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AIRLINE COMPETITION: CLEAR SKIES OR TURBULENCE AHEAD?

HEARING

BEFORE THE

SUBCOMMITTEE ON ANTITRUST, BUSINESS RIGHTS, AND COMPETITION

OF THE

COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE

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AIRLINE COMPETITION: CLEAR SKIES OR TURBULENCE AHEAD?

TUESDAY, MAY 2, 2000

U.S. SENATE,
SUBCOMMITTEE ON ANTITRUST, BUSINESS RIGHTS,
AND COMPETITION,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The subcommittee met, pursuant to notice, at 2:04 p.m., in room SD–226, Dirksen Senate Office Building, Hon. Mike DeWine (chairman of the subcommittee) presiding.

Also present: Senator Kohl.

OPENING STATEMENT OF HON. MIKE DeWINE, A U.S. SENATOR FROM THE STATE OF OHIO

Senator DEWINE. Good afternoon. Two years ago, this subcommittee held hearings to examine the competitive structure and activity of the aviation industry. We have been following the industry closely in the 2 years since those hearings, and aviation continues to be among the most difficult marketplaces to evaluate.

It is clear that competition has succeeded in improving service and prices. In fact, since Congress deregulated the airline industry in the 1970's, passengers have flown far more, to a greater number of destinations, and at a lower average price than ever before. The hub and spoke system, from all reports, is responsible for a great deal of that progress.

But despite the general improvements in service and price deregulation, we continue to hear complaints from consumers, complaints ranging from high prices for business travelers, to poor customer service for leisure travelers, particularly in hub cities. Possibly as a result of this dissatisfaction, start-up airlines continue to enter the market. Despite their effort to meet customer demand, however, most start-ups fail, often while complaining about the anti-competitive tactics of the incumbent airlines, especially those that are entrenched in hub airports.

In response to the failures of start-up airlines, Federal enforcement and regulatory agencies have increased the scrutiny of the industry. Specifically, the Department of Justice has investigated a number of major carriers and has filed a case charging American Airlines with predatory pricing. Further, in the last 2 years the Department of Transportation has issued and withdrawn draft competition guidelines and is now considering whether to issue new guidelines. We will examine the implications of both of these Government actions in our hearing today.

Now, with regard specifically to the Department of Transportation and its guidelines, I would like to make a couple of points. As most of you know, the draft guidelines that the Department of Transportation issued 2 years ago met with a great deal of criticism, and I shared the concern of many of the critics, namely that the draft guidelines were both too vague and too restrictive.

Now, I know that the Department of Transportation has received a great number of comments on the guidelines, and I hope that if the Department does reissue the guidelines that they took those comments into account and produce a document that moves the debate forward.

More generally, however, I am still concerned about the notion of Department of Transportation guidelines being used as a benchmark for enforcement policy. By their very nature, guidelines are difficult to draft, and they run the risk of either over-regulating behavior, which is the last thing we should be doing in the aviation industry, or not providing enough guidance to competitors.

Accordingly, at this point I continue to believe that the vigorous, reasonable enforcement of the predatory pricing laws are a better alternative. If correctly enforced, the predatory pricing laws should enable the Government to punish illegal activity without chilling the sort of tough competition that we want to encourage.

As I noted earlier, the Department of Justice is currently litigating its first predatory pricing case in years, and I think it makes sense to await the outcome of that case before we consider any different type of enforcement mechanism.

In the meantime, the industry continues to evolve. Perhaps one of the most significant changes is the tremendous growth of regional jet service to provide direct, non-stop service to many new cities. These jets are smaller and cheaper to fly than the traditional jet airliner, but are much more popular than the turbo-prop planes that they are replacing.

I am interested in hearing from our witnesses today in regard to what impact the regional jet will have on the hub and spoke system. I would also like to discuss other aspects of the aviation industry which impact on competition, such as exclusive gate arrangements at many airports and the need to modernize our air traffic control system.

Because of Government actions addressing competition and the industry's reaction to marketplace changes, this is an important and an exciting time in the aviation industry. We have a very distinguished and experienced group of witnesses with us today to help us analyze recent developments, and I look forward to hearing from them as this subcommittee continues its work to increase competition and to help consumers.

Let me turn now to the ranking minority member of the subcommittee, Senator Kohl.

STATEMENT OF HON. HERBERT KOHL, A U.S. SENATOR FROM THE STATE OF WISCONSIN

Senator KOHL. Thank you, Senator DeWine.

To paraphrase Charles Dickens, in many respects airline competition today is a "tale of two cities." Consumers in large markets such as New York, Los Angeles or Washington, DC, traveling to

other large cities often benefit from vigorous price competition among several choices in air carriers. Unfortunately, outside these large markets, the picture is much bleaker. Travelers in smaller and medium-size markets continue to have few alternatives to the large incumbent carriers on many routes.

As a result, only some of the benefits promised during airline deregulation have been realized. Fares continue to be higher than they should be, and choice continues to be limited. Moreover, start-up carriers face serious obstacles in establishing service competing with the incumbent carriers. And according to business writer James Glassman, the established large airlines seem content to divide the country into separate fiefdoms defended by fortress hubs, avoiding direct competition with each other and thereby ensuring high fares and higher profits. That is why he advised investing in their stock.

When a start-up does enter a new route dominated by a single carrier, the results are dramatic. Indeed, after Sun Country Airlines recently began competing against Northwest from Milwaukee to Minneapolis, prices dropped substantially, by as much as half, according to our research, from the levels of just 2 years ago. The findings reflected in the charts behind me demonstrate this dramatic change.

But the difficulty is not so much getting these start-ups into the market, it is keeping them in the market in the face of relentless and possibly predatory competition. Mr. La Macchia, the President of Sun Country, will testify to the problems faced by new entrants challenging large carriers in their fortress hubs; for example, difficulty in obtaining airport gates, huge increases of capacity by the incumbent carrier, and large bonuses paid to travel agents for directing consumers to the dominant carrier. We invited the CEO of Northwest to testify to give his side of the story, but he declined.

To be sure, there are no simple solutions to these problems, but one answer may lie somewhere other than in antitrust enforcement. That is because the standards for predatory pricing are uncertain, making the large airlines' behavior in many cases lawful under prevailing antitrust laws. And antitrust enforcement almost always leads to complicated, protracted, and lengthy proceedings. However, it is clear that abuses exist, abuses that need to be corrected, and that in many places the competitive conditions in the airline industry are far from ideal.

For this reason, today we are writing to the Secretary of Transportation to urge him to utilize his enforcement powers in an innovative and effective way. The Transportation Act authorizes the Secretary to prevent "unfair, deceptive, predatory, or anti-competitive practices in air transportation." We believe, and the weight of authority is strongly on our side, that some conduct by airlines, although legal under antitrust law, is nonetheless unfair, unscrupulous, and anti-consumer, and clearly actionable under the DOT statute.

Using this approach—that is, having the DOT bring an action against an airline for unfairness rather than predatory pricing—can avoid years and years of litigation about whether or not the technical requirements of antitrust law have been met. In other words, it will help consumers sooner rather than later, and it is

more fair to the airlines, who don't deserve to be in legal limbo for years and years and years.

Mr. Chairman, some of us may have different views about how to promote competition, but all of us here today want to ensure that the traveling public has the greatest possible number of choices, the lowest possible prices, and the highest possible quality of service and standards in air travel. So we are eager to hear what our panelists think of these ideas and the state of airline competition today.

It is a terrific group of witnesses, and I especially want to thank Professor Kahn, the father of airline deregulation, who is appearing before this committee for the first time since 1987. We welcome you all.

I return to you, Mr. Chairman.

Senator DEWINE. Senator Kohl, thank you very much.

Let me introduce our first panel. Alfred Kahn is Emeritus Professor of Political Economy at Cornell University and a special consultant to National Economic Research Associates. He is the former Chairman of the Civil Aeronautics Board and is well known throughout the industry as the father of airline deregulation.

Steven A. Morrison is Professor and Chair of the Department of Economics at Northeastern University. During 1998 and 1999, he was a member of the congressionally-mandated Transportation Research Board Committee for the Study of Competition in the U.S. Airline Industry. Professor Morrison testified in front of this subcommittee about aviation competition about 2 years ago and we are happy to have him back with us today.

Professor Kahn, we will start with you and we will take your opening statement. Thank you for appearing, both of you.

PANEL CONSISTING OF ALFRED E. KAHN, PROFESSOR EMERITUS, DEPARTMENT OF ECONOMICS, CORNELL UNIVERSITY, ITHACA, NY, AND STEVEN A. MORRISON, PROFESSOR OF ECONOMICS, NORTHEASTERN UNIVERSITY, BOSTON, MA

STATEMENT OF ALFRED E. KAHN

Mr. KAHN. Thank you, Mr. Chairman. One prefatory sentence. While identifying me as the father of airline deregulation is an exaggeration of history, I do not demand a paternity test. I am honored by your invitation and hope I can be of some use to you.

Fortunately, I can leave to my colleague, Professor Morrison, who is the coauthor of the really definitive studies of the effect of airline deregulation, documentation of my firm opinion that deregulation has been a great success, in particular by unleashing the forces of competition and bringing air travel within reach of people of limited means without sacrifice of safety.

I had in my formal statement, which I will try quickly to summarize, a recognition of the fact that this has been accompanied with a great deal of discomfort and congestion. In part, I want to point out that was precisely our purpose. When we had planes flying half full and half empty, it was nice to have an empty seat next to you.

Our purpose was to bring low-fare, lower-quality service, and that inevitably meant letting the airlines compete to fill those empty seats. So the congestion is part of a remedy; low-price and

greater congestion is part of what we were attempting to accomplish. But in addition, there has been a major failure, I think, of Government institutions to provide the necessary infrastructure and to price it correctly, and we can go into that, but it is not really your subject today.

I don't have to point out to this committee the truism that deregulation means increased reliance on competition, and increased reliance on competition means greatly increased importance of vigilance on the part of the antitrust authority.

In these remarks, I want to concentrate on one aspect of antitrust policy as applied to this industry that has inspired the greatest amount of controversy in several years, namely the determination of what constitutes or should constitute unfairly exclusionary policies—"unfair, deceptive, predatory," in the terms of the authority of the Department of Transportation.

Along with the reform of the arrangements for providing infrastructure and pricing it, and continuing to try to get rid of the barriers to competition at the international level, I can think of no other aspect of Government policy with greater significance for the preservation and expansion of the benefits of deregulation.

I therefore strongly endorse the proposition that DOT both has and should have joint responsibility. It is the precise counterpart of the statutory responsibility of the Federal Trade Commission to prevent unfair methods of competition in industry generally, from which airlines were exempted because historically they were subjected to direct regulation.

The basis for the increased concern about such assertedly exclusionary tactics as predatory pricing, interference with fair access to airport facilities, refusal to interline or exchange luggage, or the offer of special override commissions in the face of competitive entry, is by now entirely familiar. And I just want to set it forth in a series as quickly as I can of propositions.

Average yields per mile have declined some 40 percent, adjusted for the Consumer Price Index, in real terms. But full fares, paid by only about 6 percent of all traveled mileage, have apparently increased on the order of 70 percent; that is, adjusted for the CPI. If you don't adjust it for the CPI, they have increased five-fold. So you have had this increased spread of fares.

Now, I think in large measure, maybe in major measure, that spread has been beneficial for travelers, both those who pay the low fares and those who pay the high fares. It reflects wide differences in costs, with length of route, with density of route, with time of day. If you try to get discount fares between New York and Washington at 8 a.m. on a Monday morning, you are not going to get it. Obviously, you are paying more, but that is because congestion costs are higher at that time, and the cost of holding seats out for last-minute availability, which is one of the things you pay a lot for.

In the case of the fare quoted to me, Ithaca to Washington, 300 miles or less, round trip fare was $732. You could divide it by the mileage. I don't have any scientific basis for telling you that I find that outrageous, but I do take comfort from the fact that if I can stay over a weekend, I can get very good fares, and most people do. So there is this increased spread.

I should point out that in some measure that spread is discriminatory. It clearly is charging travelers with a highly inelastic demand what that traffic will bear. But even discrimination, on balance, is beneficial. It is a way, for example, of filling seats that would otherwise be empty, charging very low fares to discretionary travelers. And as long as they cover the incremental costs of serving them, they contribute toward using bigger planes which are more efficient, with an increased availability of routes to different places, which is clearly a product of deregulation, and convenient scheduling, all of which are particularly beneficial to business travelers.

At the same time, it has clearly raised legitimate concerns about whether it represents also monopoly exploitation of the demand-inelastic travel, not just business travelers, but people traveling on family business who can't get a certificate from a crematorium that they deserve a lower fare. I know about that; I have had that experience.

There are only two ways of preventing that exploitation, if it exists. One is, of course, the resumption of regulation. I don't know anybody—well, I know some who are in favor of it, but nobody I respect. [Laughter.]

The only alternative is freedom of entry, and that, of course, is exemplified by the increasing challenge to the sharp increases in full fares by new entrants in the middle-1990's. The Department of Transportation has documented it. It estimates that they saved travelers some $6 billion in 1996. That is how a deregulated, competitive industry is supposed to protect not really consumers generally, but any subgroup of consumers. If a small carrier says, I can serve these people at lower cost and at a lower fare, free entry is the way in which we rely for protection.

I won't recite the pattern that is described by the Department of Transportation, the pattern that is exemplified by this showing, but certainly it has been found in case after case, a drastic reaction, very sharp price reductions, an enormous increase in the offer of discount fares only on the particular routes where the challenge occurs. When and if the entrant is driven out, fares go back up to their previous level. And, of course, other carriers thinking about entry, seeing what happened to the one before, are going to be hesitant about entering.

Now, I can't even tell you that that is the typical scenario. It has certainly happened many, many times. I have not been able to do a continuing study, and I regret that the Department of Transportation doesn't seem to have done so, to tell us whether that is the typical picture or not.

But, interestingly, I came across my desk yesterday a monograph by Professors Fred Allvine, of the Georgia Institute of Technology, about whose work I have known in the past, and Ashutosh Dixit, of the University of Georgia, which appears to document at length and in great detail exactly the kind of scenario that is described there and purporting to show a pattern of very great consistency. And I urge you and the Department of Transportation to look at it very carefully.

There is no question, according to the studies by Drs. Morrison and Winston, that entry by more or less low-fare carriers, low-cost,

has made a disproportionately great contribution to the benefits of price competition in the industry. And they have actually made estimates of that and they show that the contribution to savings from reduced real fares by Southwest and other new entrants has been more than twice as great as the competition supplied by incumbent carriers. It plays an extremely important role in disciplining the industry.

Now, the industry is especially susceptible to predation because you can move aircraft in and out, and that is an almost unusual circumstance in this industry. The incumbents incur virtually no additional sunk costs if they simply increase capacity on challenged routes, and then they can readily take the capacity out. And that also makes it easier for the people who are there to depart because they don't have major sunk costs. They can transfer their planes out or be induced to do so.

Yield management techniques also increase the ability of the industry to practice predation. Because of that, it is extremely difficult to apply the test that has typically been adopted by the courts in antitrust cases under the Sherman Act and under the Clayton Act because the principal component of the average variable costs that supply the principal test under antitrust jurisprudence are not production costs, which are very, very low. They are opportunity costs, the revenues that you sacrifice by transferring capacity from one route to the challenged route, and what the Department of Transportation pointed out, the sacrifice of net revenues that you may be making if you had pursued a less aggressive policy.

That immediately makes it clear how difficult that is to interpret and to administer, and I am one of the first to recognize it. But, in principle, I point out to you that the report of the National Research Committee, of which I was a member, that reported last summer clearly recognizes the infirmity of simply using average variable production cost. That reflects direct expenses, but it is an unsatisfactory proxy—I am quoting them—for marginal costs because it doesn't account for the more profitable opportunities that are foregone.

Now, I should emphasize, in fairness, the overall profitability of this industry is nothing to write home about. It seems over the years clearly to fall somewhere below the average, and perhaps markedly below the average, of industry generally.

On the other hand, that doesn't mean that there is no room for additional competition. If competitive entry were freer than it is today of predatory responses, the intensified competition could be associated with lower costs, both because of the increased pressures that it would impose on the incumbent carriers to reduce their costs and because a greater proportion of the traffic would be carried by low-cost carriers.

My last observation, and I will stop. There is always a danger in proceeding more vigorously against what appear to be predatory pricing responses of weakening competition itself. That is a legitimate concern that a more vigorous attack on these responses by labeling healthy consumer-benefitting responses as predatory could outweigh the benefits.

On the other hand, some of the responses to the Department of Transportation's initiative to move against them on the ground that it would suppress more competition than it would protect generally ignores the fact that the only circumstances under which DOT would move under these would be when the incumbents were not offering those low fares in such profusion until they were challenged, and then only in the particular routes on which they were challenged.

The initiative has in almost all cases, almost invariably, come from the entrants. So when one sheds tears about limiting the competitive response of the incumbents, it is important to bear it in the context that they occur only when the initiative has come from competitive entrants. And, of course, they are promptly withdrawn when they succeed in driving competitors out.

On the third hand—you remember President Truman said he used to go to bed at night praying for a one-handed economist—there is the difficulty in enforcement actions of predicting which of these vigorous competitive responses will have an ultimately anticompetitive effect and which will not, and in which markets, therefore, competition is likely to persist, to the lasting benefit of consumers.

I am sorry that I have left you with a three-handed dilemma. I do want to present you, however, with the case for saying this is a serious problem. There is serious basis for anger on the part of the 6 percent of mileage, and that is all it is, who pay the full fare, and all of them live in Ithaca. [Laughter.]

Therefore, I think DOT's exercise of its independent authority should be encouraged.

Thank you.

Senator DEWINE. Professor, thank you very much.

[The prepared statement of Mr. Kahn follows:]

PREPARED STATEMENT OF ALFRED E. KAHN

I am honored by the invitation to appear before you today, and hope I can be of some assistance to you in your consideration of the state of competition in the deregulated airline industry and the application of the antitrust laws to it.

Fortunately, I can leave to my colleague, Professor Steven Morrison, co-author of the definitive studies of the effects of airline deregulation, documentation of my firm opinion, and his, that deregulation has been a great success—in particular, by unleashing the forces of competition, bringing air travel within reach of people of limited means, without sacrifice of safety.

There are, I think, two things to be said about the fact that it has also been accompanied by a marked increase in discomfort and congestion: first, that it was precisely the failure of regulation to offer travelers a low-cost/lower-quality product that was its greatest failure; and, second, that this deterioration in the quality of the air travel experience is a consequence, in important measure, of the failure of government to provide the optimal infrastructure—specifically, air traffic control and airport capacity—and to price it correctly.

I take it as a truism, which requires no explanation to this Committee, that the withdrawal of direct regulation shifts the responsibility for protecting consumers to competition and responsibility for preserving that competition to increased vigilance in enforcing the antitrust laws.

In these remarks, I propose to concentrate my attention on the aspect of antitrust policy, as applied to this industry, that has inspired the greatest amount of controversy in the last several years—namely, the determination of what constitutes or should constitute unfairly exclusionary practices, such as the Department of Transportation is charged with preventing. While I have not been in a position to make any direct assessment, on the basis of historical experience, of the importance of such practices—and am not at all clear how it might be conducted—I have at least

the strong impression that the intense controversies engendered by DOT's promulgation of proposed rules in fulfillment of that responsibility, in April of 1998, does properly reflect their importance. Along with the reform of the arrangements for providing and pricing access to infrastructure and our long-continuing efforts to lift the governmentally imposed barriers to competition at the international level, I can think of no other aspect of government policy with greater significance for the preservation and expansion of the benefits of deregulation—perhaps I should add, of greater importance, for good or ill.

Consistently with that opinion, I strongly endorse the proposition that DOT both has and should have that responsibility: it is the precise counterpart of the statutory responsibility of the Federal Trade Commission to prevent unfair methods of competition—from which airlines were exempted because of their historical subjection instead to direct regulation.

The basis for the heightened concern in recent years about such assertedly exclusionary tactics as predatory pricing, the interference with new entrants obtaining fair access to airport facilities, refusals to interline or exchange luggage, and the offer of special override commissions to travel agents targeted at markets subjected to new competitive entry is by now entirely familiar.[1]

1. While average yields, per mile, have declined on the order of 40 percent in real terms—i.e., adjusted for changes in the Consumer Price Index—since deregulation, full fares, paid on only some 6 percent of total mileage, have apparently increased on the order of 70 percent. That sharply increased spread has surely been in large—indeed, I offer the impression, major—measure beneficial to all travelers, for two reasons. In part, it reflects wide differences in real costs as between long and short, dense and thin routes and by hour of the day and day of the week, as well as of holding seats open for last-minute availability. Moreover, to the extent that the fare differentials are discriminatory, they make it possible to use larger, more efficient planes and offer more convenient scheduling on a greater number of routes than would have been possible if all fares had to be uniform. Within limits—of incremental costs at the bottom and stand-alone costs at the top—the offer of heavily discounted tickets to discretionary and/or leisure travelers, in order to fill seats that would otherwise go empty, while charging higher fares to demand-inelastic travelers, is beneficial to both of them.

2. At the same time, this increased discrimination has also raised legitimate concerns about the likelihood that those full fares reflect also monopoly exploitation of travelers who cannot make their reservations weeks in advance or stay over a weekend—the most familiar devices by which the airlines discriminate between demand-elastic or discretionary travelers, on the one side, and demand-inelastic, exploitable ones, on the other.

3. There are, effectively, only two ways of preventing exploitation of the demand-inelastic travelers. One would be a resumption of regulation; since no economist I know advocates this, it would be superfluous to expatiate on our reasons for not recommending it.

4. The only alternative protection, and the one completely consistent with deregulation, is competition. One important function of free competitive entry is to ensure that no group of travelers is ever charged more than the costs of serving it alone. This process was apparently exemplified by the increasing challenge to the sharp increases in full fares by new entrants in the middle '90s—documented by the Department of Transportation, along with an estimate that they saved travelers some $6 billion in 1996. This is precisely the way in which a deregulated, competitive industry is supposed to protect not merely consumers generally but any smaller subgroup of them.

