Journal of Transportation Management

Volume 1 | Issue 1 Article 6

4-1-1989

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Matthew V. Scocozza
McNair Law Firm

AIRLINE MERGER POLICY AND ENTRY BARRIERS: A LESSON FROM THE PAST

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McNair Law Firm

INTRODUCTION

Many criticisms have been voiced about the U.S. Department of Transportation's oversight of the airline merger authority under Section 408 of the Federal Aviation Act. The Department of Transportation inherited this function from the Civil Aeronautics Board on the occasion of that agency's sunset on December 31, 1984. On January 1, 1989, Section 408 of the Federal Aviation Act was sunset. Airline mergers are now governed by the general antitrust laws of the United States as administered by the U.S. Department of Justice.

This paper is designed to give an inside look at each of the mergers approved during the DOT era as well as the basis upon which the decisions were made. Since review of barriers to entry was of critical importance in the DOT review process, a primary focus of this paper will be on barriers to entry. Since this paper will touch upon acquisitions as well as mergers, I will use the term "merger" to refer to both types of transactions.

This document will respond to criticisms voiced in the past as well as review the important market by market analyses undertaken by staff and decisionmakers. All too often critics have been quick to judge the DOT perion of merger review by the "numbers" of cases approved, revised, or disapproved. Responsible reviews of the decisions should be made after an analysis of the specific circumstances surrounding each case. Only when there is a clear and informed understanding of past merger decisions can there be a sound basis for the continued development of airline merger policy.

This paper will also briefly address two other developments that some may argue should play a greater role in entry barrier analysis in the airline industry -- airline owned computer reservations systems or "CRSs" and special arrangements, referred to as code-sharing agreements, between large carriers and selected smaller feeder carriers. These developments may also have relevance to the discussion on exclusionary conduct which follows.

AIRLINE MERGER POLICY AND ENTRY BARRIERS

The CAB's and Department's review of airline mergers has been governed by Section 408 of the Federal Aviation Act of 1958.[1] Section 408 (b) establishes the standard for review that is to be applied. Before deregulation, Section 408 (b) conferred on the CAB broad discretion to approve or disapprove airline mergers under a "public interest" test. Maintenance of competition was not always the CAB 's highest priority in applying this test. When Congress enacted the Airline Deregulation Act of 1978,[2] it amended Section 408 to reflect its decision that the airline industry should be governed by the forces of the marketplace, not by federal economic regulations. Although Congress retained the public interest test, it added a specific competitive test.[3] Section 408 required the Department to approve a merger 1) that will not result in a monopoly or further an attempted monopoly and that will not likely lessen competition substantially in any region of the United States and 2) that is not inconsistent with the public interest. Section 408 requires the Department to disapprove a merger that does not meet these standards, unless DOT found that it met significant transportation needs and conveniences of the public that cannot be met through any reasonably available alternative transaction that would be materially less anti-competitive.[4] Parties challenging a transaction bore the burden of proving its anti-competitive effects.[5]

The competitive test of Section 408 was very similar to that of Section 7 of the Clayton Act. For the record, the CAB and DOT have never approved an anti-competitive merger under the transportation needs and conveniences test. The Department, therefore, applied standards established under Section 7 in their review of airline mergers. Under Section 7, review of a merger must consist of a "functional analysis" which includes a consideration of an industry's structure, history and future, according to the Brown Shoe and General Dynamics decisions and their progeny.[6]

In reviewing mergers, the CAB and, DOT attempted to determine whether the merger would provide carriers market power enabling them to charge fares above, or reduce service below, competitive levels. This is also the central inquiry in Clayton Act cases in other industries. However, the method of analysis for other industries frequently may differ from that employed for the airline industry. Most Clayton Act cases involve industries where new entry is unlikely. The courts therefore assume that a significant increase in market shares or concentration statistics substantial lessening of competition unless the proponents of a merger can show otherwise. In contrast, both the CAB and the Department have found that high concentration statistics are not themselves reliable indicators of market power in the airline industry, especially concentration statistics in individual city-pair markets. This position was based on the belief that in the absence of constraints on entry, carriers can enter individual city-pair markets relatively easily. Before deregulation proved to be one of the biggest constraints on entry. Once this barrier was removed, the threat of potential entry could discipline the service of carriers actually in a market. This belief in turn was not based solely on theoretical musing, but on the CAB's real-world observations in some of its earliest decisions such as the National Acquisition and the Texas International-Continental Cases that

