwest consists of JetBlue, Frontier, and Spirit Airlines. With fewer competitors with national footprints, anticompetitive coordination is easier and more likely. Rivals would likely find it easier to signal each other and come to tacit agreement on key variables such as capacity cutbacks, which would keep fares higher than under more competitive market conditions. Second, the merger would facilitate the metamorphosis of an industry in which hubs were designed to be open access facilities at which multiple, competing airlines provided service, to only a few mammoth, closed systems that are virtually impermeable to competition and provide a hostile environment in which LCCs and regional airlines have difficulty thriving and expanding.

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