As I put it in my testimony on April 22, 1998,

> The theoretically correct basis for . . . charges to subgroups of customers . . . is stand-alone costs—the hypothetical cost of serving any partial grouping of customers alone. That is the ceiling that would prevail if there were perfectly free entry: . . . .
>
> Clearly, the best way of ensuring that such a ceiling will prevail is free entry itself; and it was indeed on freedom of competitive entry that we relied for the protection of travelers when we deregulated the airlines. But what seems to have occurred time and again in recent years has been: unrestricted fares are jacked up and up; that induces entry of low-cost, more or less uniformly low-

[1] I testified on the subject before the Aviation Subcommittee of the U.S. Senate Committee on Commerce, Science, and Transportation approximately two years ago (April 22, 1998) and before the Transportation Subcommittee of the same Committee on May 5, 1998, and published a more formal statement, "Comments on Exclusionary Airline Pricing," which was published in the *Journal of Air Transport Management* in 1999.

fare rivals, emulating Southwest, who can profitably serve those customers at much lower fares; the incumbents then cut their fares deeply and sharply increase the number of low-fare seats they offer on the routes—and only on the routes—on which they have been challenged; the new entrant departs; and fares immediately go right back up, with no further challenge. That is the kind of scenario that the Department of Transportation says it has seen played out many times in the last few years and that it sees as crying out for remedy.

I should point out, at the same time, that the pattern I have just described is by no means uniform and invariable. While the TRB Committee, of which I was a member, that reported on Entry and Competition in the U.S. Airlines Industry last summer,[2] found some of the responses of incumbents to competitive entry "difficult to reconcile with fair and efficient competition" (p. 6), it could find no uniform pattern in the instances of possibly exclusionary conduct presented to it by the Department of Transportation: while incumbent airlines typically reduced their fares sharply in response to such entry, sometimes increasing capacity, sometimes not, there is no clear and consistent relationship between those responses and either the disappearance of the challengers or the restoration of fares to their previous level. On the other hand, there has just come across my desk a monograph by Professors Fred Allvine, of the Georgia Institute of Technology, and Ashutosh Dixit, of the University of Georgia, which appears to document, at length and in great detail, the kind of scenario that I have just described, showing a pattern of great consistency; it clearly deserves your careful attention and that of the Department of Transportation.

5. Market entry by low-cost, more or less uniformly low-fare-charging carriers has made a grossly disproportionally great contribution to the benefits of price competition in the industry, according to the studies of Drs. Winston and Morrison.[3]

6. The airline industry is especially susceptible to predation, because of the mobility of aircraft and the consequent relatively small proportion of sunk costs in undertaking to serve and responding to competitive entry into individual markets: the incumbents need incur virtually no additional sunk costs when they increase capacity on challenged routes and entrants can be readily induced to depart, because of their ability correspondingly to move their equipment out.

7. The sophistication of the major airlines in practicing yield management, rationing the availability of deeply discounted tickets, makes it easy for them sharply to increase the availability of such fares on individual routes in response to competitive challenge and to withdraw them when the challenge disappears.

8. This character of the industry and of its costs makes it extremely difficult to apply the test of predation that has been most widely adopted by the courts—namely, pricing by the incumbent below their short-term marginal or average variable production costs. In the circumstances that I have just described, the principal component of those average variable costs are not production costs but opportunity costs—the revenue foregone elsewhere by transferring capacity to the contested route and/or the revenue from undiscounted or only modestly discounted ticket sales sacrified by the suddenly increased availability of deeply discounted ones. This is the essence of the condition incorporated in all three indicators of "unfair exclusionary practices" proposed by the Department of Transportation: that "the ensuing self-diversion of revenue results in lower local revenue than would a reasonable alternative response."[4] (in Transportation Research Board, p. 166)

I must emphasize, in fairness, that the overall profitability of the airline industry seems hardly reflective of what one would expect from a monopolist: overall, it apparently has, on average over the years, fallen well below the average of American industries generally.[5] This consideration does not, however, exclude the possibility

[2] Special Report 255, National Academy Press, Washington, DC, 1999.

[3] In their magisterial studies of airline deregulation, Winston and Morrison estimate that the contribution to the savings from reduced real fares since deregulation by Southwest and other new entrants has been more than twice as great as the "competition supplied by incumbent carriers," with Southwest accounting for some three-quarters of the former. Winston, "U.S. Industry Adjustment to Economic Deregulation," Journal of Economic Perspectives, summer 1998, p. 101.

[4] Despite the more or less even division of the members of the TRB Committee for the Study of Competition in the U.S. Airline Industry on the issue of whether DOT should be encouraged to proceed with its independent enforcement actions or defer to the Department of Justice, all members recognized the critical relevance of opportunity costs in these circumstances (pp. 8, 86): "to the extent that AVC [average variable cost] mainly reflects the direct expenses incurred in production, it is an unsatisfactory proxy for marginal cost—since it does not account for more profitable opportunities foregone." By emphasizing revenue "self-diversion," DOT seemingly was trying to incorporate opportunity costs into its method of detecting predation.

[5] I have had time only to look at the industry's ranking among the Fortune 500 only over the last seven years: its median ranking was 21st out of 38 industries, reflecting rankings averaging

of purchasers of unrestricted tickets having a legitimate complaint; and it by no means follows that if unrestricted fares were to come down, discount fares would inevitably have to go up. The industry is far from perfectly competitive, there is therefore a wide range within which its rates of return can vary, not only from year to year, but also in the long run, if only because its costs are not exogenously fixed by perfectly competitive input markets but are themselves instead responsive in important measure to the intensity of competition in airline markets. If competitive entry were freer than it is today of predatory responses, the intensified competition that it could bring could clearly be associated with lower costs, the latter because of both intensified downward pressures of competition on the costs of incumbents and increase in the proportion of the traffic carried by the low-cost carriers.

There is always a danger, in proceeding more vigorously against what appear to be predatory pricing responses by incumbent airlines to competitive entry of weakening competition itself. The concern is a legitimate one—that a more vigorous attack on responses by incumbent airlines to competitive entry may, by labeling healthy and consumer-benefiting competitive responses by incumbents as predatory, outweigh the benefits. On the other hand, some of the responses of the Department of Transportation's initiative to move against such responses, on the ground that it would suppress more competition than it would protect, generally ignore the fact that the only possible circumstances under which such a policy would discourage such price reductions would be when the incumbents were not offering such low fares in such profusion until they were challenged, offered them then only in direct response to competitive entry and only on the particular routes affected, and—in those instances in which the competitor had been driven out—promptly withdrew them. On the third hand, however, there is the difficulty, in enforcement actions, of predicting which of the vigorous competitive responses will have that ultimately anti-competitive effect, which will not, and in which markets, therefore, competition is likely to persist, to the lasting benefit of consumers.

Senator DEWINE. Professor Morrison.

STATEMENT OF STEVEN A. MORRISON

Mr. MORRISON. Thank you. It is a pleasure to be back today. My remarks will be brief. There is more detail in my testimony and in the sources that are referenced in the testimony.

What I would like to do is go through some points to provide my answer to the question that is the theme or the title of these hearings: "Airline Competition: Clear Skies or Turbulence Ahead?" My approach to this issue, as to all issues of this type, is empirical. I look at the data.

What I am going to do in the next 5 minutes is, first, present some aggregate figures that provide an overview of the extent of competition in the airline industry, then present the results of some statistical analyses that shed light on the factors that underlie those aggregate results, and then speculate on some possible policy responses that may improve competition.

As for the overview, I would like to look at some key measures of the extent of competition in the airline industry and its effects. One of the most important measures of competition is the number of carriers per route. And using that measure, competition has been stable for the last 7 years, at a level some 30 percent higher than it was before airlines were deregulated.

As, or more important than that simple measure of number of carriers per route, as Professor Kahn indicated, is the presence of low-fare carriers. And by that measure, low-fare carriers' share of passenger miles is now at an all-time high, at 12 percent. But the influence of low-fare carriers goes beyond their own share of pas-

around 32 out of 35 in 1993–95 and a very satisfactory 12 out of some 38 in 1997–99; but one need only dip back into the catastrophic losses the industry suffered in the 1990–92 period to put the quite satisfactory showings over the last years in proper context.

senger traffic because they influence the fares of other carriers who compete against them, as the chart illustrates.

If you look at the percentage of traffic that flies on routes with low-fare competition, that measure, as well, is at an all-time high of 42 percent.

Senator DEWINE. Forty-two?

Mr. MORRISON. Forty-two. I will add parenthetically that two-thirds of both of those numbers is due to the premier low-fare carrier, Southwest.

Using an even broader definition of the influence of low-fare competition to include not just routes served but the effect of potential competition, I have calculated the effect of Southwest Airlines alone influences fares on 94 percent of passenger miles in the country, just Southwest Airlines.

These figures on the extent of competition are of interest because we know both theoretically and empirically that more competition leads to lower fares. But as Professor Kahn said, we can just look at fares to see what has happened. Fare per mile adjusted for inflation is at a historical low of a little bit less than 14 cents a mile. Indeed, there is a wide variation in fares. We documented that in the report of the Transportation Research Board panel.

So adding in the service benefits and fare changes, travelers today are saving some $20 billion annually over what they would have paid in the years of regulation. So, viewed in the aggregate, airline markets are working. But aggregate statistics can hide some details.

Although the average traveler is better off, our estimate is that some 20 percent of travelers are paying higher fares, the 6 percent that Professor Kahn indicated, but others as well. And what I want to do in the second half of my testimony is talk about what factors account for these winners and losers.

To address that, Cliff Winston and I performed some statistical analyses. The original source is documented in the testimony. Some of the findings—perhaps most of them are not surprising, but they provide a useful quantification of conventional wisdom.

I have good news and bad news. The good news is competition from Southwest Airlines saves travelers some $10 billion a year. Competition from other low-fare carriers saves travelers some $1.5 billion a year. The bad news is the long-term exclusive use gates at airports and other lease policies that make it difficult for airlines to acquire new gates, by our estimates, cost travelers $3.8 billion annually.

Slot restrictions at the slot-controlled airports, the high-density rule, costs travelers $.6 billion annually. Hub dominance costs travelers $.4 billion annually, but this appears to be because, with a few exceptions, Southwest Airlines does not operate from dominated hub airports.

What we have found is that fares at hubs are no higher than fares elsewhere that Southwest doesn't serve. Southwest has such a huge impact on the outcomes in the marketplace that one needs to in almost any analysis take their presence or absence into account when making comparisons.

Finally, in the bad news category, we were provided by the Department of Transportation a list of some 20-odd routes where

their unfair exclusionary practices criteria appeared to have been violated. The routes on which those violations occurred cost travelers $20 million a year. So that is a rather small number compared to the billions that I have been referring to before.

What can we do about it? Low-fare competition, especially from Southwest, has a powerful effect on fares. To increase the likelihood of the next Southwest coming on line, we could, and I think we should, eliminate restrictions on foreigners owning and operating U.S.-based airlines.

We need to do something, and I am not entirely sure what, to increase gate availability. From what I have read, it appears that existing policies of the DOT or existing regulations of DOT and of airport operators provide them with more leverage than they are using to open up gates, but that is certainly an area that needs some attention. Remove slots and replace them with congestion-based takeoff and landing fees. I am not up to date on exactly what has happened, but I know some legislation has been passed in that regard. Finally, I differ with Professor Kahn about the importance, but more importantly about the avenue to take with alleged predatory behavior. I believe it should reside with the Department of Justice.

To summarize, to answer the question: airline competition: clear skies or turbulence ahead, I would say clear skies with a little light chop.

[The prepared statement of Mr. Morrison follows:]

PREPARED STATEMENT OF STEVEN A. MORRISON*

INTRODUCTION

From time to time since airlines were deregulated over 20 years ago, the question of the functioning of airline markets arises. For example, seven years ago, after four years of staggering losses, a national commission was formed to investigate whether the deregulated airline industry was capable of achieving financial viability.[1] The industry's fortunes improved without any regulatory intervention and for the last several years it has been recording record profitability. Recently, concern has shifted from the plight of airlines to a concern for their passengers. This testimony summarizes recent empirical analyses I have undertaken to address the state of competition in the airline industry.

THE BIG PICTURE

Figure 1 shows the trend in the number of "effective competitors"[2] at the route level from 1977, the year before formal deregulation, through 1999. The number of carriers per route averaged about 1.7 in 1977 and rose to about 2.5 by 1986. Following the merger wave of the mid-1980s and bankruptcies in the early 1990s, the number of effective competitors per route has been fairly constant since 1993 at 2.2, an increase of more than 30 percent since 1977.

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* Portions of this testimony rely on and are extracted from Steven A. Morrison and Clifford Winston, "The Remaining Role of Government Policy in the Deregulated Airline Industry," in Sam Peltzman and Clifford Winston, eds., "Deregulation of Network Industries: What's Next?," Washington, DC: The Brookings Institution, 2000 (forthcoming). The paper is available in the research section of my web site.

[1] The National Commission to Ensure a Strong Competitive Airline Industry, Change, Challenge and Competition: A Report to the President and the Congress, August 1993.

[2] Because a simple count of carriers on a route would treat a carrier with a large market share of equal importance as one with a small market share, a measure of competition that takes market share into account is appropriate. In particular, I use the inverse of the widely used Herfindahl-Hirshman index (HHI), which equals the sum of the square of each firm's market share. Thus, if two carriers each had a 50 percent market share, the HHI would be $0.50^2+.050^2=0.50$. Inverting gives two equal-sized competitors. The same result would occur with three carriers with market shares of two-thirds, one-sixth, and one-sixth.

In addition, however, to the number of carriers on a route, the identity and business models of those carriers are also important, especially if one's ultimate interest is the effect of competition on fares. Figure 2 shows two measures of the influence of low-fare carriers. The first measure is the percentage of domestic passenger miles flown by low-fare carriers. This measure increased steadily from 1978 until 1985, declined in 1986 with the bankruptcy/merger of People Express and has grown steadily since 1987. In 1999 low-fare carriers accounted for 12 percent of domestic passenger miles, the highest percentage ever.[3] The second measure, however, gives a more accurate picture of the effect that low-fare carriers have on airline competition and fares. This measure takes into account that the influence of low-fare carriers is greater than their share of traffic because they influence fares of other carriers flying the same routes (in this case, the same city pair). In particular, it measures the percentage of domestic passenger miles flown (by all carriers) in city-pair markets that are served by low-fare carriers. This measure follows the same pattern as the previous one: increasing until 1985, declining until 1987 and increasing since then. In 1999, low-fare carriers influenced fares on routes accounting for 42 percent of domestic passenger miles, an all time high.[4] In addition, using a broader measure of the effect of low-fare carriers that incorporates the effect of actual route competition, competition on nearby routes, and the effect of potential competition, I have found that Southwest Airlines alone affects airfares on routes that account for 94 percent of U.S. domestic passenger miles.[5]

Interest in the extent of competition in the industry stems from the observation that more competition—especially from low-fare carriers—leads to lower fares. This is addressed directly in Figure 3, which shows domestic airline yield (average fare per mile) from 1970 to 1999. Fares, adjusted for inflation, have fluctuated, but followed a declining path since 1971. Compared with 1976, before the regulatory reform that preceded deregulation in 1978, fares have fallen 40 percent. In 1999, real yield was a bit less then 14 cents, its lowest level ever. However, as shown in the figure, fares were falling even before deregulation. How much of the decline in fares is due to deregulation and how much would have happened anyway (due to factor prices and technological change, for example)? This is addressed in Figure 4, which shows a conservative estimate of how much lower fares are due to deregulation.[6] For the last six years fares have been about 27 percent lower than they would have been if they were regulated. (Thus, about two-thirds (27/40) of the fare decline since 1976 can be attributed to deregulation). Further investigation shows that 80 percent of passengers, accounting for 85 percent of passenger miles, pay lower fares than the estimate of regulated fares.

Deregulation has also affected service. Previous research has found that travelers have gained substantially from the increase in flight frequency facilitated by the acceleration of hub-and-spoke operations.[7] Because deregulation freed airlines to serve all markets, travelers have also gained from having to make fewer connections that require changing airlines. These gains have been partially offset by more crowded flights, travel restrictions that are inconvenient for business travelers (especially the required Saturday night stay), a few more connections, and slightly longer flight times because of congestion. Accounting for fare and service quality changes, the annual net benefits to travelers from airline deregulation currently exceed $20 billion.

THE DETAILS

The results presented in the previous section indicate that, on average, travelers have benefited from airline deregulation but that a small minority has not. In this

[3] About two-thirds of the passenger miles flown by low-fare carriers are accounted for by Southwest Airlines. Although the passenger miles of other low-fare carriers were at an all-time high in 1999, their share of passenger miles (4.0%) was slightly less than in 1997 (4.1%) when it reached an all-time high.

[4] Again, about two-thirds of this is due to Southwest Airlines.

[5] See Steven A. Morrison, "Actual, Adjacent, and Potential Competition: Estimating the Full Effect of Southwest Airlines," unpublished manuscript (available in the research section of my website).

[6] The estimate compares actual deregulated fares with an estimate of what fares would be if they continued to be regulated. Of course, one has no way of knowing for sure what regulated fares would be. However, a good guess can be made with an updated version of the fare formula that the CAB used during the last few years of regulation. See Steven A. Morrison and Clifford Winston, The Evolution of the Airline Industry, Washington, DC: The Brookings Institution, 1995.

[7] Steven A. Morrison and Clifford Winston, "The Evolution of the Airline Industry" provides a detailed discussion of the findings reported in this paragraph. The benefits from increased frequency are nearly as important as the benefits from reduced fares, amounting to more than 80 percent of the benefits from lower fares.

section I take a more disaggregate view to try to identify those factors that distinguish the winners from the losers and to identify any trouble spots and possible policy remedies.

To address this question, my colleague Cliff Winston and I used regression analysis to examine the factors that influenced fare changes between 1978:4 and 1998:4 on the 1,000 most heavily traveled routes in 1998.[8] We found that increased competition, especially from Southwest Airlines and other low-fare carriers leads to lower fares. In particular, we found that competition from Southwest Airlines accounted for $9.7 billion of the fare savings since 1978:4. Competition from other low-fare carriers accounted for $1.5 billion, while additional competition from pre-deregulation carriers accounted for $0.4 billion.

In another regression we examined the factors that influence the level of fares (rather than the change in fares) on the same set of routes used above. We found that the most important factor that increases airfares to travelers was (lack of) gate availability. In particular, we found that, other things equal, airports with a higher fraction of gates available for use by other airlines (i.e., generally common use gates) had lower fares. Quantitatively, if all airports had common use gates, or other arrangements that precluded exclusive use of gates by incumbent airlines, travelers would save $3.8 billion annually.

Slots (at O'Hare and LaGuardia) raise fares by $0.6 billion annually.

Domination of hub airports raises fares by $0.4 billion annually, other things equal. Figure 5 sheds additional light on the hub premium issue. The figure shows the percentage by which fares at 12 concentrated airports differ from fares at two sets of control groups. Although the results differ from airport to airport, on average, fares at concentrated hub airports are 23 percent higher than at all other airports. But, as indicated above, the effect of Southwest Airlines on fares is so important, that when the comparison group excludes airports that Southwest serves, the average concentrated airport has fares 6 percent lower than the comparison group.[9] Thus, it appears that what looks like a hub premium is actually a "premium" that airlines charge anywhere they can when they do not compete against Southwest.

On routes where carriers appear to have violated the Department of Transportation's Unfair Exclusionary Practices criteria, fares are lower during the periods when the alleged transgressions are occurring and return to their previous levels after the episodes are over. We found that fares on these routes, before and after the alleged predatory activity, are $20 million higher than on otherwise comparable routes.

CONCLUSION AND POLICY RECOMMENDATIONS

By and large, airline markets are working and competition is healthy. There are a few trouble spots, however. By far the most important is access to gates at airports. Slot restrictions are a distant second, followed by hub dominance. The quantitative importance of alleged predatory activity is quite small.

Although competition is robust, more competition would be better. The effect of Southwest Airlines on competition and fares shows that just one airline can have a large impact on competition and fares if it is well financed and well managed. The likelihood of another Southwest entering the industry would be increased if federal limits on foreigners owning and operating U.S.-based airlines were eliminated.

The FAA/OST Task Force[10] has recommended several policies to improve gate availability at airports as has the TRB Committee for Study of Competition in the U.S. Airline Industry.[11] These range from using the AIP and PFC programs to improve gate availability to airport authorities buying back gates from dominant incumbents. Although I do not have a particular policy in mind, any policy that improves gate access should have a large impact on competition.

As for slots, I believe they should be eliminated and replaced with congestion-based takeoff and landing fees.

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[8] Steven A. Morrison and Clifford Winston, "The Remaining Role of Government Policy in the Deregulated Airline industry," in Sam Pelzman and Clifford Winston, eds. "The Deregulation of Network Industries: What's Next?," Washington, DC: The Brookings Institution, 2000 (forthcoming) (available in the research section of my web site).

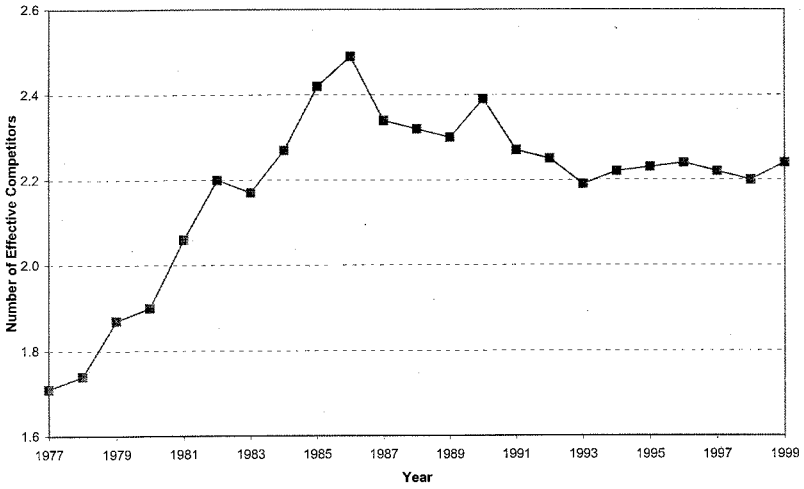
[9] This comparison is potentially misleading because three of the concentrated airports are served by Southwest (Salt Lake City, St. Louis, and Detroit). However, if these three airports are eliminated from the analysis, fares at the nine remaining concentrated airports are 29 percent higher than at all other airports and 1 percent lower than the comparison group that excludes airports served by Southwest.