"Airline markets are nearly always concentrated by traditional antitrust standards, yet most are competitive in performance."[7] Therefore, in the CAB merger cases cited (among others), and in concentrated on the Department's own merger decisions, such as the Southwest-Muse and Northwest-Republic cases, bother agencies concentrated on determining whether any entry barriers that would justify inferring a loss of competition from a substantial increase in concentration existed in the specific markets at issue.[8] And since the agencies drew no presumptions from concentration statistics, they looked to merger opponents to demonstrate the existence of entry barriers or otherwise to show anti-competitive effects. The Department discussed this issue at some length in the Northwest-Republic case.[9]

One of the most significant developments in airline operations in a deregulated environment has been the establishment of hub-and-spoke route networks. In hub-and-spoke networks, airlines serve many routes emanating from a common hub. By combining local traffic flying between the hub and each spoke end-point with traffic flying between different end-points, airlines lower their per passenger costs of operating any specific flight segment. Hub and spoke operations permit airlines to serve smaller local markets that could not sustain service with local traffic alone. In addition, airlines compete vigorously with each other for passengers moving between the same pairs of spoke end-points by offering single-plane or connecting service over alternate hubs. The growth of hub and spoke operations have clearly benefited many airline customers. However, it has also generated controversy in airline merger cases.

Since one of the CAB's earliest merger decisions under the Deregulation Act, opponents, including the Justice Department in some cases, have contended that the efficiencies of hubbing are so substantial that control of feed or "hub dominance" is an entry barrier in hub city-pair markets. The CAB never seriously doubted that access to feed was a relative efficiency factor that could reduce a hubbing carrier's per passenger costs. However, the CAB also found, based on the evidence before it, that other factors -- such as lower operating costs, strong local traffic demand, reliance on one-stop or connecting service to compete with non-stop service, or feed from their own hubs -- would permit carriers to enter successfully hub city-pair markets served by a carrier with hub dominance. Therefore, the CAB consistently concluded that the benefits of feed were not so large as to preclude the threat of competition from disciplining a carrier with hub dominance. Again, the CAB's conclusion was based on hard evidence from the real world. In each case, the Board had before it examples of carriers actually serving hub city-pair markets that they should not have been serving if hub dominance really were a barrier to entry. The National Acquisition and Continental-Western merger cases are good examples.[10]

The hub dominance issue was hotly contested in DOT merger cases as well, especially those involving combinations of carriers that had hubbing operations in the same city, such as the Northwest-Republic (Minneapolis/St. Paul and Detroit) and TWA-Ozark (St. Louis) cases.[11] The Justice Department opposed each of these mergers. In approving them, the Department determined that the record did not support the Justice Department's contention that competitors could not use other advantages, such as those outlined above, to match the benefits of hub - dominance and enter the hub carrier's markets. Again, the Department had evidence of carriers actually operating where they should not have been if hub dominance really impeded entry.[12]

Some observers have made much of the fact the Justice Department and Department of Transportation took such diametrically opposed positions on these mergers. I think these observers have read more into these differences then they fairly should. Out of twenty-odd major merger decisions by the Department, the TWA-Ozark and Northwest-Republic transactions were the only two that the Department approved when the Justice Department urged outright disapproval.[13] The Justice Department reached its position in part because it relied on the traditional antitrust notion that increased concentration implies loss of competition and in part because it believed that one-stop or connecting service was not competitive with non-stop service. DOT did not find that the record supported either contention. At the risk of oversimplifying, DOT found its expertise in the airline industry, supported by the records in the cases, to be a more reliable than the Justice Department's general antitrust expertise.