[10] FAA/OST Task Force, "Airport Business Practices and Their Impact on Airline Competition," October 1999.

[11] Transportation Research Board, National Research Council, "Entry and Competition in the U.S. Airline Industry," Special Report 255, Washington, DC: National Academy Press, 1999.

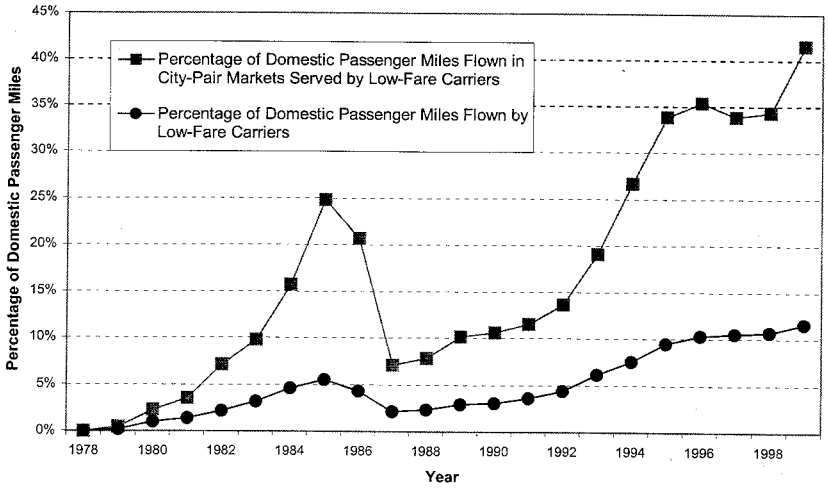
Although I have found that the likely effect of alleged predatory behavior is small, it should not be ignored. In cases of alleged predatory behavior by airlines, I believe the Department of Justice should investigate and take appropriate action, rather than the Department of Transportation.

Figure 1
Competition at the Route Level



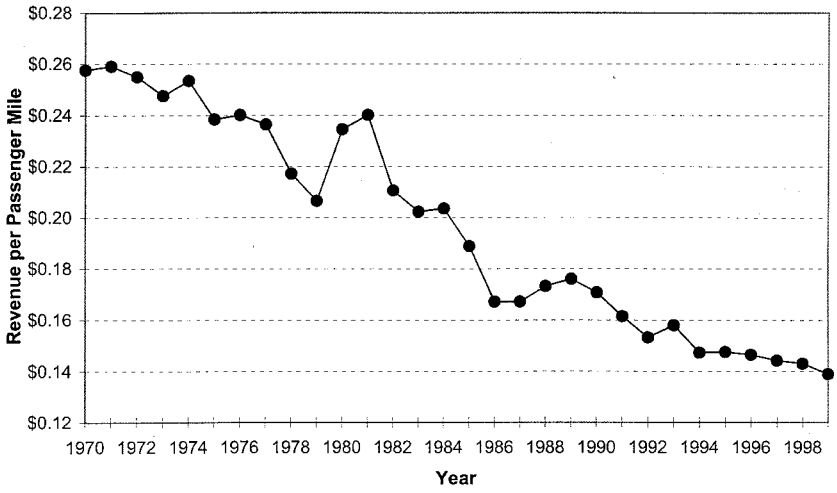
Data Sources and Variable Construction: Author's calculations from data in U.S. Department of Transportation, Data Bank 1A. The data point for 1999 is for the first two quarters only.

Figure 2
The Influence of Low-Fare Carriers



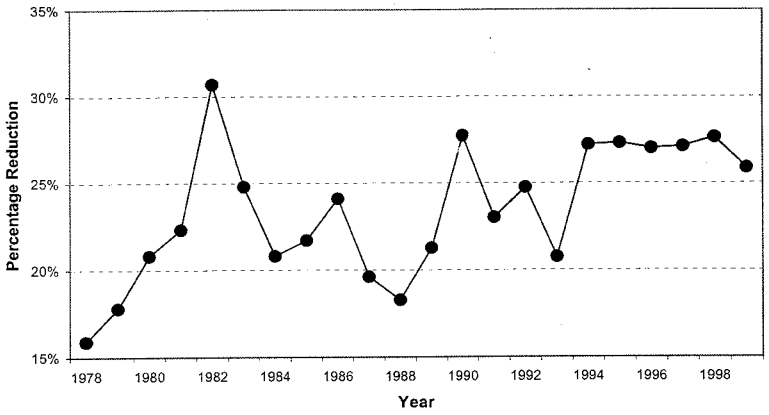
Data Sources and Variable Construction: Author's calculations using data from U.S. Department of Transportation Data Bank 1A, and Form 41. The 1999 data point for Percentage of Domestic Passenger Miles Flown in City-Pair Markets Served by Low-Fare Carriers is for the first and second quarters only.

Figure 3
Domestic Airline Yield Adjusted for Inflation (1999 dollars)



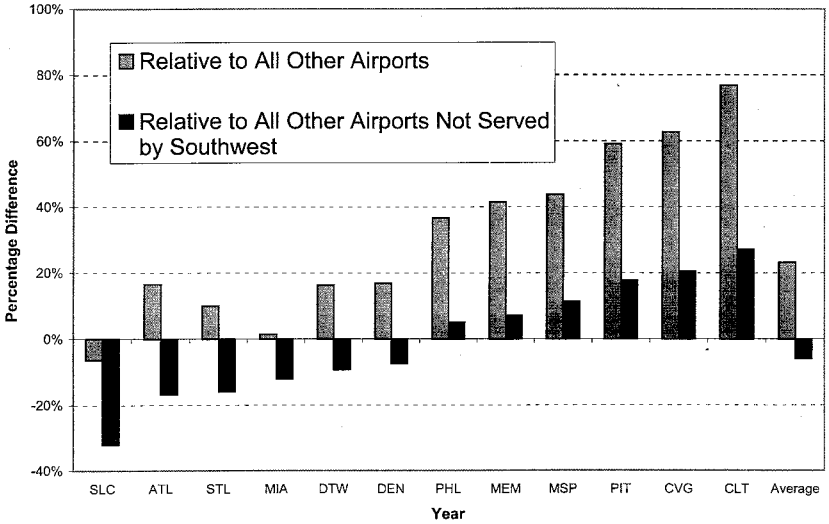
Data Sources and Variable Construction: Author's calculations using yield data from the Air Transport Association (www.air-transport.org) and Consumer Price Index data from the U.S. Bureau of Labor Statistics (www.bls.gov). The figure for 1999 is preliminary.

Figure 4
Percentage Reduction in Fares Relative to Regulated Fares



Data Sources and Variable Construction: Author's calculation. This figure updates the calculation of fare savings in Steven A. Morrison and Clifford Winston, *The Evolution of the Airline Industry,* Washington, DC: The Brookings Institution, 1995. The data point for 1999 is for the first two quarters only.

Figure 5
Domestic Fares at Concentrated Hub Airports in 1998



Data Sources and Variable Construction: Author's calculations using data from the U.S. Department of Transportation, Data Bank 1A. (SLC = Salt Lake City, ATL = Atlanta, STL = St. Louis, MIA = Miami, DTW = Detroit (Wayne County), DEN = Denver, PHL = Philadelphia, MEM = Memphis, MSP = Minneapolis-St. Paul, PIT = Pittsburgh, CVG = Cincinnati, CLT = Charlotte.)

Senator DEWINE. Good, very interesting.

Mr. Morrison, do you want to summarize for me in descending order the items that are causing the problems as far as lack of competition? Give me that again.

Mr. MORRISON. Gates.

Senator DEWINE. Gates, number one.

Mr. MORRISON. Number two is slots. Number three is hubs.

Senator DEWINE. Gates, slots, hubs.

Mr. MORRISON. Number four is alleged predatory behavior.

Senator DEWINE. OK, and that is the order?

Mr. MORRISON. Yes.

Senator DEWINE. Professor Kahn, you mention in your testimony that having the Department of Transportation take action to prevent unfair exclusionary practices may actually weaken competition, and I agree that that is a concern. How would you protect against that sort of unwanted result?

Mr. KAHN. I am not sure that I have an easy answer. We have the experience of the Federal Trade Commission in dealing with the entire economy. It has almost precisely the same authority under Section 5 of the Federal Trade Commission Act. I have seen many criticisms of the FTC, but I have never heard it seriously maintained that, on balance, they have weakened competition.

One of my main reasons for wanting DOT to retain that concurrent authority is that the Supreme Court has virtually written predation out of the antitrust laws. They have expressed the opinion time and again that predation is rarely tried and even more rarely succeeds.

And by an interesting coincidence, the Supreme Court—I suppose it is not surprising, given the fact that they are lawyers—is a victim of a perceptual lag. They are all trained by the University of Chicago and the economics profession has moved about 15 years past the University of Chicago on the question of whether predation is or is not a real problem. And since I have referred to myself as a premature post-Chicagoan, I take enormous satisfaction from that fact. And I would urge you to look at the Allvine-Dixit memorandum.

So it is a question of what your opinion is about the sufficiency of the Sherman and Clayton Act prohibitions as they have been interpreted by the Supreme Court. I think there is an enormous lag there, and I think that we should give DOT a chance. I think their sensitivity to the danger of interfering with good competition is very clear.

But the way I weigh the dangers, I weigh the danger much more on the other side because, as I pointed out, they would never move in a situation in which competition before the entry of the entrant was effective. They would move only in those particular situations in which somebody took the initiative to come in, cut fares sharply. Then, of course, they are all in favor of competition, but only as long as it is responsive and it is not initiating.

The only other point I would make and then I promise to stop is that I have had correspondence with Professors Winston and Morrison on this point. Their measure which demonstrates that predation has cost consumers virtually nothing is a measure of the extent to which, after assertedly predatory conduct, fares move up

beyond the entry at which they were before the competitor came in.

In other words, if you have entry and fares go down 50 percent, and then you have assertedly predatory tactics and fares just go back up to the pre-entry level, their measure would say zero cost to consumers. I think most of us would define predation as being successful to the extent it restores fares to the previous level. I recognize that that might be an extreme the other way.

They have also introduced a second measure, which is, well, if it restores fares to the previous level and those fares were unusually high, that is compared with fares elsewhere, then to the extent that they were unusually high, we will count that as a cost to consumers.

My concern is with the pattern of pricing in the industry all through the industry that has these very high unrestricted fares. So, again, these measures which they identify, I think, minimize the costs of what many of us would feel were the costs of predation.

Mr. MORRISON. May I follow up?

Senator DEWINE. Absolutely.

Mr. KAHN. As he has in writing.

Mr. MORRISON. Indeed, what we found was that, of course, while these alleged predatory activities are going on, fares are lower, and that when they are finished, fares go up to the level that they were before, not higher, but that those fares before and after were some $20 million, the number I mentioned before, on the aggregate higher than on otherwise comparable routes.

As far as the notion that predation in one market spreads to others, I suspect that is true, but there is no way that I can figure out to measure it, so the extent of it is speculative.

Mr. KAHN. Yes. That was the other point I made in my letter to them that one of the main bases for the post-Chicago view of predation is that engaging in this kind of tactic protects the price level all over your network because it deters future entry. And, of course, Professors Winston and Morrison are absolutely right. There is no way of measuring it, but, of course, the fact that something can't be measured doesn't mean it doesn't exist.

Senator DEWINE. Senator Kohl?

Senator KOHL. Thank you, Mr. Chairman.

Professor Kahn, we have heard from several start-up airlines that they find it very difficult to compete with the established airlines at their hubs where the incumbents dominate the market. Northwest in Minneapolis, US Air in Pittsburgh, and Delta in Atlanta are just a few examples, although there are many others.

When a new airline comes into a market, the established airline can and oftentimes does drastically cut its fares to undersell the entrant and can add vastly more capacity. Some airline critics and consumer advocates call these tactics predatory and say that they ought to be illegal under antitrust law.

Do you have a view on that, Mr. Kahn?

Mr. KAHN. Well, my view is that some of those are almost certainly predatory, sufficient even to deter a Southwest Airlines from challenging the incumbent hub-dominating carriers.

Now, there are two reasons why Southwest stays out. Partly, when the hubs are congested, they can't engage in their really effi-

cient, rapid turnaround operations. But the other reason, I know, is that if they were to try to come into Minneapolis to remedy the situation that you described, they would run into a buzz saw.

Now, it is generally understood in the industry that you don't really take on Southwest. They have a very great longevity. But it is also understood that Southwest doesn't go into Boston, A, for the perfectly good reason that I have mentioned, but, B, because it is already dominated and it would start this kind of major price war. So, of course, they locate at Providence and Manchester, which is great, and at Baltimore, which is again great.

I mean, they are public benefactors, there is no question about it. But I think that even they are deterred from challenging directly—and I have heard this example—specifically in Minneapolis because of what they know the response is likely to be.

Senator KOHL. Professor Morrison, are you concerned that these types of tactics practiced by some of the airlines will harm consumers by driving competition out of the market or preventing them from getting into the market in the first place? Doesn't it bother you?

Mr. MORRISON. Yes. My problem is what to do about it.

Senator KOHL. Well, what about this DOT authority to commence an action?

Mr. MORRISON. Well, the DOT authority, in my view, is fairly vague, these best alternative responses, and depending on where these data would come from, it might be 6 months after an action that you knew whether it was legal or illegal.

As was mentioned by Senator DeWine and as everybody knows, there is currently a Department of Justice case against American Airlines. I know that American Airlines and its allies say that the Justice Department wants to create new law. And I gather what they mean by that is a different definition of cost, and time will tell.

Senator KOHL. Well, in the case of Minneapolis, for example, if they called in Northwest and said, you know, we are watching this very carefully, and detailed what they are observing and how important it was, in their opinion, to keep a competitor fairly in business or not to drive them out of business unfairly, and that, you know, while they are not going to commence an antitrust action, they have the authority to take a careful look at this and bring to bear some very serious consequences, don't you think that that provides them with the ability to do what you are concerned about?

Mr. MORRISON. Yes. As I recall, they did that without these new guidelines under Secretary Pena when Reno Air entered into their markets. And they responded very aggressively, as I recall, with a phone call, or maybe it was more than that, from the Secretary. They moderated their response.

Senator KOHL. Professor Kahn, I believe that all American consumers owe you a debt of gratitude for the ground-breaking work you have done to promote airline deregulation. Sitting here today in 2000, I wonder how you would assess the state of airline competition today. More specifically, has deregulation brought about lower fares and increased consumer choice, as you imagined, and what are the biggest competitive problems that we are looking at 20 years after deregulation?

Mr. KAHN. I have no disagreement at all with the general conclusions of Drs. Winston and Morrison. The benefits to travelers, the $20 billion that they estimate—you understand these estimates are very difficult because you have to know what fares would have been in the last 20 years and what regulatory policies would have been adopted and changed if we hadn't deregulated.

But I don't even have to look at their estimates. I can look around me and I see that last year 94 percent of all mileage was at discount fares, and that the average discount from the, I say, perhaps outrageous full fare is 69 percent. And I see the behavior of carriers. There couldn't have been more than 15 percent of all mileage at discount fares when it was regulated, and once we gave them freedom, they clearly competitively were pricing down. I would say that deregulation has exceeded my timid expectations by far.

Senator KOHL. Are there some major problems that you think need to be addressed?

Mr. KAHN. Well, I think that, number one, clearly the infrastructure. I mean, the system that we have for providing air traffic control and airports could only have been designed by a sadist. The pricing of access to airports, particularly at times of congestion, and to air traffic controls systems is insane.

When we had all those delays last summer and the airlines responded, well, we schedule our flights when the travelers want to travel—and they are absolutely right, but if you charged for paintings the way you charge for landings at airports, so much per pound, regardless of the day of the week, regardless of the amount of congestion, regardless of the week of the year, you would have riots where Van Gogh paintings were for sale.

I mean, a market system would permit those rates at those airports and access to air traffic control to be much higher, and then use those surplus revenues to subsidize use of the air traffic control system and access to those airports off-peak or at feeder airports, and we might get some redistribution of the traffic.

And that is what we did when I was chairman of the New York Commission. When I came, rates on Long Island were 5 cents a kilowatt hour, morning, afternoon, evening, summer, winter, spring and autumn. By the time I left, rates to big users, for whom alone you could have the necessary meters, were 3½ cents, 3 cents, 2½ cents, and in the summer, when the temperature got above 84 degrees, 30 cents. That is sensible pricing.

So the Government is simply not following elementary economic advice, A, in the way it finances investment in air traffic control, the fact that it is subject to the budgetary process. There has got to be some sort of separate corporatization where it can raise its own capital and then can price intelligently. That is one.

The second is the international, including the one that Steven mentioned, the prohibition of foreign ownership. I want Richard Branson to come in here with Virgin Airlines. And the third, I think, is this threat to independent entry of the kind of violent competitive response that many of them can tell you they encountered, temporary violent response, when they dare to come in and bring in competition.

Senator KOHL. Just to finish my questioning with that line, in this specific case, Minneapolis-Milwaukee, Sun Country Airlines, is clearly beneficial to consumers. Mr. La Macchia testifies that they are going to put them out of business. He doesn't have much longer to go.

If he would suggest that that is what is happening, what can we do, what should we do, either one of you?

Mr. KAHN. I have been in communication with the Department of Transportation trying to see if we could devise a test that would not be, I think, as impossible to administer, for the reasons that Professor Morrison has mentioned. Was there a more profitable course that they have abandoned, and in abandoning it, they have taken losses; that is, they are pursuing a less profitable course than otherwise. That is an acid test of predation, and I find it extraordinarily difficult to do so.

I find myself attracted, as other economists have been, to the notion that if an incumbent carrier responds in this way, with sharp reductions in rates and increasing in the offer of discount seats and capacity, and the entrant is driven out, then the incumbent should be required to stay there to retain those offerings for something like 2 years. That would be a real test of whether they really thought that they were taking the most profitable course or whether they were designedly taking losses which could be explained only in the expectation of succeeding in predation.

Senator KOHL. Ok. Mr. Morrison.

Mr. MORRISON. I agree with Professor Kahn that it is difficult. As to the 2-year idea, it is an intriguing idea. I don't know how easy even that would be to enforce, what with the fare structures the way they are with quite variable fares. I really don't have an answer. It is a difficult question because of the structure of airline costs, and it will be interesting to see what the outcome of this American Airlines case is.

Mr. KAHN. I think it is partly like pornography. I can't define it, but I know it when I see it. I am quoting a very distinguished predecessor.

Senator KOHL. I will just end with this observation. In a sense, with great respect and deference to what you are saying, it is pretty basic to this hearing. What do you do in those situations where you do have clearly, or apparently, some predatory situation that is going to drive out a competitor we don't want to drive out. I don't have an easy answer either, but that is why we are here today.

And I am somewhat troubled by your suggesting that you don't have any remedy that you would——

Mr. MORRISON. Well, my remedy is the Department of Justice.

Senator KOHL. Antitrust?

Mr. MORRISON. Yes.

Senator KOHL. Long, drawn-out?

Mr. MORRISON. It is better than the alternative.

Senator KOHL. By that time, somebody like Sun Country might be long gone.

Mr. MORRISON. Might be.

Senator DEWINE. Let me ask both of you this question. One of the advantages of the hub and spoke system is that it allows the

airline to serve a number of markets that would not economically be feasible using the point-to-point system.

With the increasing use of regional jets which are cheaper and smaller than conventional domestic jets, some of those markets may now be able to support point-to-point service. Will regional jet service, in your opinion, decrease the economic value of hubs? How will that impact all that?

Mr. KAHN. My crystal ball on this is going to be much poorer than Mr. Carty, who will follow me and who kind of instructed me many years ago on the benefits of hub and spoke in very lucid testimony that he gave.

Certainly, the availability of regional jets is a very hopeful development. There are, I understand, major difficulties in getting the unions to accept them, and I hope that those can be worked out because there are point-to-point markets that it appears could economically be served. That would tend to encourage the possibility of entry and avoiding the congestion at hubs, which is another very important consideration.

I seriously doubt that it will diminish in a major way the importance of hub and spoke. I mean, the market has told us what we had great difficulty in predicting when we were trying to regulate, that hub and spoke is an extraordinarily efficient way of providing improved service. And whether or not there is a hub premium, if you leave out Southwest from the control group or you do not, it is a wonderful place to live in terms of convenience of service.

Senator DEWINE. Professor.

Mr. MORRISON. I agree with Professor Kahn. I think that there are obviously markets where the regional jet can and does and will operate, but to expect it to have a significant effect to dismantle hubs, I don't think is going to happen.

Senator DEWINE. Let me ask another question. Both of you have talked about and stressed improved access to airports as an important way to increase competition. Do you want to share with us any specific suggestions as to how to improve this access?

Mr. MORRISON. As I said, I am not an expert on this, but various things I have read recently indicate that the Secretary of Transportation, FAA, and airport operators have authority unused at this time that can be used to free up even gates that are under exclusive-use, long-term leases.

The passenger facility charge, PFC program, appears to be or has the potential to be a way to increase the number of gates. An aspect of that program is that gates constructed under it cannot be exclusive-use, long-term gates. So that is something that the evidence isn't in yet. One can be hopeful about.

But as I said, I think there is enough on the books already if it were utilized, taken seriously, and used aggressively to free up airports at these hubs that are where the gates are scarce.

Senator DEWINE. Professor.

Mr. KAHN. I am sorry. I don't have anything more to add to that. We have a very large number of assertions to that effect, and the staff of the national research committee looked at that and felt that there was substance to it. Clearly, it is a carryover of the method by which airport construction was financed in the past, and that carryover has simply got to be eliminated.

Senator DEWINE. We want to thank both of you very much. It has been very helpful. Thank you for coming.

Let me invite our second panel to come up, and as you are coming up, I will introduce you.

Donald J. Carty became Chairman, President, and Chief Executive Officer of American Airlines in 1998, after having served as President of AMR Airline Group and American Airlines since 1995. He also serves as Chairman and interim Chief Executive of Sabre.

Robert Ferguson III has served as Chairman of the Board, President, and Chief Executive Officer of Midway Airlines since February 1997. Mr. Ferguson also sits on the board of directors of Capital Cargo International Airlines, an air freight company, and in the past has served as CEO of Continental Airlines.

Bill La Macchia has been President and Chief Executive Officer of Sun Country Airlines since 1998, and has been an instrumental part of Sun Country's success and growth into a $250 million company.

Mr. Ferguson, we will start with you. Thank you all for coming.

PANEL CONSISTING OF ROBERT FERGUSON, PRESIDENT, MIDWAY AIRLINES, RALEIGH-DURHAM, NC; DONALD J. CARTY, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, AMERICAN AIRLINES, DALLAS, TX; AND BILL La MACCHIA, JR., PRESIDENT AND CHIEF EXECUTIVE OFFICER, SUN COUNTRY AIRLINES, MENDOTA HEIGHTS, MN

STATEMENT OF ROBERT FERGUSON

Mr. FERGUSON. Thank you very much. Mr. Chairman, Senator Kohl, committee members, thank you for the opportunity to speak with you today. I am the President of Midway Airlines. It is the only airline in America named for an airport it doesn't serve. We are presently based in Raleigh-Durham, NC.

I have been involved in the aviation business now for some 20 years, and I think it is fair to say I have seen a number of boom-and-bust cycles through the course of that period. In 1993, when I was the President of Continental Airlines, I had the opportunity to testify before a commission established by President Clinton, and one fact struck me as rather remarkable.

Since 1978, at the inception of deregulation, some 119 airlines have been started, and 117 of them had failed. That didn't seem like a very auspicious beginning. They failed for bankruptcies, they failed for mergers, they failed because of bad business plans. The chances of success in this business, in fairness, if you are a little guy, are very small.

I would like to tell you, however, that I do think it can be done. There are ingredients, and I guess I would like to tell you a little bit about Midway Airlines. In our case, we believe that you can succeed in this business by beginning with a business plan that is not premised on skimming the cream of the major air carriers and their established routes.

Rather, an airline needs to find a growing market, an economically vibrant city, perhaps one that is not an existing hub, and it is located in our case in Raleigh-Durham. Challenging a major car-

rier directly by initiating service into their hubs on the first day of business is not a recipe for success.

Two, the carrier must be well financed. He must have patient investors. We have had both. We appreciate it.

Three, the product being sold, airline seats, must absolutely be priced for profitability, not market share. Many of the new entrant carriers over the years have priced for market share and not profitability.

Four, you must place an emphasis on safety, dependability, low fares, and hopefully, if you are lucky, financial stability. We need a loyal workforce and, in fact, ultimately we need some support from the Government. We need access to airports, we need access to slots and gates. We need a fair hearing before Federal regulatory agencies.

And, in fairness, it would be good if we had an air traffic control system that we could fly around with. In our little case, in the month of April, 58 percent of the delays we experienced were attributable to the air traffic control system.

Of the six elements that I have mentioned, we have tried to apply all of them at Midway, and we have applied one additional one. We have applied regional jets, 50-seat aircraft, allowing us to size the capacity of our equipment for the size of the markets in which we participate.

Raleigh-Durham was not the most auspicious place for a hub. I will point out that American Airlines had a little experience in Raleigh-Durham. In our opinion, part of the reason they were not successful was that the average aircraft size was too large for the market. Raleigh-Durham is, after all, the 50th largest market in the United States. I don't believe there is another hub that is in a city that is less than the 30th largest.

Midway's story, like so many other start-ups, began trying to carve a niche in Chicago. We were unsuccessful. We were unable to compete with the dominant carriers, even though we carried the name of the city. Unlike Chicago, Raleigh-Durham presented us with a great opportunity, and opportunity, in fact, carved for us by American Airlines. They built the gates, they built the infrastructure, they built the maintenance facilities.

We seek to serve our customers. We have created a unique product. We serve our customers with only technologically advanced equipment. It is environmentally-friendly, it meets all existing noise standards. We have some 32 aircraft with an average age of 2.3 years. Of those aircraft, 22 are regional jets. We have 17 new 737's on order, 2 of which have been delivered.

In fact, over the course of the last 3 years, we have the highest on-time performance in the industry, although I speak in that respect only in regard to the 10 carriers who publish their statistics because I can't know about the others. Our baggage statistics routinely beat the major carriers, although, as I mentioned, we are once again too small.

We have more leg room than our typical competitors, although I have to say Mr. Carty is about to one-up us in that respect. We have leather seats. We think we have friendly and professional service and, of course, we focus on safety.

Finally, we do offer fares that are lower than those of our major competitors. We are, however, not a low-fare carrier. We are a lower-fare carrier and much higher quality. After an initial period of unprofitability, we have been profitable now for 13 consecutive quarters, and we take some pride in that and the fact that we have built a business plan that actually works.

The most important factor for us, however, is we are in the midst of a growing city. Raleigh-Durham grew 24 percent last year. It is growing at 35 percent presently. There is robust competition in Raleigh-Durham. We have Southwest Airlines and we had MetroJet. We have American Airlines and, in fact, we have every other major air carrier.

We have been successful and we intend to continue being successful. We have done that partly by avoiding picking fights with the major air carriers. We avoid picking major fights with them because it is simply a fact of life in the airline industry and any industry in which there is very little margin that if you try and skim another guy's passengers, he is going to react strongly and aggressively.

We are beginning to feel that we are part of a hub. We are finally achieving that status. We have grown from 47 flights 4 years ago to 236 flights a day. We would react aggressively and affirmatively. At some point in the future, we are going to have to fly into somebody else's hub, however. We tried it once. We flew into another carrier's hub in a market that hadn't been served in at least the prior 10 years, and immediately we were matched with overlaying services.

The Government can play a role; they can be a help. Little guys do have a difficult time. Next time we go into a hub, we will go with a much more aggressive posture. We will serve it as completely as we can and we will be prepared to take the losses necessary to sustain those services.

The other item I would like to mention here briefly is—and I know my time is up and I apologize for that. Air 21, when you pass that bill, is going to be extremely helpful to small carriers like ourselves. In the case of LaGuardia, one of the major carriers withdrew two slots from us, coincidentally at about the time we started service into one of their hubs.

In any event, we are going to operate into and out of LaGuardia now under the security of having slots available to us, and we thank you for that. We are also thanking you for the help you are going to give us in DCA. At least we are going to get a chance to compete for some slots on the same basis as the other carriers achieved them.

I believe, in the end, the Government can play a role. The role, however, is not the one that I heard mention of a moment ago. I do not believe the Justice Department is the right place for this to reside. I got a $12 million education earlier in the 1990's. I do not believe that the competition we see in the airline business is against the law. I do think, however, it is fair to say it is probably predatory.

And I was very disappointed that one of your prior witnesses took away my final line. I don't know whether, "I know it when I see it" is basically the bottom line on predation. There are clear ex-

amples in our business of people going out of their way to ensure that other guys don't succeed. I do not in any respect believe those are against the law. I simply do not believe the laws in this country have been set up to address our business, and that is a public policy question. It is one for you to answer.

If we are going to have a standard of predation, it is not one that applies to the bread makers or the steel mills or the oil businesses of the 1920's and 1930's. We are in a very different world and we need to have a lot of debate before we decide.

I will make one suggestion. The Department of Transportation, with one phone call, or perhaps a bit more, managed to get my two slots back from the very same guy who took them away, and in that respect I am very thankful and very appreciative of the efforts made on our behalf.

Senator DEWINE. Mr. Ferguson, thank you very much.

[The prepared statement of Mr. Ferguson follows:]

PREPARED STATEMENT OF ROBERT FERGUSON

Mr. Chairman, Senator Kohl and Committee Members, I would like to thank you for the opportunity to testify today. I am the President of Midway Airlines based in Raleigh Durham, North Carolina. I have spent over 20 years in the aviation industry and have enjoyed the considerable challenges it has presented. During this time, I have seen many cycles of boom and bust.

In 1993, as President of Continental Airlines, I testified before a Commission appointed by President Clinton and charged with examining the Aviation industry. I was stuck by one stark fact. Following airline deregulation 119 airlines had been started and 117 had failed. Since 1993, there have been additional bankruptcies and failures. The chances of success in this business are small, but still some airlines do succeed and many others will continue to try. I would like to tell you what I think are the critical ingredients to success, describe how Midway has applied those lessons, and finally address briefly the question of the intense competition that exists in this industry and what others might call predation.

It is my belief that in order to start—and perhaps more important, to survive—in this industry, an airline must:

One, build a business plan that is not premised upon cream skimming the routes of the major carriers. Rather, the airline needs to find a growing, economically vibrant city that is not an existing hub and is located in an area of unserved and underserved cities. Challenging a major carrier directly by initiating service into one of their hubs on the first day of business is a recipe for failure.

Two, the carrier must be well financed by patient investors who understand that they are likely to sustain significant losses before reaching profitability.

Three, the product being sold—airline seats—must be priced for profitability not market share.

Four, the carrier must place an emphasis upon the basics: safety, dependability, low fares, and financial stability.

Five, build a loyal workforce that enjoys the airline business, conveying confidence and placing the customer first.

Six, obtain government support for equal access to airports, slots, gates and a fair hearing before federal regulatory agencies.

These six elements constitute a yard stick that has been successfully applied at Midway, but can also be used by other new entrant airlines. They are borne out in part by recent market research conducted by Harris Interactive Inc. and reported in the Wall Street Journal last Thursday April 27th. Mr. Chairman with your permission, I would like to submit the article for the permanent record and a copy has been provided to you as the last page of my statement.

Midway's story, like so many other new start ups, began with an effort to carve out a niche in a major market, Chicago. In part due to restraints on access to gates and to intensified competition from other airlines at Chicago's Midway airport, the airline moved its hub and headquarters to Raleigh Durham in early 1995.

Unlike Chicago, Raleigh Durham presented Midway with an ideal platform to relaunch itself. American Airlines had decided to withdraw from Raleigh-Durham, leaving no dominant competitor in place. Indeed, American left an excellent infrastructure of gates, baggage handling facilities and maintenance equipment essential

to our making a solid beginning. Raleigh Durham, as many of you know, is one of the fastest growing communities on the East Coast. Our target was to focus on the business customer traveling to and from this high growth area.

To serve our customers, Midway created a product that is unique for new entrant carriers. We use only new, technologically advanced and environmentally friendly aircraft that exceed all existing noise standards. We are an all jet airline with 32 aircraft having an average age of 2.3 years. Midway has on order 17 new Boeing 737–700's, two of which have already been delivered. We have the best on time performance of any airline in the U.S. over the past three years. Baggage handling, which is frequently a source of endless complaints, is also among the best in the U.S. Midway is too small, however, to be reported with the large incumbent airlines and is, thus not in Department of Transportation's (DOT) rankings. Further, we offer leather seating with extended leg room to all of our passengers on our larger aircraft and professional and friendly service coupled with an attention to safety. Finally, we offer fares that are generally lower than our competitors. We are not, however, a low fare airline; rather, we are a high quality, lower fare carrier.

After an initial start up period of unprofitability following our move to Raleigh, we have been profitable for the last 13 quarters. This is a significant accomplishment as many other new airlines remain unprofitable. The single most important factor in this success has been the fact that we are based in a growing city where we have been able to build our hub without the need to challenge from the first day of business any large incumbent carrier. Rather, we have taken the infrastructure left by American Airlines and built a hub that has grown from 42 daily flights to 7 states in 1995 to 236 daily flights to 25 destinations in 14 states. We now have a solid base of loyal customers who know our airline and appreciate our attention to detail.

There is robust competition in Raleigh Durham, however, from both Southwest Airlines and USAIR. Other major carriers, including American Airlines, are also providing service to Raleigh Durham. Indeed, we were able to survive Southwest's entry into Raleigh Durham market, an event that has precipitated the exit of many other large and small carriers in other markets, because we have been able to quietly build a strong hub that serves a somewhat different passenger than Southwest.

We have consciously avoided picking fights with the major airlines by flying directly into their hubs. This strategy has avoided the bruising battles that your Committee has heard about repeatedly from new airlines, which some call predation. I would call it the "facts of life" in the airline industry. It is a simple fact that no airline, whether it is American, United, or anyone else, can be expected to allow a new carrier to begin operating out of their hub without mounting a robust and vigorous response. Midway would do the same. Margins in this business are very small and a few passengers each day siphoned off by another carrier mean the difference between profitability and a loss.

At some point in the future, Midway will have to fly into some of the major carriers' hubs. In one instance, we tried it and had to withdraw in the face of an intense competitive response. We learned valuable lessons from this experience. What I am seeking is to build Midway into a strong, profitable competitor. When we make our next foray into a major carrier's hub, I will do it on the basis that I have the financial resources and passenger base necessary to stay.

The Government does have an important role to play in this next competitive phase. First, to succeed, Midway and other new entrants need access to slots, gates and other airport infrastructure on the same terms as the incumbents. In the case of landing slots (an issue Mr. Chairman that you know about in depth from your experience with the Cleveland/London route), the recently passed Wendell Ford Aviation Act, known as "Air 21", will give Midway 9 slots at LaGuardia airport, which we currently lease from a major carrier for $1.88 million per year. We are also now able to apply for "in perimeter" slots at National Airport. The avoidance of these lease costs will be one of the most important things I can do to increase our profitability. In the future, as airports are expanded with the new airport construction funds made available by Air 21, the government needs to ensure that some gates are reserve for small carriers.

The Government also can play an important role in tempering the most outrageous behavior by competitors. Every airline needs help from DoT. It is critical that DoT use its oversight role to keep the competition within bounds. I do not believe that it requires antitrust action by the Justice Department. Indeed, from my own experience at Continental, it is very hard, if not impossible, to prove an antitrust case. What I expect is for the Department of Transportation to simply call the incumbent carrier and make it clear that their behavior is unacceptable. In the case of Midway, I know that DoT's own actions had such a positive result with one of our competitors. This does not mean re-regulation of the industry, rather I view it

as the carrot and stick approach. If you want our help, then stop engaging in unfair competition against the other smaller guy. What is the standard to be applied? I think it is imprudent to try and put it on paper. This only creates controversy, like when DoT issued its competition guidelines. To paraphrase the Supreme Court, addressing another issue, we know unfair competition when we see it.

Mr. Chairman, I want to thank you for this opportunity and I would be happy to answer your questions.

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Airlines' Reputations Hinge on the Basics, Study Shows

Dependability, Low Fares, and Financial Stability Are Key in Travelers' Minds

By SCOTT MCCARTNEY
Staff Reporter of THE WALL STREET JOURNAL

Airlines have been trying to boost their much-maligned reputations by removing seats to increase legroom, hiring celebrity chefs and televising soothing, conciliatory ads.

But what really impresses travelers, according to a new online study of 20,867 U.S. adults, is dependable, no-hassle transportation at a reasonable cost, plus happy employees and strong financial performance.

Southwest Airlines, which offers nothing but bare-bones domestic service at budget prices, topped the list with the best reputation among the 10 major U.S. airlines, according to the study by Harris Interactive Inc. and the Reputation Institute, a New York research group. Despite its weak coffee and sparse snacks, respondents liked Southwest's industry-leading on-time record, its low fares and its friendly employees who often employ humor in the cabin.

"When you fly coach, you know you're going to be sandwiched in. But it's more enjoyable on Southwest," says Nancy Miller, a senior business manager at the University of Arizona in Tucson, Ariz., who participated in the survey.

Ms. Miller said on one Southwest trip, flight-attendant gags had passengers laughing so hard that several passengers were in tears. "It's the only airline I've flown where it looks like the people are enjoying their jobs," she said.

The study, made available exclusively to The Wall Street Journal, found the top three drivers of reputation for airlines were the quality and reliability of its services, the workplace environment and the financial performance. Late flights, surly flight attendants and even bankruptcies from earlier decades tarnished carriers. Passengers pay attention to labor troubles. And they don't want to have to worry about financially strapped carriers that may be working maintenance on the cheap.

"People do notice if someone is happy on the job," says Joy Sever, a senior vice president at Harris.

That Southwest enjoys such a strong reputation is hardly a surprise—the Dallas-based airline consistently ranks at the top of the airline pack in travel surveys and rankings of the most admired companies, and has the lowest rate of complaints filed at the U.S. Department of Transportation.

Rating The Airlines

The top domestic and international carriers rated in a survey of airlines and their services. Top reputation rating = 100.

Domestic

RANK	AIRLINE	RATING
2	Delta	70.0
4	United	67.2
6	Northwest	65.9
8	Trans World	63.3
10	Alaska	61.6

International

RANK	AIRLINE	RATING
2	Lufthansa	74.7
4	KLM	74.1
6	British Airways	72.5
8	Swissair	72.0
10	Air Canada	68.8

Source: Based on a study by Harris Interactive and The Reputation Institute

Effect of a Crash

But what was surprising was how devastating the crash of an Alaska Airlines MD-80 off the California coast was to that carrier's once-glowing reputation. Alaska, a unit of Alaska Air Group Inc., Seattle, ranked last among U.S. carriers, even though it historically has enjoyed strong customer loyalty and high marks for quality service.

The survey was taken March 3 to March 10—about five weeks after the Jan. 31 crash of Flight 261. Subsequent scrutiny of Alaska's maintenance practices swayed respondents, according to comments participants made. And 88% said they recalled mentions of Alaska in the media in the past year, nearly double the recall of any other carrier.

"Alaska is not a familiar airline to most people, so the crash created doubt," says Charles Fombrun, director of the Reputation Institute and a professor at New York University's Stern School of Business.

A spokesman for Alaska said the airline was concerned about the crash's impact on its reputation, but confident the reputation would rebound. The airline also noted that after an initial dip in traffic, passengers had returned to Alaska, and airplanes were fuller than last year.

Airlines with longstanding reputations for quality overcame recent operating problems. AMR Corp.'s American Airlines ranked third behind Southwest and Delta Air Lines in overall reputation among U.S.-based carriers, even after a year of customer service woes as a result of a devastating pilot sickout and numerous operational problems last summer. Likewise, UAL Corp.'s United Airlines, which recently placed last in one airline quality survey, placed fourth in the reputation study behind American. "Reputation may have a strong halo effect not necessarily grounded in immediate results," says Dr. Fombrun.

In comments explaining their responses, travelers showed they have long memories. Many based a carrier's reputation on their own experience, even if it was decades earlier, and some said they were influenced by travel nightmares suffered by friends or family.

Indeed, the survey also shows how difficult it is for airlines to change perceptions. Continental Airlines, for example, has won travel kudos in the past few years and is on solid financial footing since its dramatic turnaround in the mid-1990s. But many participants in the Harris survey still rated its reputation low because of two past bankruptcy filings and memories of lousy operations.

Low Rating, Strong Stock

Continental ranked fifth out of the 10 major U.S. carriers in overall reputation. Asked their perception of Continental's financial performance, investors in the survey ranked the Houston company next to last among U.S. airlines, ahead of only struggling Trans World Airlines. Yet Continental's stock has skyrocketed to $40 a share from $3 in the past four years.

"Clearly a case of perception lagging reality," a Continental spokesman said, "as evidenced by the amount of recognition and awards we've received over the last five years from our investors, employees and customers."

Among non-U.S.-based carriers, Singapore Airlines enjoyed the highest reputation quotient of any airline. Like Southwest, Singapore was dominant in its category. Even though only 124 respondents had actually flown the carrier, many others were influenced by its legendary reputation for attentive service and its consistently high standing in rankings by travel magazines.

The study of the reputations of U.S. and foreign airlines was carried out between March 3 and March 10. Harris Interactive conducted interviews with 20,867 respondents throughout the U.S., randomly selected from the company's database of about 6.2 million people.

Harris rated the 10 U.S. airlines with the largest reported revenue and the 15 foreign airlines with the largest revenue. Respondents were asked first about their familiarity with the 25 airlines and then were given two to rate from the ones with which they were at least "somewhat" familiar. Respondents rated the companies on 20 attributes related to their services, financial performance, workplace environment, vision and leadership, social responsibility and emotional appeal.

Each domestic airline was rated by at least 1,100 people and each international airline was rated by at least 600 respondents. The average number of respondents for each domestic airline was 1,564 and the average number for each international airline was 822. All data were weighted to be representative of the U.S. adult population in terms of age, sex, education, race, ethnicity and household income, as well as other nondemographic variables.

Reputation-quotient scores were calculated for each airline to determine the rankings. The scores were based on the respondents' ratings of each airline on the 20 attributes. The highest possible score is 100. Each RQ rating has an "estimated sampling tolerance" of plus or minus 1.5. In comparing any two RQ scores, a difference of 1.96 would be considered significantly different at the 90% confidence level.

Senator DEWINE. Mr. Carty.

STATEMENT OF DONALD J. CARTY

Mr. CARTY. Mr. Chairman, Senator Kohl, before I begin, I have to confess that some of the folks on my legal staff were very nervous about my agreement to testify today. So I resolved it by asking them for a list of the pros and cons of testifying. They came up with 100 for and 87 against. Now, I am confused; 100 to 87 was the score of last night's Bucks' win over the Pacers. Did I mention that I was rooting for the Bucks? [Laughter.]

Actually, I confess I told my staff if the Bucks win, I am testifying for sure. If they lose, I suddenly have a bad throat coming on.

Despite years of study by economists and volumes of published reports, competition in the airline industry is still widely misunderstood by the general public, and obviously by the popular media. In the next couple of minutes, I am going to address two of the most enduring myths in airline competition: first, that hub and spoke systems are anticompetitive, and, second, that airfares are too high because of a lack of competition. In addition, I would like to talk briefly about the subject of predation in the airline industry.

Now, the hub and spoke system really is, as Dr. Kahn pointed out, very efficient. It allows a carrier to offer far more frequent service to a lot more places than could be achieved with the very same assets flying only point to point by simply combining the traffic from various points onto each hub route.

That exhibit that I have got up there explains the concept. The top diagram shows the linear or point-to-point service with five aircraft flying between five points in the West and five in the East. Now, with point-to-point service, as you can see, the carrier can only serve five routes.