The hub dominance issue arose again in the USAir-Piedmont case, even though there were no overlapping hubs.[14] The Justice Department did not challenge the merger, but another carrier, the America West Airlines did. The carrier submitted evidence on the correlation of fare levels in individual city-pair markets to a dominant carrier's share of enplanements at the end points of the city-pairs. It claimed that this statistical analysis showed that hub dominance provided market power to allow the dominant carrier to raise fares. In addition, its experts claimed that various business practices that arose in the deregulated environment -- such as frequent flyer programs, CRSs, override commissions for travel agents and sophisticated discount fare capacity control programs -- might give such large advantage to hubbing airline as to be barriers to entry in hub city-pair markets. I believe that they may have been following a lead suggested by Professor Mike Levine in his article in the Yale Journal on Regulation.[15]

The Department carefully reviewed these contentions and the record in the case. It found that the statistical analysis was flawed and therefore could not be relied on to demonstrate that hub dominance conferred market power. With respect to Professor Levine's article, I think he has raised some interesting theoretical and analytical questions which probably deserve consideration in the review of any future airline mergers. However, the Department makes its, merger decision based on the characteristics of the airlines and the markets in the particular case before it. In the USAir-Piedmont case, the Department found that any competitive advantages that the business practices gave to USAir or Piedmont were not so large as to make the practices entry barriers in the markets affected by the USAir-Piedmont transaction. I don't think anyone would seriously argue that the ability of a carrier like American to offer frequent flyers free travel to numerous European and Caribbean destinations also allows it to compete effectively against USAir's frequent-flyer program, even in cities like Syracuse where USAir enjoys a strong presence. Some of these business practices may even facilitate entry or expansion.

Limitations on airport access are the other potential entry barrier that the CAB and DOT have most frequently considered in merger cases. These limitations may take two forms: (1) the lack of terminal or other ground facilities to accommodate increased service; and (2) regulatory ceilings on the number of flights permitted to operate at an airport. Federal restrictions on the number of operations at four airports ("slots") -- Laguardia and John F. Kennedy International airports in New York, Chicago O'Hare and Washington National -- are the most well known of the latter category, but some airports have succeeded in imposing their own limits as well.

Limitations on terminal facilities have been most frequently cited by merger opponents as entry barriers in cases where hub dominance was also a central issue, such as the Continental-Western, Northwest-Republic, and TWA-Ozark cases. In each of these cases opponents argued that a potential entrant needed the ability to establish its own hub at the affected city in order to exercise effective competitive discipline over the merging carrier's hub operation and that there were insufficient ground facilities to permit a new hub. Generally speaking, the agencies have agreed that the affected airports did not have adequate facilities to permit immediate entry on a hub scale. However, the agencies found that there were adequate facilities to permit entry on a lesser scale. As the earlier discussion of hub dominance suggests, the agencies also found the threat of entry on less than a hub scale to be sufficient to provide effective competitive discipline. Therefore, the agencies have not found limitations on airport ground facilities to be entry barriers.[16] In the TWA-Ozark case, one carrier, Southwest Airlines, did have access to sufficient ground facilities to support a hubbing operation.

When the Department considered whether slots are an entry barrier it usually focused on the New York and Washington slot-controlled airports. Each of these airports serves a metropolitan area that also receives substantial air service through at least one airport that is not under slot restrictions. With one exception, the records before the Department showed that services at the airports without slot constraints were part of the same market as services at the slot-constrained airports. Therefore, existing or potential service at the unrestricted airports provided competitive discipline for services at the slot constrained airports. The Department accordingly found that slots were not an entry barrier requiring disapproval of the mergers. The USAir-Piedmont case is an example.