In the bottom diagram, you have got an airline that is open to hub between the eastern and the western cities. Now, using virtually the same five airplanes, the carrier can link each western city with every eastern city and, of course, vice versa. In addition to that, he creates service between the hub itself and each of the other 10 cities. As a result now, the carrier offers service in essentially 35 markets, which is a seven-fold increase in the destinations using virtually the same number of aircraft.

So I guess the question is, does the tremendous deficiency of hubs lead to dominant airlines that are harmful to consumers. Well, obviously, for consumers living in a spoke city, the answer is clearly no. Because of competition between the networks of different carriers, a spoke passenger, or at least most spoke passengers, enjoy frequent, one-stop service through a hub to nearly anywhere in the world. And in most spoke cities, passengers get to choose from several different airlines, each serving that particular spoke to a different hub and then on to many of the same destinations.

Now, that brings you to the question of passengers living in the hub cities. The hub and spoke system provides non-stop service to scores of destinations; in fact, far more service than the local population of the hub city could support without the feed traffic from

all those other cities. So for all the talk of the alleged evils of hubs, what has happened is nearly every city in America wants to be one.

Now, despite the rhetoric, most hubs, and certainly American hubs, are very competitive. There is a constant competitive pressure, and that pressure can come from four different sources. The first is direct competition from another airline. Passengers that at least live in our two major domestic hubs, Dallas/Ft. Worth and Chicago, have not one, but two established hub carriers battling for their business.

At O'Hare, United Airlines is significantly larger than American, and Delta Airlines operates a large hub at Dallas/Ft. Worth. So this creates substantial direct competition on many routes. And beyond the routes where there actually is competition, when there is a second hub carrier, you have the threat of potential entry on the routes where that carrier doesn't yet operate.

Second, in addition to the direct competition that you can have from major carriers, established low-fare carriers like Southwest offer tremendous competitive pressure using alternative airports; in the case of Dallas/Ft. Worth, Love Field, and in the case of Chicago, Midway. And those airports and that particular carrier in this instance competes for the same hub-originating passengers that DFW and O'Hare do.

Third, the longest established low-fare carriers are not alone. New entrants continue to begin new service on Dallas/Ft. Worth routes, and some have operated successfully there for a number of years now.

And, last, because most hubs are also spokes from every other hub, large or small, the most heavily traveled routes across the United States really have become the battle ground on which the competitive skills of one hub carrier are pitted against another.

Now, these sources of competition combine to challenge at least our carrier's every move, and this intense competitive pressure has had the desired effect. At the same time, American tries to remain price-competitive in our hubs and across our system. But we also spend a lot of other money on competition. We will invest over $2 billion in ground facilities in the next several years. We have on firm order about $6.7 billion worth of new aircraft, and in 1999 spent more than $800 million on on-board catering, more per passenger than any other major carrier in the United States. And we have begun a $400 million program to refurbish the interiors of our existing fleet, including the program that Bob Ferguson mentioned to create more room throughout all our coach cabins.

Now, these aren't the steps that you would expect of a dominant hub monopolist. These are investments that we need to make in product and service because we are engaged in very vigorous competition.

Now, let me turn to the topic of air fares, perhaps the most complicated and misunderstood aspect of airline competition. The various public reports of trends in air fares seem always to conflict with one another. The industry reports declining prices and yields, and has year after year after year. In the meantime, the media reports trumpet periodic fare increases and high business fares.

Well, who is right? Well, it turns out, as Dr. Kahn said, both are. When adjusted for inflation, average fares have fallen almost 39

percent since deregulation. And while it is true that full, unrestricted fares have gone up over the last 10 years, even those fares have increased only slightly more than the rate of inflation.

Now, what is happening is the fare structures, the difference between the lowest fare and the highest, are being stretched. The highest fares are a little higher, but the lowest fares are much lower. And in the end, a large majority of our customers are paying less and traveling more, just what you would expect in a healthy, competitive industry.

I will turn now to a few comments about predation in the airline industry, and I have to point out that this subject is somewhat sensitive because, as Senator DeWine observed, we are currently engaged in litigation with the Government, and I might add a host of private claimants as a result of that Government claim, over allegations of predatory conduct at our DFW hub. Accordingly, my comments are going to be limited to a very few general observations.

Most importantly, American Airlines is an outstanding airline, and quite frankly I cannot imagine why anyone would ever want to fly on any other airline if you can get there on American. Nevertheless, there are some people who still seem to want to fly on a variety of other airlines, and competition is very brisk.

In that context, I would like to address some assertions of predation at DFW which I find particularly difficult to fathom because DFW may represent the single most competitive hub in America. It has two major carriers, American and Delta, both operating hubs there, and we battle it out everyday. The Nation's most profitable airline, Southwest, is in its backyard at Love Field, along with Continental, and I might add start-up carrier Legend Airlines. And DFW has no slots, no limits on gates, no other facility constraints that would be a barrier to new entry.

Not surprisingly, Dallas/Ft. Worth has attracted start-up carriers over the years. Some who entered this competitive environment tried to serve DFW with various combinations of point-to-point, single low-fare strategies, infrequent service, few on-board amenities, no frequent flyer programs, and/or small networks that were unable to sustain profitable service. Other start-ups, as in the case of carriers like Bob Ferguson referred to, have found better business strategies and have successfully operated DFW routes for years. And Dallas/Ft. Worth continues to attract new entry even today.

I think it would turn the antitrust laws completely on their head to interpret them to limit the kind of price and service competition that we have got in a market like DFW. Virtually all airlines match low prices that are launched by their competitors. We didn't undercut competitive prices at DFW, nor did we ever pursue a strategy to operate a route at prices below our variable costs, which, as several people have testified, is the well accepted measure of predatory pricing under the law of the United States.

In some cases, we did add seats to a route if we thought additional capacity was needed because of the increased demand that was stimulated by lower fares. That just makes good business sense. We are a formidable competitor. We strive to provide our customers the service they want at a reasonable price, and we invest tremendous resources to improve our ability to serve our cus-

tomers today and win more customers tomorrow. That, in our view, is what competition really is all about.

Senator DEWINE. Mr. Carty, thank you very much.

[The prepared statement of Mr. Carty follows:]

PREPARED STATEMENT OF DONALD J. CARTY

I would like to thank Chairman DeWine, Ranking Member Kohl and the other members of the Committee for inviting me here today. Despite years of study by economists and volumes of published reports, competition in the airline industry is still widely misunderstood by the general public and the popular media. This level of misunderstanding is one of the primary reasons I greatly appreciate the opportunity to speak with you today.

In the next few minutes, I will address two of the most enduring myths in airline competition: First, that hub and spoke systems are anticompetitive, and second that airfares are too high because of a lack of competition. In addition, I will talk briefly about the subject of predation in the airline industry.

One of the most dramatic results of deregulation has been the formation of hub and spoke route networks. Started in the United States, the hub and spoke system is now the most common model for successful aviation operations world-wide—and with good reason. A hub and spoke system is very efficient. It enables a carrier to serve many routes with frequent flights by combining traffic from various points onto each hub route.

The exhibit I have brought today explains the concept. The top diagram shows linear or point-to-point service with five aircraft flying between five points in the west and five in the east. With point-to-point service, the carrier can serve only five routes. In the bottom diagram, the airline has opened a hub between the eastern and western cities. Now, using the same five aircraft, the carrier can link each western city with every eastern city and vice versa, plus create service between the hub itself and each city. As a result, the carrier can now offer a total of 35 routes—25 between the eastern and western cities and 10 more between each city and the hub. This result—35 routes as opposed to 5—is a seven-fold increase in destinations using the same number of airplanes.

In addition to their efficiency, hubs also permit service to much smaller communities than linear service could ever support. Suppose in our example that Western City Number 1 had only 10 passengers for each departing flight bound for Eastern City Number 1. That would never be enough to support daily nonstop service. But when combined with other passengers originating in Western City Number 1, bound for each of the other eastern cities, plus the hub, the route becomes commercially viable.

This ability to concentrate traffic at a hub that is bound for different destinations allows a hub and spoke carrier to serve each spoke city with greater frequency than could be achieved without the combination of passengers from the other spoke points.

Thus, a hub and spoke system affords tremendous efficiency. It allows more frequent service to more places than could be achieved with the same assets flying only point-to-point. But does it lead to dominant airlines that are harmful to consumers?

To consumers living in a spoke city, the answer is clearly no. Because of competition between the networks of different carriers, spoke passengers enjoy frequent, one-stop service through a hub to nearly anywhere in the world. In most spoke cities, passengers can choose from several different airlines each serving the spoke to a different, competing hub and then on to many of the same destinations. For example, a passenger in Columbus, Ohio flying to Los Angeles can travel with a single connection on Southwest through Nashville, on America West through Phoenix, on Northwest through Memphis, on TWA through St. Louis, on United through Chicago or Denver, or on American through Chicago or Dallas/Ft. Worth. The Official Airline Guide shows dozens of daily flights via several hubs for this route.

For passengers living in hub cities, the hub and spoke system provides frequent service, numerous nonstop destinations and vigorous competition. For all the talk about the alleged evils of hubs, nearly every city in America would love to be one. Hub-originating passengers enjoy non-stop service to scores of destinations—far more service in terms of both frequency and destinations than the local population could support without the "feed" traffic from other cities.

Despite the rhetoric, most hubs, and certainly American's hubs, are very competitive. There is constant competitive pressure from four sources. The first is direct competition from another major airline. Passengers living in American's two largest hubs, Dallas/Ft. Worth and Chicago, have not one, but two established hub carriers

battling for their business. At O'Hare, United Air Lines is significantly larger in scope and scale than American—a fact we are working very hard to change. Delta Air Lines operates a hub at Dallas/Ft. Worth—a hub where Delta enplanes more passengers than Northwest at its Memphis hub, Continental at its Cleveland hub or Southwest at its hub in Phoenix. And Delta has promised to expand its presence at DFW in its recently announced growth plan. This creates substantial direct competition on many routes and the threat of potential entry on the rest.

In addition to direct competition from other major carriers, well-established low fare carriers like Southwest offer tremendous competitive pressure using alternative airports like Love Field and Midway to compete for hub originating passengers at DFW and O'Hare.

The long-established low fare carriers are not alone. New entrants continue to begin new service on Dallas/Ft. Worth routes, and some have operated successfully for several years.

Last, because most hubs are served as spokes from every other hub, large or small, the most heavily traveled routes across the U.S. are the battlegrounds on which the competitive skills of one hub carrier are pitted against another.

These sources of competition combine to challenge American Airlines' every move and this intense competitive pressure has had the desired effect. At the same time American tries to remain price competitive in our hubs and across our system, we will also invest over $2 billion in ground facilities improvements in the next several years—including more than $500 million in the near term at DFW alone. We have on firm order about $6.7 billion worth of new aircraft, in 1999 spent more than $800 million for onboard catering—more per passenger than any other major carrier, and have begun a $400 million program to refurbish the interiors of our existing fleet, including our program to remove two rows of seats from every aircraft to create more room throughout our coach cabins. These are not the steps one would expect of a dominant hub monopolist. These are investments in product and service made by a company engaged in vigorous competition.

Let me now turn to the topic of airfares—perhaps the most complicated and misunderstood aspect of airline competition. For years, the fact that on any given route, most carriers charge the same fares has been misunderstood as evidence of collusion. Nothing could be more wrong. The reason fares are often the same is that passengers have taught us that they shop for air transportation based on price. That fact, coupled with computer systems that allow the whole world to see every available fare, means that we can and must match most fares to ensure that we do not lose passengers. The fares are the same for the same reason you often see identical gasoline prices between gas stations on the same corner. Our passengers will rarely pay more for American than for United, Delta, Continental or any other airline. So if we want to keep our customers flying on us, we have to meet the market price.

What about the reports of ever increasing airfares? The various public reports of trends in airfares seem always to conflict with one another. The industry reports declining prices and yields, while media reports trumpet periodic fare increases and high business fares. Who is right? Well, it turns out both are. When adjusted for inflation, average fares have fallen almost 39 percent since deregulation according to Air Transport Association statistics. However, while it is true that full, unrestricted fares have gone up in recent years, over the last ten years even those fares have increased only slightly faster than inflation. What is happening is that the fare structures—the difference between the lowest fare available on a route, and the highest—are being stretched. The highest fares are a little higher, but the lowest fares are much lower. Most importantly, the number of people enjoying deeply discounted fares has soared while the number of those buying the full fares has decreased to less than 7 percent of all tickets sold. In the end, a large majority of our customers are paying less and traveling more—just what you would expect in a healthy, competitive industry.

As the fare structure gets stretched, the art and science of revenue management becomes more important. Offering the right number of seats at various price points in this range of fares is one of the most complex challenges to successful commercial operations. The key is to achieve an optimum "mix" of high fare passengers and low fare, typically leisure passengers. Often in this industry, start up airline managers are tempted to try to sell every seat at one low fare for simplicity. Because of the low variable costs in the airline industry, they cover short-term costs and appear to be making money. However, the revenue generated from those fares must not only cover short run variable costs, but must eventually, over the long term, cover the much higher long-run fixed costs of operations as well—a business reality that is often miscalculated by start up carriers.

A single fixed price would not be good news for travelers or airlines. If airlines sold all of their seats at a single price and that price was high enough to cover vari-

able and long term fixed costs, that average price would be higher than many deep discount fares available today. So instead, airlines use a wide variety of prices, associated with various fare restrictions to achieve a balance that offers enough flexible fares at a higher price for business travelers, combined with many deeply discounted seats available for leisure travelers. And all of our fares are constantly re-evaluated based on competition and market pressures.

The discussion of single-price efforts by start up carriers leads naturally into a discussion of predation in the airline industry. I must point out that this subject is very sensitive because we are currently engaged in litigation with the government and a host of private claimants over allegations of predatory conduct at our DFW hub. Accordingly, my comments are going to be limited to a few general observations.

First and most importantly, American Airlines is an outstanding airline that offers its customers one of the best route networks in the world, the best frequent flyer program, terrific customer service agents at our gates, ticket counters and reservation offices, proficient, well-trained pilots, mechanics and flight attendants and now even the most comfortable, spacious interiors in our aircraft. In short, I cannot imagine why anyone would ever want to fly on any other airline if we can get you there.

Nevertheless, there are some people who still seem to want to fly on a variety of other airlines, which leads me to my second point about predation. Assertions of predation at DFW are particularly difficult to fathom, because DFW may represent the single most competitive hub in America. It has two major carriers operating hubs there and battling it out every day. It has the nation's most profitable airline, Southwest, in its backyard at Love Field, along with continental and start up carrier Legend Airlines. DFW has no slots, gates or other facility constraints that would be a barrier to new entry. Not surprisingly, Dallas/Fort Worth has attracted start up carriers over the years. Some who entered this competitive environment tried to serve Dallas/Fort Worth with various combinations of point-to-point, single low-fare strategies, infrequent service, few on-board amenities, no frequent flyer programs and/or small networks and were unable to sustain profitable service. Other start ups have found better business strategies and have successfully operated DFW routes for years. Dallas/Fort Worth continues to attract new entry even today.

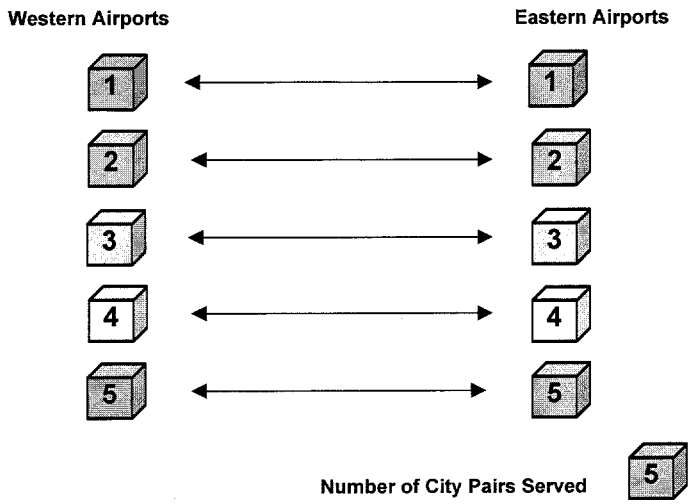
It would turn the antitrust laws completely on their head to interpret them to limit the kind of price and service competition I have just described at DFW, rather than to promote it. Virtually all airlines match low prices launched by their competitors. American did not undercut the competitive prices at DFW, nor did we ever pursue a strategy to operate a route at prices below our variable costs—the well-accepted measure of predatory pricing. In some cases we added seats to a route if we thought additional capacity was needed because of increased demand stimulated by lower fares. If, at the same price, more people want to fly on American Airlines than on another airline, its because every single day our employees get up in the morning and go to work to make exactly that happen. We are a formidable competitor because we strive to provide our customers the services they want at a reasonable price. We work hard and invest tremendous resources to improve our ability to serve our customers today and to win over more customers tomorrow. That, in our view, is what competition is all about.

I would like to conclude with an observation on an emerging competitive issue—global competition. Aviation is a network business. The U.S. Government, through its approval and endorsement of immunized alliances has created an environment in which U.S. carriers have formed partnerships with other airlines throughout the world.

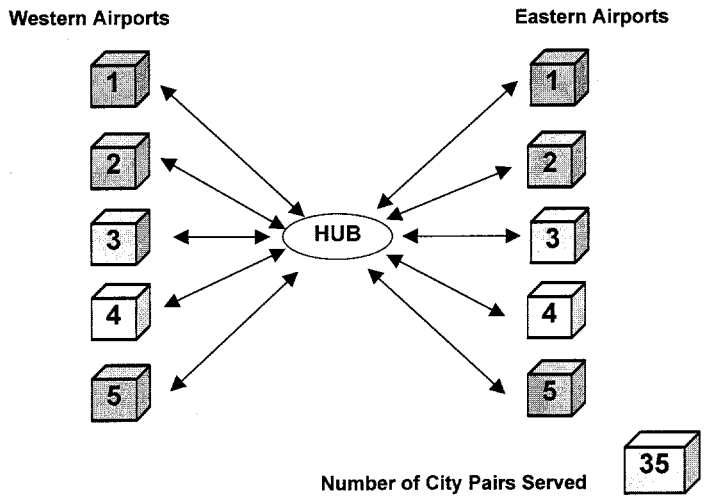
In a world of alliances, it is particularly important for the government to foster an atmosphere of healthy competition. That means no one alliance should be favored or disfavored by government policy. Just as the networks of the hub and spoke carriers in the U.S. overlap and compete with one another for domestic passengers, it is important that the international networks of the global alliances overlap and thus spur robust competition. Accordingly, we were very pleased when Dr. Kahn agreed to support American's application in the China route case. As Dr. Kahn pointed out to the Department of Transportation, it is essential that a decision in that case take into consideration the need to balance competitive opportunities among alliances. The Department has an opportunity to achieve this balance by awarding the available route rights to a U.S. passenger carrier in a global alliance that will compete with the incumbent airline alliances that have held historic rights to serve China for many years. We are hopeful that the Department will act favorably on this opportunity.

Economics of Hub and Spoke Systems

Point-to-Point Service



Service Via Hub Connections



AMERICAN AIRLINES,
Dallas/Fort Worth Airport, TX, June 15, 2000.

Hon. MICHAEL DEWINE,
Chairman, Senate Antitrust Subcommittee, U.S. Senate, Washington, DC.

DEAR CHAIRMAN DEWINE: On May 2, 2000, I testified at the Subcommittee's hearing on competition in the airline industry. As part of that testimony, I responded to your question concerning T2, the website being developed jointly by several of the major airlines, including American. I have since learned that my answer is being misconstrued by competitors of T2 in an attempt to mislead policymakers. T2's competitors would like policymakers to believe that there is some kind of improper agreement among the equity owners of T2. I am writing to you to ensure that my answer is properly understood. I would very much appreciate it if this letter could become a part of the official record of the hearing so that I may stop the improper use of my earlier testimony.

At the hearing, you asked a question about exclusivity provisions in the T2 agreement. There has been an extraordinary amount of false and misleading information spread about T2 on this point, so it is important for me to be very succinct. There are no agreements, tacit or express, among the T2 equity holders or participants, to make any fares available exclusively on T2. In fact, the written agreements state precisely the opposite. Pursuant to the express terms of the equity and charter associate agreements, any carrier may make available any fare offered on T2 to any, or every, travel agency whether online or traditional bricks and mortar.

What I said at the hearing was that there is an expectation that some fares may appear on T2 and not on other sites. The point is that carriers are likely to independently choose to make some deeply discounted fares available on T2 and their own airline site, but not on the other online travel agency sites. This is not because of any illicit, exclusive agreement among the airlines, but because of simple economics. Every airline has a strong incentive to sell its service through the least costly distribution channel. For some very deeply discounted fares, a low-cost distribution mechanism may be an essential means of preserving a thin margin above variable costs.

The market-leading structure of T2 is expected to operate at lower distribution costs for every airline that uses it to sell air transportation services—lower than any other online travel agency site such as Travelocity or Expedia. Accordingly, every airline will have an economic incentive to make the deepest discounted tickets available through T2 because it is the least expensive distribution channel, other than a carrier's own website. The attractive economics of T2 are even slightly better for the equity holders who have the added desire to see their investment in T2 succeed.

T2 is an innovative response to the very serious problem of distribution costs for the airline industry. For some time, the four computerized reservation systems have operated largely free of price competition for the services they provide to the airline industry. Accordingly, the fee paid by every airline to a CRS for each booking made by travel agencies or over the Internet has increased at a rate of about 7 percent every year since 1994, despite declining computing and telecommunications costs. T2's innovative pricing has made the first small dent of competition in this area of airline costs. We are hopeful that T2 will afford the technological foundation for much greater costs savings in the future. Quite frankly, it is time for the CRS owners and the largest online travel agencies to respond to the T2 challenge with new innovation and price competition, not misinformation and aggressive lobbying.

I would be happy to provide you or your staff with additional information on this subject, if you wish. Thank you for the opportunity to respond to the misuse of my earlier testimony.

Sincerely,

D.J. CARTY,
Chairman, President, and CEO.

Senator DEWINE. Mr. La Macchia.

STATEMENT OF BILL La MACCHIA, JR.

Mr. LA MACCHIA. Thank you, Chairman DeWine, Senator Kohl.

Senator DEWINE. As you can tell by the bell, we have a vote that has just started, but we will proceed with your statement.

Mr. LA MACCHIA. OK, thank you. I couldn't tell because I didn't know what that was, but I am new to this. I am just a small-town kid from Wisconsin, so bear with me.

Senator DEWINE. We have heard that before. [Laughter.]

Mr. LA MACCHIA. Thank you, Mr. Chairman, Senator Kohl, for your attention to the issue of airline competition and the antitrust concerns associated with market dominance from mega airlines.

We are a different story. We started as a charter airline in 1983. We continue to this day to operate on behalf of tour operators, not only that we own, but others that have utilized our service through the years. Let me emphasize we are not in favor of re-regulation. We are in favor of being given the opportunity to compete in a fair and open marketplace, and provide choices for the traveling public.

The major airlines will argue that Government should not play a role in promoting competition. Clearly, the major airlines have a double standard. They want Government assistance when it benefits them internationally, but cry foul when new entrants and low-cost carriers ask for the same consideration to promote domestic competition.

Today, I will argue that promoting domestic competition is necessary. Predation does occur. Northwest Airlines, the fourth largest airline, but arguably the most predatory and anticompetitive of the majors, is employing a variety of tactics that are questionable under the Sherman Antitrust Act and threaten to drive us out of the market. We are based in Minneapolis. We had options when we bought this airline to do other things, but we felt we were committed to the community, and we knew what we were getting into and we believe our business plan is just.

According to third quarter 1999 DOT figures, as you will see in this chart, Northwest Airlines and its affiliates comprised 68.5 percent of the market share in the Twin Cities, their partners being Continental, America West, and Mesaba. That doesn't even take into account its charter subsidiary, Champion Airlines, which is not required to report to the Department of Transportation.

Competition is good, but it is the intent of the carrier's aggressive action which must be called into question. We believe it is Northwest's intent to drive us from the market and achieve an even greater level of monopolization.

History shows that Northwest's strategy of predation has worked before and, left unchecked, will probably work again. We are all aware of what happened in 1993 when Reno Air entered the Minneapolis market to provide 3 daily non-stop trips between Reno and Minneapolis, with connecting service to West Coast cities. Northwest then increased its service, actually announced service, as they were not flying that market, and it added service from Reno to Los Angeles, Seattle and San Diego.

Northwest, utilizing its tactics of perks such as frequent flyer miles, had targeted the residents of Reno, and at the end of the day had really called for Reno to make a business, which was to withdraw from the market. Today, a 7-day advance fare from Minneapolis to Reno is $1,026.

By driving Reno Air out of the Minneapolis market and raising its fares, it is believed Northwest was able to recoup the investment it made in below-cost pricing. Again, this disproves conventional wisdom and contestability theories on predation.

Now, flash forward 5 years to September 1998. The Northwest pilots go on strike and the Minneapolis-St. Paul market is held

hostage without sufficient choices for air transportation. We had made a decision based on our market strategies and the manner of the business that we were anticipating losing by not flying for one of Northwest's subsidiaries, MLT Vacations, and we saw an opportunity in the marketplace that that market was indeed deserving of an alternative.

Studies by the Department of Transportation and the Minnesota Planning Commission showed that Minnesotans were paying higher than average fares compared to other cities of comparable distances, costing them an additional $500 million per year.

This graph was created by Dr. Paul Stephen Dempsey, a renowned expert on airline competition from the University of Denver. As you can see the pink line—this goes back to the first quarter of 1990, over 10 years, and the pink line with the box represents Minneapolis-St. Paul. And you will see in some cases where there are dramatic decreases on the other markets where low-fare competition had come into play.

As with Reno, Northwest responded vigorously to Sun Country's announcement when we began scheduled service on June 1, 1999. There is a chart which shows exactly the fare decreases which complements that of Senator Kohl about the Minneapolis-Milwaukee market, and we knew this going into it. We knew that the prices would be matched. Our business strategy and our marketing strategy was such that we felt we were going to be able to create our niche in the marketplace. In addition to the fare matches, there were also those of capacity increases.

In the chart on the bottom which shows the history in markets where we are currently flying, you will see by the jagged red line at the top what happened when, in 1996, we had entered the Minneapolis-St. Paul market on a scheduled charter basis. Northwest completely matched fares and increased capacity. We pulled that down and the rates went back up. Then you will see how they operate with the thick dotted line as to the non-Sun Country markets, non-low-cost competition.

What constitutes fair competition? Well, what a difference a few years makes. In 1992, Northwest said the pricing behavior we just described was unfair and even illegal, which points out another glaring double standard by Northwest. After sustaining enormous losses from an extended price war with American, Northwest filed a predatory pricing lawsuit against American. Northwest said that American was offering discounts for a greater number of passengers and incurring substantial revenue losses itself.

Northwest also alleged that American engaged in illegal anticompetitive and monopolistic activities which were intended to further eliminate competition. In fact, Northwest Chairman Gary Wilson referred to American's then CEO, Bob Crandall. "It is not fair, it is time that the bully in the schoolyard got punched." Well, after their unsuccessful lawsuit, a new and even more forceful bully came into the schoolyard, that being Northwest Airlines.

In addition to its own fleet of 428 aircraft, Northwest is utilizing its tour operator, MLT Vacations, which is 100-percent owned by Northwest, and its charter affiliate airline, Champion Airlines, which is owned 40 percent by Northwest. The other individual that owns the airline is Carl Poulad, who is a major stockholder in

Mesaba Airlines. MLT's reservation center has also recently introduced their air outlet center to introduce drastically discounted fares on Sun Country routes, not only to come after us, but another travel company in the Twin Cities.

This combination of Northwest, MLT, and Champion is so unique in the industry it does not even show up on the radar screens of Federal regulators. Together, MLT and Champion have been able to aggressively compete with Sun Country without Department of Transportation, Department of Justice, or congressional scrutiny. This relationship is an anomaly in the industry, but a significant competitive advantage and one that this committee should be very focused on for possible antitrust implications.

No other major airline in the United States has Northwest's ability to dominate a market for both scheduled and charter flights. Northwest has used MLT to add low-fare capacity on our common routes. They have also utilized MLT and its charter airline, Champion, to add frequency on common routes.

The Minnesota Attorney General asked the DOT to investigate their behavior and wrote, "It is not difficult to conclude that the use of this three-front attack by Northwest creates a climate of expanded seating, reduced prices, and scheduling conflicts designed to push an emerging competitor out of the marketplace."

Northwest has recently announced service on routes that they had not flown, which is two flights a day to New York's JFK and also two flights a day to San Antonio. These are the only new domestic routes announced by Northwest this year in their Minneapolis or Detroit hubs.

In cities where Sun Country has two flights a day, Milwaukee and Detroit, Northwest has added two to three times the number of discount seats. Clearly, it was not their benevolence which provided——

Senator DEWINE. Mr. La Macchia, I have to interrupt you. We are now down to 5 minutes in the vote. We only have about 5 minutes to get there, so we will have to——

Mr. LA MACCHIA. Very well. I will end at this moment.

Senator DEWINE. We will be back in approximately 15 minutes. Thank you very much.

[The subcommittee stood in recess from 3:25 p.m. to 3:44 p.m.]

Senator DEWINE. Mr. La Macchia, you wanted to finish?

Mr. LA MACCHIA. I will just finish.

Senator DEWINE. Yes, sir, proceed.

Mr. LA MACCHIA. In a hearing before this committee on April 1, entitled "Airline Hubs: Fair Competition or Predatory Pricing," then Northwest Senior Vice President of Corporate Affairs, Richard Hirst, had testified, "We sublease gates at Detroit and Minneapolis to numerous of our competitors, including Southwest Airlines, America West, and new entrants such as Vanguard and Frontier. In addition, we provide ground handling services at Detroit, such as Spirit and Reno Air, as well as maintenance services to our other competitors. Frankly, it is in Northwest's best economic interests to do so."

If sharing facilities and other services is in Northwest's best economic interests and they utilize this as a statement as to how anticompetitive behavior in the fortress hubs does not exist, then why

shortly after his testimony did Northwest cancel our agreements for a ground handling office and ticket counter space in Boston, preferring to leave the space vacant rather than leasing to us? And 1 month later, we received notice of the same in Los Angeles.

In June 1999, 6 days after we began scheduled service, Northwest canceled our part sharing and purchase agreement. And if it is in their best economic interests to provide maintenance service to competitors, why is it that we are not allowed to purchase unwanted and excess parts from their surplus parts listing which is used by all other airlines, which is industry standard in the best interests of this industry to provide support for other airlines, if needed?

In order for competition to work, it must be fair. The charts that I have here show that major airlines operate differently when they are competing against another major airline, versus Southwest Airlines, and a new entrant. The strategy of a large, high-cost, mega carrier is clear. They will sacrifice short-term profitability with opportunity costs in order to reestablish monopoly power. In the end, the consumer is going to lose and pay higher fares.

Again, as part of their suit against American, John Dasburg, CEO of Northwest Airlines, said, "In the long run, predatory pricing will reduce the number of airlines, ultimately cutting the number of flights and choices available, particularly in smaller markets. This will leave the few surviving airlines free to price just as high as they want to for just as long as they want." We thank him for making our point so well.

Over the last decade, major airlines have created a reputation of predation that, left unchecked, will end the emergence of low-fare carriers in large hub markets, and send a message to the community that if Southwest Airlines isn't there, you don't have competition in a low-fare category.

In conclusion, our mission today was to inform you of our situation, as it is unique. What you choose to do with this information is entirely up to you. We have chosen to compete for the customer and will do so and continue to do so in a fair and honorable manner.

Thank you.

[The prepared statement of Mr. La Macchia follows:]

PREPARED STATEMENT OF BILL LA MACCHIA, JR.

Thank you, Chairman DeWine, ranking member Senator Kohl, distinguished members of this subcommittee, for your attention to the issue of airline competition and the anti-trust concerns associated with the market dominance of mega airlines.

Let me begin by thanking Alfred Kahn, the father of deregulation, for his testimony today. Now is the time to take his efforts to the next level. To truly promote competition, more must be done to level the playing field.

Let me emphasize: we are not in favor of re-regulation. We are in favor of being given the opportunity to compete in a fair and open marketplace and provide choices for the traveling public. We are against predatory behavior designed to protect monopolies and cartels.

The major airlines will argue that the government should not play a role in promoting competition and that, left alone, competition will flourish. Why is it then that the majors continue to come before Congress and the Department of Transportation (DOT) and beg for government intervention for open skies agreements and access to international airports? And further, why do they request antitrust exemptions for their alliances?

Clearly, the major airlines want to promote a double standard. They want government assistance when it benefits them internationally but cry foul when new en-

trants and low cost carriers ask for the same considerations to promote domestic competition.

For this hearing, let me also debunk conventional wisdom and contestability theory that predation is "implausible" and therefore, does not occur. The argument that companies rarely engage in predatory conduct because of the prohibitive upfront costs and the notion that the attempt by the predator to "recoup" the financial losses will not be successful is proven incorrect in several instances in this testimony.

Further, the argument that the predators would not engage in this behavior because a stream of new entrants would come after the previous one driven from the market is also incorrect, as airlines establish a dominance in their hubs and a reputation for predation that deters new entrants from coming in and competing.

For our testimony today, we will argue that promoting domestic competition is necessary, predation does occur, and how Northwest Airlines (the fourth largest airline, but arguable the most predatory and anticompetitive of the majors) is employing a variety of tactics that are questionable under the Sherman Antitrust Act and threaten to drive us out of the market.

NORTHWEST'S STRATEGY FOR MARKET CONTROL AND DOMINATION

According to 3rd quarter 1999 DOT figures, Northwest alone control 62 percent of the market share in Minneapolis/St. Paul (MSP) compared to Sun Country 8 percent. With it's alliance partners, Continental, Mesaba America West, Northwest's combined market dominance exceeds 70 percent. That doesn't even take into account its charter subsidiary, Champion, which is not required to report to the DOT.

With this level of domination, why is it that Northwest continues to aggressively attack Sun Country via fare actions, capacity increases and control of facilities?

Again, competition is good—but it is the "intent" of the carrier's aggressive action which must be called into question. We believe it is Northwest's intent to drive us from the market and achieve an even greater level of monopolization.

History shows that Northwest's strategy of predation has worked before, and left unchecked, will probably work again.

RENO AIR VS. NORTHWEST AIRLINES

Northwest's predatory conduct against Sun Country replicates predatory conduct by Northwest that drove a low cost competitor, Reno Air, from the MSP market in 1993.

In April 1991, Northwest canceled service between MSP and Reno, Nevada, because that route was not sufficiently profitable.

In February 1993, seeing a niche that was not being served, Reno Air announced that it would begin three daily non-stop trips between Reno and MSP.

NWA's new Reno service

Northwest retaliated and announced it would also begin three daily MSP/Reno non-stop flights. In addition, Northwest said it would begin daily roundtrips from Reno to Reno Air's destination cities of Los Angeles, Seattle and San Diego.

NWA adds flights, perks for Reno

To further squeeze the Reno market, Northwest then announced on May 1, 1993, it would begin a second daily flight from Reno to both Los Angeles and Seattle. In addition, Northwest announced special "World Perks" (i.e. frequent flyer) bonus miles for Reno residents in an effort to control that market.

NWA slashes fare, adds capacity

to further secure their dominance, Northwest matched Reno Air's low fares on the Reno/MSP route and also matched or undercut their fares on their other common routes. In addition, Northwest offered more seats than Reno Air and provided additional seats at these low prices.

This predatory combination of reducing price and adding capacity forced Reno Air to abandon the market.

Predation returns NWA to profits

In June 1993, after Reno Air's withdrawal from the market, Northwest's lowest fare increased from $86.36 to $135.46 to $149.09. Its lowest refundable fare increased from $136.36 to $454.55. Today, a seven-day advance fare from MSP to Reno is $1,026.

Reno Air did sue Northwest for its predatory practices in 1997. That lawsuit was dropped when Reno Air was bought by American Airlines.

By driving Reno Air out of MSP and then raising its fares, Northwest was able to recoup the investment it made in below-cost pricing. Northwest's predation and intent to dominate the Reno routes worked, disproving again conventional wisdom and contestability theories on predation.

ENTER SUN COUNTRY

Flash forward now five years to September 1998, the Northwest pilots go on strike and the MSP market is held hostage without sufficient choices for air transportation.

Studies completed by the U.S. Department of Transportation and State of Minnesota Planning Commission, showed that Minnesotans were paying higher than average fares compared to other cities for comparable distances—costing them an additional $500 million per year due to a lack of competition.

This graph and the other airfare comparison charts I will be showing you today were created by Dr. Paul Stephen Dempsey, a renowned expert on airline competition and the Director of the Transportation Law program at the University of Denver. As you can clearly see, Minneapolis/St. Paul has historically the highest airfares compared to other hub cities.

Sun Country saw an opportunity to provide an affordable choice for air travel and announced it would begin scheduled service on June 1, 1999.

NWA'S PREDATION: SAME SONG, SECOND VERSE

As with Reno, Northwest responded vigorously to Sun Country's announcement and promptly slashed fares. Compare the following, seven-day advance purchase fares on flights from MSP in the summer of 1998, before Sun Country began scheduled service to summer of 1999, when Sun Country inaugurated scheduled service.

	1998	1999
Northwest fares to:		
Boston	$814	$298
New York	750	$298
Washington, DC	675	$298
Seattle	628	318
Detroit	634	218
Milwaukee	427	128

In addition to fare matches, Northwest has added capacity on routes flown by Sun Country, including both additional flights and larger aircraft. For example:

	August 1998 (per week)	August 1999 (per week)
Northwest flights to:		
Anchorage	3 planes/570 seats	5 planes/950 seats.
Phoenix	5 planes/750 seats	6 planes/940 seats.

The public has benefited since Sun Country entered the market. Consumers are expected to save an average of $120 million in the first year of our scheduled service.

NWA'S DOUBLE STANDARD

Now, you may ask, what is fair competition? What a difference a few years makes. In their 1992 lawsuit against American, Northwest contended that this type of pricing behavior was unfair and even illegal, which points out another glaring double standard by Northwest.

In 1992, after sustaining enormous losses from an extended price war with American Airlines, Northwest filed a predatory pricing lawsuit contending that American had dropped fares to drive them out of business.

Northwest said that American was "offering discounts for a far greater number of passengers and incurring substantial revenue losses to itself." Northwest also alleged that American engaged in "illegal, anticompetitive and monopolistic activities" which were "intended to further its goal of eliminating competition."

Northwest Chairman Gary Wilson also implied that American Airlines was trying to ground Northwest with below-cost pricing. Referring to American's CEO Bob Crandall, Wilson said, "It's not fair . . . It's time the bully in the schoolyard got punched."

After their unsuccessful lawsuit, a new and even more forceful bully came into the schoolyard . . . Northwest Airlines.

ENFORCEMENT OF THE SHERMAN ANTITRUST ACT

While Northwest may have been unsuccessful in suing American, in current there does exist remedy for this anticompetitive behavior.

The Sherman Act outlaws all contracts, combinations, and conspiracies that unreasonably restrain interstate trade. This includes agreements among competitors to fix prices, rig bids and allocate customers. The Sherman Act also makes it a crime to monopolize any part of interstate commerce.

Under the Sherman Act, an unlawful monopoly exists when only one firm provides a product or service, and it has become the only supplier not because its product or service is superior to others, but by suppressing competition with anticompetitive conduct.

Joel Klein, Assistant Attorney General for the U.S. Department of Justice's (DOJ) antitrust division appeared before the Senate Judiciary Committee on March 22, 2000.

Klein said that, under the Sherman Act, DOJ had identified predatory pricing and monopolization practices by American Airlines.

On March 22, 2000, Klein testified:

> [First let me say a few words about our pending case against American Airlines under section 2 of the Sherman Act for monopolizing airline passenger service on routes emanating from its hub at Dallas/Ft. Worth International Airport. As the complaint we filed sets forth in detail, American repeatedly sought to drive small, start-up airlines out of DFW by saturating their routes with additional flights and cut-rate fares. After it succeeded in driving out the new entrant, American would re-establish high fares and reduce service. Passenger traffic surged when the low-cost airline began operations and more people could afford to fly, and then fell back dramatically after American had driven out the upstart and resumed monopoly pricing. American knew this strategy was a money-loser in the short term, but expected to make that up by preserving its ability to set fares at monopoly levels.
>
> American, like anyone else in our capitalist economy, is free to compete, and compete aggressively. But it crossed a fundamental line into predation. This is the first predation case brought against an airline by the Antitrust Division since the industry was deregulated in 1979. I think it will be tremendously important for our traveling public throughout the country, who deserve the lower fares and expanded choices available in a competitive airline marketplace.]

As with the recent government break-up of AT&T and the proposed break-up of Microsoft, the federal government has the authority and responsibility to break up other monopolies. The major airlines, each monopoly in their fortress hubs but collectively a giant cartel, may be the next target for such action.

Examine how Northwest uses a wholly-owned tour operator, charter airline affiliate and discount "Air Outlet Center" to create a mini-monopoly and control the Minneapolis/St. Paul market.

NWA MARKET DOMINANCE AND MONOPOLIZATION

MLT Vacations (100 percent NWA owned); Champion Airlines (40 percent NWA owned); and Air Outlet Center (a division of MLT's Reservation Center).

In addition to its own fleet of 428 aircraft, Northwest is also using its tour operator MLT Vacations (100 percent owned by Northwest) and its charter-affiliate airline, Champion Airlines (40 percent owned by Northwest) to go after Sun Country. MLT's reservation center has also recently introduced their "Air Outlet Center" to drastically discount fares on Sun Country routes.

Let me first explain: the combination of Northwest, MLT and Champion is so unique in the industry that it does not even show up on the radar screen of federal regulators. Together, MLT and Champion have been able to aggressively compete with Sun Country, without DOT, DOJ or Congressional scrutiny.

This relationship is an anomaly in the industry but a significant competitive advantage and one that this committee should be most interested in for possible Sherman antitrust implications.

No other major airline in the United States has Northwest's ability to dominate a market for both scheduled and charter flights.

Northwest has used MLT to add low-fare capacity on Sun Country common routes. Compare their service before and after we began scheduled service.

	August 1998	August 1999
Northwest/MLT to:		
Las Vegas	680 seats	920 seats.
Los Angeles	1,650 seats	2,170 seats.
Orlando	560 seats	1,030 seats.

Northwest has used MLT and it's charter airline Champion to add frequency on common routes with Sun Country. Compare before and after we announced scheduled service.

	Summer 1998	Summer 1999
Northwest's MLT/Champion to:		
MSP/Las Vegas	2x/week since 1985	Daily.
MSP/Orlando	2x/week since 1985	Daily.

What is surprising is that many of these increases are on routes that Northwest was already experiencing its lowest operating profits. MLT's own employees have questioned why Northwest is asking them to do this.

History has shown, as with Reno Air, that Northwest is willing to suffer slim margins and even losses in the short-term to drive a competitor from the market and recoup profits later by restoring the routes to higher fares.

Left unchecked, this predatory behavior will again drive competition from the MSP market. You'll recall from an earlier chart that the cost of air travel in MSP is among the highest for consumers. Why? Because of the dominance and control of Northwest Airlines.

The Minnesota Attorney General has asked the DOT to investigate Northwest's behavior and wrote, "It is not difficult to conclude that the use of a three-front attack by Northwest (through Champion, MLT and its own carriers) creates a climate of expanded seating, reduced prices, and scheduling conflicts designed to push an emerging competitor out of this marketplace."

NEW NWA ROUTES VS. SUN COUNTRY

Northwest has recently employed a new, more aggressive strategy of going after Sun Country on routes they were not serving and Sun Country had a niche. In March, Northwest announced new twice daily nonstop service to New York-JFK and new nonstop service to San Antonio.

We have to question why—after all the years of careful market analysis—would Northwest suddenly decide to begin new service to those routes. Again, it is important to question their "intent."