The exception which proves the rule, the Texas Air-Eastern case, involved unique circumstances. The merger involved the combination of the two competitors in the Northeast Corridor air shuttle markets (Washington National-Laguardia and Laguardia-Boston). The Department found that these markets were airport specific and that a competitor would have to provide hourly service to compete effectively in the markets. The Department found that in these circumstances slots were an entry barrier and it refused to approve the acquisition until the applicants gave up enough slots to Pan American to mount a competitive shuttle operation.[17] In this case, the Department agreed with the Justice Department that there were competitive problems that needed to be fixed before the transaction could be approved.

Before turning away from mergers I would like to address two points recently raised by critics of past merger policy. First, they suggest that the relative stability in market shares of merging carriers at their hubs indicates that their hub dominance has insulated them from competition. Second, they suggest that recent trends toward fare increases may be manifestations of a loss of competition in the industry. To infer a lessening of competition in the airline industry from either phenomenon requires a leap of faith that isn't justified.

Concerning market shares, as even the Justice Department acknowledges, immediate new entry is not required, and should not be expected, in order to exert competitive discipline on incumbents in an airline market. Three hubs affected by DOT approved mergers, Minneapolis St. Paul, Detroit and St. Louis has each seen entry by new carriers and expansion by incumbents other than the merging carriers. As to fares, the downward movement in fares for much of the last two years coincided with dramatic decreases in the price of aviation fuel, which is the second largest component of airline operating expenses. In recent months, aviation fuel prices have stabilized or started to rise. In addition, many airlines have made commitments for, or started to take delivery on, large orders for new aircraft. These aircraft must be paid for. Thus, the recent upward trend in fares reflect no more than a change in airline cost structures

Turning to CRSs, the affiliations of the five U.S. travel agent CRSs with airlines has been a subject of controversy ever since the CAB first examined the issue. In its CRS rulemaking,[18] the CAB found that CRS operators used their CRSs to increase their share of sales by agents subscribing to their CRS services at the expense of their airline competitors. This phenomenon is referred to as the generation of incremental revenues. The CAB found that by generating incremental revenues, CRS operators could reduce their own unit costs of providing airline service while raising the costs of their airline competitors. The CAB also found that airline economics and distribution practices required airlines to be listed in any CRS that had gained significant penetration in the travel agent industry. Therefore, the CAB found that CRSs were analogous to essential facilities under the antitrust laws.

Based on its findings, the CAB adopted regulations that reduced CRS Operators' ability to generate incremental revenues with their systems.[19] The rules also required the operators to give access to their CRSs to other airlines on non-discriminatory terms and at non-discriminatory prices.[20]

The CRS rulemaking has proven to be far from the last word on CRSs. A number of airlines have filed private antitrust actions against the airline affiliates of the largest CRSs, American and United.[21] A key issue in those cases is whether CRSs should be classified as essential facilities.

As I noted earlier, the opponent of the USAir-Piedmont merger argued that CRSs might be an entry barrier. The Department rejected this argument in part because neither USAir nor Piedmont at that time owned a CRS. Since the Department's decision, USAir has agreed to join a group of four foreign airlines to purchase a fifty-percent interest in United's CRS.[22]

The Department very recently issued its study of the CRS industry. The Department's study is probably the most comprehensive -- it is certainly the longest -- since the CAB's rulemaking. Nevertheless, I do not believe that the study itself can answer all questions about the current effects of airline-CRS affiliation in entry barrier analysis for airline mergers. Among other things, the study suggests that CRSs continue to generate some incremental revenues for their airline affiliates, but precise determination of the amounts and causes of incremental revenues was not possible. CRSs also earn substantial fee payments from airlines that are listed in their displays. It would not, however, be fair to infer from these findings alone that CRSs benefit their airline affiliates so much that competitive discipline in the airline industry has been materially eroded. Even if CRSs do create some advantages for their airline affiliates, they also provide other carriers with convenient, quick and reliable access to the nationwide distribution network represented by travel agents. To the extent that CRS participation allows carriers to avoid using other more costly distribution methods, CRSs may enhance competition.[23]

Code-sharing agreements also have been the subject of much discussion lately. Code-sharing agreements are arrangements in which a commuter carrier's flights are listed in schedules and CRSs under the airline designator code of a large jet operator. The large airline usually enters into these agreements to provide additional feed support from smaller communities to its hubs. In addition to sharing codes, the commuter services will often be marketed under a trade name closely aligned with the name of the jet carrier, for example American Eagle or United Express. Connecting flights between the parties to code-sharing agreements receive the same priority as true single-carrier connections in CRS schedule displays. In addition, the jet operators offer joint fare arrangements to their code-sharing partners that are more favorable than those they offer to other commuters.