Did Northwest see a market opportunity because Sun Country had expanded the market on these routes? Or, do they want to establish control of the route, drive Sun Country away, and then raise fares when competition no longer exists? As you'll recall, a similar thing happened when Northwest went after Reno Air's other destination cities.

ADDED CAPACITY WHERE SUN COUNTRY HAS MORE FREQUENCY

Northwest has also acted very aggressively in key markets where Sun Country has frequency.

In the markets where Sun Country has two flights per day, Milwaukee and Detroit, Northwest has added 2.5 to 3 times the number of discount seats that Sun Country has. Northwest has also added 2.5 to 3 times the number of discount seats that Sun Country has to Boston, where it previously had no other competition.

This aggressive, predatory behavior is of grave concern to us.

As every airline knows, the best assurance of profitability is to add frequency to your routes and attract more frequent or business travelers. If Northwest acts in this kind of predatory manner for every route that Sun Country has more than one flight per day, Sun Country may not be able to build a profitable hub.

SHERMAN ACT: SUPPRESSING COMPETITION BY ANTICOMPETITIVE CONDUCT

Beyond pricing, the Sherman Act also says that an unlawful monopoly exists when one supplier is able to suppress competition with anticompetitive conduct. While the mega carriers will say they do not engage in anticompetitive behavior in their fortress hubs, this is another example of saying one thing and doing another.

In a hearing before this committee on April 1, 1998, entitled "Airline Hubs: Fair Competition or Predatory Pricing?" Northwest's Senior Vice President of Corporate Affairs, Richard B. Hirst, testified:

> [On a related point, unfounded claims have been made that major network carriers engage in anticompetitive practices to preserve their dominant position at hub airports. These charges are wholly without merit. Detroit, for instance, is a facility constrained airport and all airlines are similarly constrained in their growth, most significantly Northwest. Nonetheless, we sublease gates at Detroit and Minneapolis to numerous of our competitors, including Southwest Airlines and America West and new entrants such as Vanguard and Frontier. (Northwest Deck, page 62) In addition, we provide ground handling services to competitors at Detroit such as Spirit Airlines and Reno Air, as well as maintenance services to other competitors. (Northwest Deck, page 62) Frankly, it is in Northwest's best economic interest to do so.]

If sharing gates, facilities and other services is in Northwest's best economic interest, why then, shortly after Mr. Hirst's testimony, did Northwest do the following?

In October 1998, Northwest canceled our agreements for groundhandling, office and ticket counter space in Boston, preferring to leave the space vacant rather than lease to Sun Country. One month later, they did the same in Los Angeles.

In June 1999, six days after we began scheduled service, Northwest canceled our part sharing agreement and posted a large sign in Detroit saying "no parts to Sun Country."

If it is Northwest's best economic interest to provide maintenance services to competitors, why is it that Northwest even refuses to sell Sun Country its unwanted and excess parts from their surplus parts listing service, which is used by all other airlines?

With regard to gates, Sun Country has repeatedly asked Northwest to sublease us gates at the Main passenger terminal. Repeatedly, they ignored or refused our request.

VARYING DEGREES OF COMPETITION

Let us reiterate: competition is a good thing. But in order for competition to work, it must be fair. Our concern, and the concern of other new entrants and low-cost carriers is the severity of competing methods employed by mega carriers against low cost carriers.

Compare the fare histories of the following charts and see the differing degrees of how a major competes with a major; major competes with Southwest; and a major competes with a new entrant.

FAIR AND EQUAL ACCESS TO COMPETITION

The strategy of the large high-cost mega carriers is clear. They will sacrifice short-term profitability in order to re-establish monopoly power in the market place. In the end, the consumer . . . your constituents . . . lose and pay higher fares.

Again, as part of their suit against American, John Dasburg, CEO of Northwest Airlines said, "In the long run, predatory pricing will reduce the number of airlines, ultimately cutting the number of flights and choices available, particularly in smaller markets. This will leave the few surviving airlines free to price just as high as they want for just as long as they want."

We thank him for making our point so well.

While the mega carriers can shift their vast resources to cover routes where they are being extra-competitive and operating at or below costs, the new entrant cannot. We need prompt action by the DOT and DOJ to take action against the predatory behaviors I've outlined today.

Beyond that, if new entrants and low-cost carriers are to survive we need:

Fair and Equal Access to Airport Facilities. The major carrier in the market, who dominates that hub, should not be allowed to dictate policy and bully the airport commissions and local governing bodies into submission—thereby, squelching competition. New entrants, who are able to bring value to the community should have access to gates and facilities.

Fair and Equal Access to the Most Profitable Routes. Particularly, we need open access to slot-controlled airports, where the major airlines have a lock on the airports and refuse to allow new competition in. This is an areas where Congress has provided some relief through the FAA Reauthorization bill, but more must be done to open up these markets.

We are not asking for special treatment, we are only asking you for the same things that the major airlines ask you for in opening up international skies and air-

ports: for fair and open access. When you are considering their requests, we only ask that you hold them to the same standard to promote domestic competition.

Thank you.

Senator DEWINE. Mr. La Macchia, thank you very much. Mr. Ferguson has stated that he expects a competitor to react if somebody invades his hub, and therefore will not enter a hub unless he has the financial resources to handle that reaction. That was at least a summary of what he had to say. Is that the right way to approach a competitor's hub, in your opinion?

Mr. LA MACCHIA. Well, we were already there. We have been based in Minneapolis since our beginning, and it is just as much, we feel, our hub and our operation as it is anyone else's.

Senator DEWINE. How about a general question, though? My question was general.

Mr. LA MACCHIA. We look at the opportunity and our balance of our marketing approach is that there was an opportunity to utilize our aircraft. And there were individuals who did not have the ability to fly, and we recognized that and we feel we are providing that benefit to customers and we are providing individuals a choice and we are ensuring that there is competition. Ultimately, at the end of the day it is up to the customer to make that choice, but we have a very good product.

Senator DEWINE. Mr. Carty, in your testimony you note that despite the complaints about hub service, cities seem to want to host airline hubs in their airports. However, based on some press reports at least, a few mid-size cities such as Kansas City, Jacksonville, and Indianapolis appear to think they are better off maybe without hubs because of the broad range of competition they have been able to attract to their airports.

Is this type of reaction common, and what do you think is its significance?

Mr. CARTY. Well, I think it is less than common. I have been approached by at least two of those three cities in the last 10 years urging exactly the opposite. So I guess my instinct is to question the sincerity of it. The fact of the matter is cities that are hubs get a lot more non-stop flights to more destinations than any other city of comparable size.

Senator DEWINE. There is, as you have already pointed out in your testimony, quite a tradeoff, though. I mean, there is a tradeoff. That is the good news.

Mr. CARTY. Well, if you are a spoke, you get all the advantages of being a spoke.

Senator DEWINE. I understand.

Mr. CARTY. But as I said in my testimony, every hub is also a spoke, so every hub is the winner of deregulation. They get to be a spoke to every other hub, so they have got that same competition for one-stop service everywhere in the world. In addition to that, they have the premium product of non-stop service to almost everywhere in the world with high frequency. So they are the true winners.

There are very few people and very few cities that I am aware of that wouldn't prefer their cities to be hubs. The reason the hub cities have done so well in terms of economic development is they are a magnet for business and business growth.

Senator DEWINE. Mr. Carty, I do not question what you are saying, but I can take you to some cities and show you a lot of consumers who would vehemently disagree with what you are saying. And I am not going to get into specifics today, but we could cite some hubs and we could give you some examples on pricing, and I think you know what I mean. So I don't think it is quite as clear-cut as you have outlined.

I understand what you are saying, and I think most cities by and large historically have said, sure, they would like to be a hub. I also think that once you get beyond some of the business leadership in the community, you will find other consumers who will say, my Lord, why am I paying so much to fly there? And when they look into it, they find out why they are paying that much to fly there because there isn't any competition.

Mr. CARTY. Well, you know, again I would say to you that the evidence is not at all clear to me. I know the average consumer in Dallas/Ft. Worth has the availability of these same highly discounted seats that Dr. Kahn referred to on more flights to more places than any other community in the world.

He also has a full-fare ticket that is, as Dr. Kahn represented, more fully priced. The very limited number of people that are paying full-fare ticket—and I think Dr. Kahn cited a number of 7 percent—are paying very much what they paid prior to deregulation. But the average fare in all markets across the United States is down literally almost 40 percent.

Now, would consumers like more service and even lower fares? Of course, they would. That is true in almost every product in the United States today. But the transparency of pricing in our business for the last 20 years has been like no other business in the world. The rest of the businesses in the world are starting to see it with Internet, but we have essentially had the transparency of fare information in our business for 20 years that most other businesses are beginning to see.

Senator DEWINE. Mr. Carty, I don't question what you are saying. My only point is a very simple point, and I think you are candidly maybe overreacting to what I am saying. I want to make sure you understand what I am saying. All I am saying is that there are pros and cons to being a hub. That is all. There is good and bad, and as you pointed out, most people think that the good outweighs the bad. But we can take you to some communities where the pricing structure is pretty rough if you live in a hub city.

American has recently announced that it will be a part of a joint venture with Continental, Northwest, United, and Delta to create an Internet reservation site called T2. This joint venture purportedly will include a large number of other carriers, and has raised some concerns among competing reservation services.

There are contradictory reports about how exactly this is going to work, so I would like maybe if you could take a moment to briefly explain what T2 will do. Specifically, will it be an exclusive system that does not allow the participants to post their fare information on other reservation services?

Mr. CARTY. T2 is a business concept that involves, as you say, providing an Internet access capability to as much of the industry's fare and schedule information as we can possibly attract to the

site. It was originally started by the other carriers. We were recently invited to become an equity holder in that company and accepted that invitation. We had not been invited before because we were a very large holder in a competing reservation system, Travelocity, that is owned by Sabre.

I think what you are seeing with the advent of the Internet is airlines and other travel providers trying to put their product in every conceivable Internet shelf that is developed, whether it is Microsoft's Expedia, whether it is Travelocity, whether it is their own airline sites, or whether it is this combined site or the hundreds of others, the priceline.coms, and so on.

It is envisaged by this particular site that some offerings will be made on this site that won't be made on other sites, at least by the equity owners of the airlines. That is not necessarily true of other airlines. It is sort of up to them, just as it is also true today that we offer and other airlines offer on their own sites some offerings that aren't offered on the broader travel agency sites.

I think the reason for this development, Senator, is the concern by the airlines and other travel providers that a very small number of so-called electronic travel agents, Travelocity and Microsoft's Expedia in particular, were in danger of completely dominating this space, to the detriment of the travel providers themselves. So I think this is one of the strategies that the airlines have used in response to that.

Senator DEWINE. Mr. Ferguson, in your testimony you seem willing to rely upon the Department of Transportation to put pressure on incumbent carriers to basically just behave themselves. Some would argue that the Department does that now without much success. Let me just ask you if you agree with that, and if so, what else should the Department of Transportation be doing?

Mr. FERGUSON. The reason I find that the proper venue is because I had a little education, to the tune of $12 million and David Boyce's representation—and he has been representing the Government recently—on sort of what the antitrust laws are in the United States. And I don't believe the competition offered by Mr. Carty, or frankly the other major airlines, generally fits in the category of predatory. I do think there are instances in which behavior appears predatory, and certainly looks that way.

I do think from time to time the Department has stepped in. I think there are some clear examples of that. I think they have done that on our behalf. I think the efforts in rules that were passed some years ago were an attempt. In all honesty, I am not sure that we have a position as a public policy matter about where we want to get to that lets the Department, whether it be Justice or Transportation, take a real position.

I mean, it is not that fares in the industry are too high. They are not. If they were too high, we would all make money, and we don't; we make a little bit. I think the question that needs to be answered is the disparity, the widening that Mr. Carty has described. Is that unfair? And if it is, then we need a policy that espouses some way to make that close.

But I don't think the rules that were authored in the 1930's, I guess it was, are going to address that problem in our business. I just don't think that is the place to look, and so I think you have

to look to the Department. I think they have tried to do a good job. I don't think they have always been perfect, but they have tried.

Senator DEWINE. Senator Kohl.

Senator KOHL. Mr. La Macchia, in that route, Minneapolis to Milwaukee, what are the two or three most egregious things that they have done to hurt you?

Mr. LA MACCHIA. Well, one issue is because of the fact that we are in the same area for gates. We have asked the airport to step up and get involved because they were literally blocking the area for our aircraft to come in. We had shared the bag room and there were contentious relationships with their baggage handlers and the group that we had utilized.

Clearly, they have opened the inventory and the bucket of lower priced seats in that route that were never there before. It used to cost $600, as it says there, in order to continue to provide them with, well, you can get the same price by flying on us.

And, lastly, I would say in that route our job is to take care of the customers, and it is interesting to note that in situations where the other airline may have canceled a flight or were delayed or what have you, most airlines have agreements for passenger protection. There have been days when they would—in fact, they have never walked their customers down to us and have said, here is an option. That is their choice, and the customer's. But yet it goes to another standpoint when they tell a customer, no, there are no other flights, Sun Country's flight has already left, when, in fact, it hasn't. So it is really up to the customer's issue.

Senator KOHL. These are the most egregious things they have done?

Mr. LA MACCHIA. Well, it is like the bully in a schoolyard. I can go on and on. There are issues where when we have to move a part on an aircraft, it mistakenly or seemingly gets lost.

Senator KOHL. Let me just stop there. What would you have the Government do about these things?

Mr. LA MACCHIA. Well, it is not just that route, but there are issues in other routes; for example, the squeezing of travel agents to apply pressure in order to ensure that they are not losing market share and forcing the agents to operate at a certain increased level of market share, which is a distribution arm.

From our perspective, we have solutions. We are not coming here saying we need you to protect us. We are saying we have these facts of how difficult it is to compete in some of these markets. Some of the solutions that we have put into place—I agree with Alfred Kahn's issue of ensuring that the other airline stays in the market with the prices and the inventory levels for a few number of years.

I also believe that we should put the onus on the other airlines to explain and prove that their actions did not remove the new entrant from a marketplace. Everybody looks at us saying prove it. Well, you know, no one has put the onus on the other airlines and said, all right, be accountable for these actions.

We talk about limiting the impact and the squeezing of the travel agents. It is also the issue of other assets and resources that are available, and I think it is important that we review the relationships and partnerships of the airlines, not only with the technology

arm, but also now performing a relationship with purchasing and buying of parts and sharing of that. We will be applying to have entry into T2. We will see if we are denied.

We also believe that a solution is to hold airports accountable and make them show how they have spent money, and does it benefit the community or does it benefit a certain airport. And, lastly, maybe we need to come up with a better term than "predatory." I think that is a term that everybody is so hung up on. We have talked about, well, you know it when you see it, but from our perspective it is about the people.

My father and I entered into the Minneapolis market because we had a belief in a strategy. Can we move our assets elsewhere? Yes, we can, but we believe——

Senator KOHL. How long have you been in that market?

Mr. LA MACCHIA. Milwaukee-Minneapolis we initiated a year ago.

Senator KOHL. How many flights do you have a week?

Mr. LA MACCHIA. Well, we have two flights a day. Last fall, we initiated connecting service from Milwaukee to Minneapolis which would then connect to Seattle, San Francisco, and Los Angeles.

Senator KOHL. You have been doing it for how long, a year?

Mr. LA MACCHIA. A year, and we are continuing to see our loads——

Senator KOHL. But you are continuing those flights from Milwaukee to Minneapolis?

Mr. LA MACCHIA. Pardon me?

Senator KOHL. Those flights continue to operate twice a day?

Mr. LA MACCHIA. Yes, they do, and we recognize that that route, Minneapolis to Milwaukee, would not be successful down the road if we do not ensure that there is connecting traffic to broaden that base of business. We do the same out of Detroit.

My father and I continue to invest in the organization. We are not profitable. We have a strategy in place that we think we can be profitable. The scheduled service of our business is not the only part of our business. We still operate on behalf of the tour operators which allows that balance.

Senator KOHL. Mr. Carty, you have been listening to a little guy talk about his business and some of the problems he has competing with some of the big guys. What would you say to Mr. La Macchia?

Mr. CARTY. Well, Senator, listening to both Mr. La Macchia and Mr. Ferguson, and the previous testimony, I guess the question is where are the impediments to competition and how can we remove them, on the one hand. I think the gate issue is a very interesting issue.

I am not experienced in most of my route network in a shortage of gates, but I have seen reports in markets that are not as much interesting to me where there are gate shortages. The one market where I am experiencing gate shortages is Los Angeles. You can't get gates in Los Angeles. I think the financing of gates which the expanded PFC's will allow us to do should begin to alleviate that issue.

I might add that the FAA already has power to force a local airport to take underutilized gates and allocate them to carriers that want them, as opposed to those that aren't using them properly.

That power exists and that should happen. And, in fact, if that process is taking too long—and it may take too long; there are very few examples of it being tested—then it needs to be accelerated.

I am a great believer in getting rid of those impediments. I think we ought to get rid of those impediments. I think we have made some real progress on the slots. We are obviously not finished. We have still got slots left in the country, but we have made some progress. I think the air traffic control issues that Dr. Kahn referred to are critical. In fact, the removal of slots is going to aggravate them and the air traffic control problem in the short term. We need to fix that.

But in terms of the antitrust laws themselves, I think we really do need to be very careful with them. I don't disagree with the conclusion that laws that were written in the 1930's for steel companies may or may not be appropriate to today's marketplace, but I don't think that is a unique phenomenon to the airline business.

When there is a price war on the corner of a street where there are two gas stations, does the guy that matched, if the other guy goes out of business, have to keep his gas price at $.90 for 2 years afterwards? The answer is no. When MCI undercuts AT&T in the long-distance market and AT&T matches them, when AT&T finds that their lines are ringing busy because they don't have enough capacity and adds capacity, isn't that really very much a parallel to what we are talking about here in the airline business?

So I think there is a valid question of whether it is time we revisit as a country our antitrust laws. I think we ought to be very careful of treating the airlines uniquely. This is a business like every other business; in fact, as Bob Ferguson pointed out, substantially less profitable than most other business. Our price earning multiple in the airline business is in sort of the single-digit range for most of us.

And this wonderful public beneficiary that we refer to as Southwest Airlines is the only guy that has got a 20 multiple and, in fact, is returning more to his shareholders than any of us. So, you know, he is also a beneficiary of his shareholders. I just think we need to be very careful as we massage these antitrust laws that we don't invent solutions for airlines that are sort of quick-fix answers without thinking through the implications for our total economy.

Senator KOHL. OK.

Mr. CARTY. But I would support revisitation of those antitrust laws.

Senator KOHL. Mr. Ferguson, do you have something to say to Mr. La Macchia?

Mr. FERGUSON. I guess the only thing I would have to say to him is I wish him extremely good luck, and if he is going to make the service survive, he is going to have to do it premised on connecting passengers. I don't believe you can win a point-to-point war with a major air carrier in a straight-out fight.

I don't know how wealthy Mr. La Macchia and his family are, but the carrier they are fighting is probably worth $5 billion, $10 billion, I don't know. If they apply that capital, he cannot win. So, you know, he is going to have to do it by carrying people connecting through that network, but that is a business recommendation. I am not sure I see sort of how else you win that fight.

Senator KOHL. And neither one of you, Mr. Carty or Mr. Ferguson, have any quarrel with one strategy that Northwest employs, which is to price that flight between those two cities really low? I mean, you don't have a quarrel with that in terms of a business practice that is accepted in combatting competitors in this country?

Mr. CARTY. Again, I think that is the kind of business practice you would expect to see in any business. When you have got a product that is closer to a commodity than we would like it to be, if you don't match price, particularly with the transparency of pricing that I referred to a moment ago where everybody knows what everybody charges, you are just not going to have any business.

So if you have got a lot of loyal passengers in a market—and I know nothing about the Minneapolis-St. Paul to Milwaukee market, to be perfectly honest with you—you are either going to lose those passengers to price or you are going to match the price. It is as simple as that. And if you match the price and the price is significantly lower than the price that has been in the market, you are going to genuinely generate new demand.

And if you want to accommodate that demand, if you want to accommodate your loyal passenger, you have got to have enough capacity so that when he phones up and says, I want to go to Milwaukee, you have got a seat for him. So on that pure piece of it, I think that is not unique to the airline business. You know, the analogy with the communications companies is obvious. The analogy to almost every business—whether you are a gas station, a car manufacturer, a grocery store, or a communications company, I think that strategy would be common.

Now, the courts have defined a standard of predation, one that at least Dr. Kahn is uncomfortable with, and that is if you price below your variable cost, maybe we are in the situation where the person is clearly engaged in predation. But when you start redefining average variable cost to include things like opportunity cost, what you are saying to a company is you must optimize profits in the short term. Don't worry about your customers in the long term, don't worry about your business plan in the long term, don't worry about what happens in the long term. You have to deploy your assets and price them more to maximize profit tomorrow. If you don't, you are predator. That is not a standard that is going to hold up in very many industries in the United States. And I don't mean to suggest anybody here suggested it, but it is a very difficult question. Very few companies manage for the short term.

Senator KOHL. But you would also concede, would you not, that there is a public policy question here just in terms of that route that if you don't have a competitor like Sun Country, again, just business being what it is, and if they are the only carrier, Northwest is likely to be charging consumers a lot more than they would like to be charged?

Mr. CARTY. That tends to be the nature of business. I would agree.

Senator KOHL. So there are other considerations here——

Mr. CARTY. I would agree.

Senator KOHL [continuing]. That we weigh when we consider what you are saying and we consider his situation.

Mr. CARTY. I would agree with that.

Senator KOHL. Thank you.

Senator DEWINE. Senator Kohl, thank you very much.

I have a statement from Senator Grassley that I will make a part of the record at this point.

[The prepared statement of Senator Grassley follows:]

PREPARED STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM THE STATE OF IOWA

Good afternoon, Mr. Chairman. I commend you for calling another in your series of hearings on the important subject of airline competition. You and Senator Kohl have shown leadership in bringing to light many of the problems surrounding true airline competition. The traveling public owes you a debt of thanks and a vote of confidence for your efforts.