Although they have been part of the industry since the 1960's they had not generated much controversy until the 1980's when they began to proliferate. You need only look at the comments on code-sharing in two rulemaking dockets, CAB Dockets 42199 and 41686 to appreciate the intensity of this controversy.[24] Independent commuters have claimed that they cannot effectively compete against code-sharing commuters because of the benefits of improved CRS listings and the special joint fare arrangements. When the Department completed its study of code-sharing in early 1986[25] the evidence available to it did not support these contentions. The data relied on at that time suggested that independent commuters continued to play a substantial role in serving smaller communities and that they were effectively competing head-to-head against code-sharing commuters in many markets. However, later data suggested that the benefits of code-sharing may place independent commuters at a disadvantage, and that independents are declining as a force in the market.[26]

Although code-sharing arrangements may increase the costs or risks of entry by independent commuters, I believe it is fair to consider them as much entry tools as entry barriers. Increasingly, jet operators are including code-sharing arrangements as part of their program for establishing new hubs. United arranged for initiation of United Express service at American Eagle service when it opened its Raleigh-Durham and Nashville hubs. The Department has found in a number of merger decisions, including the Northwest-Republic and Alaska Airlines- Horizon cases,[27] that participation in a code-sharing arrangement may facilitate a commuter carrier's entry or expansion into markets around a hub.

CONCLUSION

The sponsors have reminded me that the purpose of this symposium is to suggest lessons that general antitrust practitioners might draw from the experiences of deregulated industries. Let me close by suggesting at least one lesson to be gleaned from both the CAB's and Department's experiences with airline mergers. It is critically important for the decision-maker passing judgement on a merger to thoroughly understand the nature of the industry and markets, and the characteristics of competition and the competitors, and affected by a proposed merger before applying the competitive standards of the Clayton Act. Presumptions or even conclusions that have been drawn about the nature of competition for some industries or markets may not be readily transferable to others. As antitrust practitioners, you can best contribute to sound antitrust policy by assuring that the decision-maker is presented with the information that will permit the thorough understanding necessary for well-reasoned and reasonable decisions.

REFERENCES

[1]49 U.S.C. Sec. 1378.

[2]P.L. 95-504, 92 Stat. 1705 (1978).

[3]The Conference Report to the Deregulation Act, in explaining the changes to Section 408, stated clearly that, "The foundation of the new airline legislation is that it is in the public interest to allow the airline industry to be governed by the forces of the market-place." H.R. Rep. 95-1779 95th cong., 2d sess. at 73 (October 12, 1978).

[4]Section 408 also empowered the Department to impose such condition in its approval as are considered just and reasonable.

[5]Effective January 1989, Section 408 was terminated and airline mergers will be governed by the antitrust laws. 49 U.S.C. Sec. 1551(a)(6).

[6]Brown Shoe v. United States, 370 U.S. 294 (1962); United States v. General Dynamics, 415 U.S. 486 (1974).

[7]Texas International/Pan American-National Acquisition Case ("National Acquisition") Orders 79-12-163/164/165 at 12 (October 24, 1979). Texas International-Continental Acquisition Case, Order 81-10-66 at 4 (August 14, 1981).

[8]Southwest Airlines-Muse Acquisition Show Cause Proceeding ("Southwest-Muse") Order 85-5-28 at 6-7 (May 3, 1985); NWA-Republic Acquisition Case (Northwest-Republic"), Order 86-7-81 at 6-7 (July 31, 1986).

[9]Northwest-Republic, supra, Order 86-7-81 at 5-8.

[10]National Acquisition, supra, Order, 79-12-163/164-165 at 19; Continental-Western, supra, Order 81-6-1/2 at 11.

[11]Northwest-Republic, supra, Order 86-7-81 at 12, 13; TWA-Ozark Acquisition Case ("TWA-Ozark"), Order 86-9-29 (September 12, 1986).

[12]E.g., TWA-Ozark, supra, Order 86-9-29 at 7-8.

[13]In one case, the Southwest-Muse acquisition, the Justice Department did not support our competitive analysis, but it nevertheless agreed that the acquisition should be approved. Southwest-Muse, supra, Order 85-6-79 (June 24, 1979). In another case, when United Air Lines purchased Pan American's transpacific international operations, the two agencies differed only on the narrow question of the need for further consideration of the issue of requiring United (which already operated to Tokyo from Seattle) to give up some of its Trans-Pacific route authority. The Justice Department would have required United to give up the authority at the time we approved the transaction. We determined that the matter deserved further consideration before any action was taken. Pacific Division Transfer Case, Order 85-11-6 (October 31, 1985).

[14]USAir-Piedmont Acquisition Case, Order 87-10-58 (October 30, 1987); appeal dismissed for lack of standing sub. nom. America West Airlines, Inc. v. Department of Transportation, No. 87-1639 (D.C. Cir. February 19, 1988).

[15]M. Levine, "Airline Competition in Deregulated Markets: Theory, Firm Strategy, and Public Policy", 4 Yale Journal on Regulation. 393 (Spring 1987).

[16]Continental-Western, supra, Order 81-6-112 at 13-14; Northwest-Republic, supra, Order 86-7-81 (July 31, 19 at 13,14-15; TWA-Ozark, supra, Order 86-9-29 at 9-10.

[17]Texas Air-Eastern Acquisition Case, Order 86-7-21 (July 9, 1986).

[18]Notice of Proposed Rulemaking EDR-466C, 49 Fed. Reg. 11644 (March 27, 1984); Final Rule, ER-1385, 49 Fed. Reg. 32562 (August 15, 1984) aff'd United Air Lines, Inc. v. CAB, 766 F. 2d 1107 (7th Cir. 1985)

[19]14 C.F.R. S 255.4 (regulation display of flight information in CRSs).

[20]14 C.F.R. SS 255.5, 255.7 (regulation the provision of CRS services to other airlines).

[21]USAir, Inc. v. American Airlines, CV. No. 84-8918 ER; Continental Air Lines, Inc. v. American Airlines, Inc., CV 86-0696 ER. (C.D. CA).

[22]Application of United Air Lines, Inc., Covia Corporation, et al., Department of Transportation Docket 45616.

[23]This issue is discussed in the USAir-Piedmont decision, Order 87-10-58 at 17-18

[24]See also EDR-470, 49 Fed. Reg. 9430 (March 13, 1984); ER 1377, 49 Fed. Reg. 12677 (March 30, 1984), PSDR-85, 49 Fed. Reg. 43709 (October 31, 1984); Amdt. No. 399-80, 50 Fed. Reg. 38508 (September 23, 1985).

[25]D. Pickrell, C. Oster, A Study of the Regional Airline Industry, The Impact of Marketing Alliances, Department of Transportation Staff Study (May 1986)

[26]C. Oster, "The Competitive Effects of Marketing Alliances: An Update", (November, 1986).

[27]Northwest-Republic, supra, Order 86-7-81 at 19; Alaska Airlines-Horizon Air Acquisition Case, Order 86-12-61 at 7 (December 23, 1986).

ABOUT THE AUTHOR

Matthew V. Scocozza is a partner in the McNair Law Firm, P.A. Washington D.C. He formerly served as the Assistant Secretary for Policy and Internaional Affairs of the United Staes Department of Transportation.