You have assembled two very distinguished panels this afternoon. Everyone is familiar with Dr. Alfred Kahn and his pioneering work on the deregulation of the airline industry. We all look forward to his comments on where we are now, and if this is the actual point that he expected the airline industry to be at this time. Similarly, we look forward to the comments of his colleague, Dr. Morrison, from Northeastern University.

I am also pleased to join you in welcoming Donald Carty, the Chairman, President, and CEO of American Airlines and AMR Corporation. Mr. Carty, I would like to personally thank you and your staff for the help that you provided me during the debate on AIR–21. This is truly a landmark piece of legislation that will hopefully benefit states like Iowa which lack a major hub airport. I know that increasing competition was our joint goal as we worked together to phase-out the antiquated slot-control system at Chicago's O'Hare and New York's LaGuardia and Kennedy airports. Your support of the phase-out, with its help for turbo-prop and regional jet aircraft, is key to helping several smaller communities in Iowa. You have been very sensitive to our needs.

Welcome also to Robert Ferguson, Chairman, President and CEO of Midway Airlines, and to Bill La Macchia, President and CEO of Sun Country Airlines. I am aware of your concerns about competition and look forward to what you have to say.

We are currently blessed with the longest peace-time economic expansion in the history of our great country. Access to economical, reliable air service is key for communities to be able to participate equally and fully in this economic boom. Trustworthy air service at economical fares is essential if businesses are to enter the national and international marketplace. If good service and fares are not available at their current business location, some businesses move to cities that can provide them. This is unfair to underserved communities.

AIR–21 seeks to bring about more airline competition. As a conferee, I successfully fought for a phase-out of the out-dated slot-control system. Why? Because I fear that an abrupt end to the slot system would only benefit large hub airports, to the exclusion of medium, small and non-hub airports. This would in turn, further skew an already skewed competition system. Looking at airline ads in the newspaper, large airport to large airport traffic already enjoy many favorable schedule and low airfare advantages. But just try to fly out of Sioux City or other Iowa regional airports and see how much you have to pay and how difficult it is to reach some locations.

The phase-out of the slot rule favors turbo-prop and regional jet aircraft that will serve small and non-hub airports.

Air–21 also provides much-needed funds for necessary infrastructure improvements at all levels of airports. These funds will help build new runways, taxiways, aprons, ramps, additional gates and terminals. This will help to ease congestion and allow airlines to either begin new service or expand existing service to reach more places and increase competition.

Also, there are new programs to directly assist small communities. One of the most important is a pilot project that allows small communities to apply for up to $500,000 in direct financial assistance to attract or improve new commercial air service. There is also a regional jet purchase loan program that will be closely followed.

Importantly, Section 155 of AIR–21 found that "15 large hub airports today are each dominated by one air carrier, with each such carrier controlling more than 50 percent of the traffic at the hub." It further states, "the General Accounting Office has found that such levels of concentration lead to higher airfares." Section 155 requires that these airports submit a written competition plan to the Secretary of Transportation before they can increase their passenger facility charge.

The competition plan is required to include the following information: availability of airport gates and related facilities, leasing and sub-leasing arrangements, gate-use requirements, patterns of air service, gate-assignment policy, financial constraints, and other pertinent data.

This is a very important provision that neither the airlines nor the affected airports should take lightly.

I have not talked about AIR–21 to say that the Congress has done its job with regard to airline competition and it is time to move on to other issues. To the contrary, we still have a job to do. We have made a good first step. That is why I comment you, Mr. Chairman, for holding this hearing. We must continue to send a message to the airline industry that there is still work to do to bring about increased competition and that we are watching. The traveling public expects no less. It will take time for some of the provisions of AIR–21 to fully mature and have their effects felt and understood. But in the interim, we must not relax our vigilance on airline competition. Oversight is the name of the game.

Senator DEWINE. Let me thank our witnesses from this panel and the previous panel for their testimony today. I think this hearing was very helpful in bringing us up to date on a wide variety of competition issues affecting the aviation industry.

As I mentioned earlier, the aviation industry is a very complex and difficult industry to analyze. It is very important that we continue to hear from the experts, both those who study aviation and the industry and those who work in the industry.

For our part, this subcommittee will continue to promote competition for large and small airlines alike. We will closely monitor developments in the next few months, with particular focus on the Justice Department litigation against American Airlines and any enforcement policy decisions made by the Department of Transportation.

This is an important time for the industry, and it is important that we take the right steps to promote competition. Today's testimony will help us do that, and I look forward to continuing to work with Senator Kohl, the other members of this subcommittee, the enforcement agencies, representatives of the industry, and the experts to ensure that consumers have the full benefits of vigorous competition in this industry.

I want to thank again this panel and our previous panel, an exceptional group of witnesses. Your testimony has been very helpful. Thank you very much.

[Whereupon, at 4:11 p.m., the subcommittee was adjourned.]

APPENDIX

ADDITIONAL SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF EDWARD P. FABERMAN, ON BEHALF OF AIR CARRIER ASSOCIATION OF AMERICA

DEAR CHAIRMAN DEWINE AND SENATOR KOHL: On behalf of travelers and communities from throughout the country, we thank you for again holding a hearing to review airline competition. As we move into the new millennium, 20 years since deregulation, we face a system in which:

- hub concentration is increasing (In some markets, the largest hub carrier has 85 to 90 percent market share. This is unheard of in any other industry.);
- there are fewer air carriers than at any time since deregulation;
- consolidation continues;
- larger carriers continue to expand their international alliances and partnerships providing them with additional resources;
- more new entrants have stopped operations or filed for bankruptcy than have started service;
- barriers to entry still exist; and
- anti-competitive behavior continues.

We have just passed the second anniversary since the Department issued draft anti-competitive guidelines. Although some carriers act as if there are no limits on actions they can take to attack new entrant competitors (they don't take similar actions in response to large carriers or even Southwest), the guidelines have not yet been finalized.

When Secretary Slater announced his intention to issue guidelines he stated: "Our responsibility at the Department of Transportation is to ensure that every airline—large or small, new or established—has the opportunity compete freely. That is what deregulation is supposed to be all about—a fair chance to compete."

When the Department issued the "Proposed Guidelines on Unfair Competitive Practices in the Airline Industry," the Secretary stated:

> The purpose of deregulation was to make the airline industry competitive and make air travel affordable. But competition only works if it exists.
>
> There is growing concern that major carriers are willing to lose money—lots of it—in the short run to drive off competition.
>
> This policy is not intended to ensure the success of any start-up carrier, but rather to ensure a level playing field. Consumers deserve a pro-competitive standard that helps ensure affordable airfares and accessible service. To provide a level playing field, we must preserve vigorous competition and prohibit unfair exclusionary practices meant solely to eliminate that competition.
>
> Our common goal is to expand the pie, to provide opportunity for all, and prepare the aviation industry for the challenges of the 21st century.

While some smaller carriers have been able to grow and compete, pressures continue. Midway Airlines, one of the carriers represented at your hearing, is an example of how one carrier has survived without offering low-cost service or competing directly with large carriers. After Midway went through bankruptcy and moved to Raleigh Durham where it took over American's facilities, it signed a marketing agreement with American. It apparently has decided that it will not compete on American's routes. It does not operate to Miami or Dallas—markets served by American. Even more surprisingly, it does not operate to Chicago, where it started. American operates to Chicago, Miami and Dallas from Raleigh Durham. Midway has been able to survive in part because it has avoided serving some of the most congested hubs and was able to serve the critical markets of LaGuardia and National

because American provided slots to them.[1] Under deregulation, each carrier should be able to serve the markets it elects to enter and at the fares it wants to charge. Nevertheless those carriers that elect to take a different approach than Midway and service a concentrated large hub airport, competing directly with a major carrier, should be able to take that approach and not face predatory behavior.

As to the approach that large carriers take to combat competition and their views of the competitive environment, I refer you to the following comments.

Former American Airlines Chairman and Chief Executive Officer Robert Crandall, speaking at a November 1997 National Press Club luncheon, made comments that demonstrate the need for the very action he denounced. He stated:

> Unfortunately, the byproducts of our cost control efforts have all too often been long and bitter labor disputes and customers upset by things like smaller seats, fewer closets and reduced food service.
>
> Losing a small percentage of the people on each plane to a startup will take away the profit of any airline. We want to keep all those passengers. Any airline that sustains losses for the purpose of damaging competitors is not going to stay around very long. That is not to say an airline won't cut fares or lose money for awhile to defend market share at an airport where it cannot afford to lose. When somebody challenges us in a market where we must prevail, we will compete. If that competition costs us money, we are prepared to do it. [Airline Financial News, November 17, 1997, p. 3.]

The following statement by Gordon Bethune, President and CEO of Continental Airlines, best summarizes what large carriers will do to force competitors out of markets:

> Last year, because we [Continental] were able to offer better discounts than United for Newark to San Francisco and Newark to Los Angeles, and because we were able to offer those discounts to the people in Boston, United put in a four jet operation, four times a day from Boston to Newark. We said, "Boston to Newark?"
>
> "What the heck's United coming in for—we ran USAir out of there some years ago." So we put four flights between L.A. and San Francisco. Get that? You do that stuff to us, we do that stuff to you. Now they're [United] down to one flight and I think we'll pull out.
>
> When you have 20 percent of the market [Continental and Northwest combined], United will say, "You know what, between those two guys they might put 100 flights into L.A. Screwing with one might be the same as screwing with the other." Now, as a joined-at-the-hip partner with Northwest, you better watch out if we do get upset. We have a lot of different ways that we can pay you back. [Business Travel News, February 23, 1998.]

The following article from the May 1998 issue of Air Transport World describes the type of actions taken by large carriers:

> In testimony before Congress last fall, Reno Air VP/General Counsel Bob Rowen said that when Reno entered the Detroit-Reno city-pair with nonstop service, Northwest, which did not offer a nonstop in the market, inaugurated its own nonstops and flooded the route with capacity. "A market that Reno entered with fewer than 4,000 seats per month soon had over 24,000 seats per month," said Rowen. Northwest also offered nonstop fares that were lower than its previous one-stop fares, he said. Rowen alleged that Northwest was guilty of predatory pricing in another instance. When Detroit-based start-up Spirit Airlines entered the Detroit-Boston market, a market heavily served by NWA, "Northwest dropped its fares by over 50%."
>
> Major airlines are unapologetic about these actions. "The imperative to defend . . . core markets means that when challenged, we will compete aggressively with whoever challenges us," says Crandall. [Bob Crandall, former CEO of American Airlines.] Matching fares and boosting capacity in the face of a challenge are "only natural," since "every consumer's first concern is price," while adding service "enhance[s] the quality of its product offering."

It is clear that some large carrier continue to engage in actions to discourage competition. The following statement from a Hoover Institute essay, "A Fair Fight" explains the likely motive behind this behavior:

> In the late 1970's and early '80s, the dominant view among economists was that so-called predatory pricing—pricing below your firm's own costs with the purpose of driving your competitors out of business—was not a profitable strat-

[1] Another successful new carrier—Midwest Express—also has obtained high density slots. Would Midwest Express still be in existence if it didn't obtain access to National and LaGuardia?

egy. The reason was simple: If you price below cost, you lose money. And if you win market share from your competitors, you lose even more money.

For predatory pricing to be worthwhile, the "predator" must more than make up such losses by charging a higher price once all its competitors drop out. But there's a problem: Once the predator raises prices above what they were when competitors were present, other firms will be tempted to enter the market. Some resourceful competitor might even buy the assets of the "victim" at fire-sale prices.

American judges who are asked to rule on antitrust matters have, by and large, agreed with this economic reasoning. But in the past 10 years or so, some economists, particularly those who employ game theory, have revived the idea of predatory pricing. They argue that if the predator can convince his prey (i.e., potential entrants) that he's serious—or "committed"—he can deter entry after he raises his price. Who, after all, wants to be the next sucker to lose his shirt? [David R. Henderson, Viewpoints, Stanford University.]

To demonstrate the significant advantages held by the nation's largest carriers, I have attached a number of charts that highlight advantages held by those carriers and the status of a new entry. As new entrants are driven out of markets and fares increase, the impacts are enormous:

Business travelers have been forced in recent years to bear the brunt of higher fares in markets where network carriers aren't exposed to low-fare competition, and business fares continue to rise. [Department of Transportation "Competition in the U.S. Domestic Airline Industry: The Need for a Policy to Prevent Unfair Practices", July, 1998.]

In describing the impact of predatory behavior, in its comments to the Department's proposed Policy, the National Business Travel Association stated:

Characteristically, corporations bear a disproportionate financial burden for air travel by their employees when contrasted to the amount that leisure travelers pay for their airline tickets. Often business travel fares are four times as much as leisure fares because of the price of the airline ticket and the accompanying federal passenger taxes.

To a great extent, we have arrived at the current dilemma because the Departments have not acted. They have allowed the situation to drift, with no enforcement or clearly defined rules of the game spelling out for airlines and consumers alike what acceptable competitive behavior is under deregulation. The Departments have not defined what constitutes predatory pricing or unfair competitive practices and have not, until recently, shown much inclination to act on those practices.

The need to move forward was emphasized by an editorial in Business Week (Airlines Should Reform Themselves," February 16, 1998.):

Consider some recent trends: Price-gouging of business customers. Virtual monopolies on certain routes. Neglect of small markets. Now, Washington is on the case, with the Transportation Department and Congress mulling some moves.

Of all the reforms being contemplated, Transportation's is the most worthwhile. Defining predatory behavior and setting up a mechanism by which airlines can be monitored and complaints promptly adjudicated would go a long way toward countering the most flagrant anticompetitive acts—like when Northwest Airlines Inc. pulled out all the stops in 1993 to outsell Reno Air Inc.'s new route between Reno and Detroit, going so far as to establish a mini-hub in Reno, a city it had never before served.

On some business routes, the big airlines have stopped competing on price. At some airports, they have a lock on slots. The upshot: New competitors can't even get to the gate, and underserved markets remain so.

Total deregulation is fully supported by small carriers. For a competitive air system to survive, we must have a level playing field and open markets. It is essential for this Committee to urge the Departments of Transportation and Justice to ensure the future of airline competition. Without it, business will be impaired and travelers will not be able to visit friends, relatives, take vacations and important business trips. Deregulation should not only exist in certain markets and for certain carriers.

U.S. Industry Traffic Market Share

12 mo. 1999	RPMs	Total Share % (w/ partners)
American[1]	111,960,032	17.54
United[2]	125,386,453	19.76
Delta[3]	104,783,407	16.76
Northwest[4]	74,168,279	11.42[7]
Continental[5]	60,024,607	12.11
US Airways[6]	41,478,104	6.54
	517,800,892	**84.13**

Small Carrier Group		Share %
Southwest	36,479,322	5.53
TWA	26,008,865	3.94
Alaska	11,777,000	1.79
American Trans Air	10,949,003	1.66
Hawaiian	4,880,100	0.74
Tower	4,115,000	0.62
Midwest Express	1,958,510	0.30
Total=	**96,167,800**	**14.58**

New Entrants		
Air Tran	3,474,490	0.53
Spirit	2,204,857	0.33
Frontier	1,994,744	0.30
Vanguard	854,803	0.13
Total=	**8,528,894**	**1.29**

Grand Total=	**622,497,586**	**100.00%**

U.S. Industry Traffic Market Share

[1]American Group		Share %
American	111,960,032	16.97
American Eagle	2,708,037	0.41
Midway Airlines	1,031,600	0.16
Total=	**115,669,669**	**17.54**

[2]United Group		
United	125,386,453	19.01
Mesa	1,339,984	0.20
Sky West	1,161,917	0.18
Air Wisconsin	1,142,405	0.17
Atlantic Coast	1,032,678	0.16
Great Lakes	265,718	0.04
Total=	**130,329,155**	**19.76**

[3]Delta Group		
Delta	104,783,407	15.89
Comair	2,533,041	0.38
Atlantic SE	1,415,152	0.21
Horizon	1,379,000	0.21
Executive	391,546	0.06
Skyway	84,517	0.01
Total =	**111,058,673**	**16.76**

[4]Northwest Group		
Northwest	74,168,279	11.24
Mesaba	1,160,259	0.18
Total =	**75,328,538**	**11.42**

U.S. Industry Traffic Market Share

[5]Continental Group		
Continental	60,024,607	9.10
America West	17,699,963	2.68
Continental Express	2,151,413	0.33
Total=	**79,875,983**	**12.11**

[6]US Airways Group		
US Airways	41,478,104	6.29
US Airways Express	1,501,961	0.23
Commutair	113,235	0.02
Total=	**43,093,300**	**6.54**

[7] If Northwest and Continental merge, then the total market share is 23.53 – the largest carrier in the U.S.

TOTAL SLOT HOLDINGS AT AIRPORT

	DCA	JFK	LGA	ORD	TOTALS
American	135	91	169	967	1362
US Airways	307	71	328	40	746
United	52	18	98	1054	1222
Delta	96	87	182	56	421
Northwest	110	12	78	90	290
TWA	32	88	51	02	173
Other	14	06	08	19	47
New Entrants	0	0	36	0	36
Totals	746	373	950	2228	4297

TOTAL PERCENTAGES

	DCA	JFK	LGA	ORD	TOTALS
	%	%	%	%	%
American	18	24	18	43	32
US Airways	41	19	35	2	17
United	7	5	10	47	28
Delta	13	23	19	3	10
Northwest	15	3	8	4	7
TWA	4	24	5	.09	4
Other	2	2	1	1	1
New Entrants	0	0	4	0	1

AMERICAN AIRLINES v. LEGEND

HUB MARKET SHARE: DFW

American 75%

Other Major American Hub

Miami 67%

SLOTS

	DCA	LGA	ORD	TOTAL
American	135	169	967	**1271**

DIRECT FLIGHTS

	Dallas-LAX	Dallas-ORD	Dallas-DCA/IAD
American	22	33	24
Legend	5	0	4

FLEET SIZE

American 641
Legend 4

Percentage of O&D Passengers

East North Central Region
#3 American 11.8%
Northeast Region
#5 American 11.1%
Southeast Region
#3 American 8.4%
West North Central Region
#5 American 6.3%
West Region
#6 American 7.8%

AMERICAN ALLIANCE PARTNERS

American Eagle
Aero California
US Airways
Reno Air
Midway Airlines
Executive Airlines
US Air Shuttle
Hawaiian
Business Express
Aerolineas Argentinas
Air Liberte
Air Pacific
Asiana Airlines
Austral
Austrian Airlines
British Airways
British Midland
Qantas Airlines
Canadian Airlines
Cathay Pacific Airways
China Airlines
China Eastern
Finnair
Grupo TACA
Gulf Air
Iberia
Japan Airlines
LOT Polish
Singapore
South African
Swiss Air
TAM

DELTA AIRLINES v. AIR TRAN

HUB MARKET SHARE: ATLANTA

Delta	80.2%
Air Tran	4.2

Other Major Delta Hub

Cincinnati	94.1%

SLOTS

	DCA	LGA	TOTAL
Delta	96	182	**278**
Air Tran	0	12	**12**

DIRECT FLIGHTS

	ATL-DCA	ATL-IAD	ATL-LGA	ATL-EWR
Delta	15	9	20	16
Air Tran	0	7	6	4

FLEET SIZE

Delta	562
Air Tran	50

Percentage of O&D Passengers

Southeast Region

#1	Delta	35.5%
#8	Air Tran	3.7%

Northeast Region

#2	Delta	16.3%
#12	Air Tran	1.1%

West North Central Region

# 2	Delta	21.1%

East North Central Region

#4	Delta	10.9%
#13	Air Tran	1.0%

West Region

#4	Delta	8.0%

DELTA ALLIANCE PARTNERS

Air Jamaica	Atlantic Coast	South African	Cayman
Malev	Air Wisconsin	SAS	Spanair
Trans Brasil	Trans States	British Midland	LAPA
TAP	Aloha	Air Canada	United Shuttle
Aer Mexico	Finnair	Varig	
Air France	Sabena	All Nippon	
Singapore	Virgin	Thai	
ASA Holding, Inc.	AOM of France	Air New Zealand	
Comair	Turkish	ALM Antillean	
Atlantic Southeast	Crossair	Ansett Australia	
Skywest	Lufthansa	National Airlines of Chile	
United	Lauda Air Luxair	Saudi Arabian	
Austrian	Korean	Sabena	

NORTHWEST AIRLINES v. SUN COUNTRY

HUB MARKET SHARE: MINNEAPOLIS /ST.PAUL

Northwest	84.5%
Sun Country	4%

Other Major Northwest Hub

Detroit 80.4%

SLOTS

	DCA	JFK	LGA	**TOTAL**
Northwest	110	12	78	**200**
Sun Country	0	0	0	**0**

DIRECT FLIGHTS

	MSP-LGA	MSP-JFK	MSP-DCA	MSP-IAD
Northwest	7	0	6	4
Sun Country	0	1	0	1

Percentage of O&D Passengers

East North Central Region

#2 Northwest 15.1%

West North Central Region

#3 Northwest 8.1%

Southeast Region

#5 Northwest 6.3%

Northeast Region

#6 Northwest 5.2%

West Region

#8 Northwest 3.9%

FLEET SIZE

Northwest	415
Sun Country	16

ALLIANCE PARTNERS

Pacific Island	Kenya	CSA Czech
Big Sky	Jet Airways	ACES
Air China	Japan Air System	Venezuela
KLM	Braathens	Copa Airlines
Cyprus	Garuda Int'l.	AVANT
Eurowings	Alitalia	Aserca
Mesaba	Horizon	VASP
BizExp/AA Eagle	Alaska	Gulfstream
EVA	America West	Air Aruba
Malaysia	Continental	Air France
Express	Virgin	Hawaiian

UNITED AIR LINES v. FRONTIER

HUB MARKET SHARE: DENVER

United	70%
Frontier	4%

Other Major United Hubs

Chicago O'Hare	47%
San Francisco	60.3%
Dulles	56.4%

SLOTS

	DCA	LGA	ORD	TOTAL
United	52	98	1054	**1204**
Frontier	0	6	0	**6**

DIRECT FLIGHTS

	DEN-ORD	DEN-SFO	DEN-LAX
United	15	12	14
Frontier	0	3	3

FLEET SIZE

United	574
Frontier	22

Percentage of O&D Passengers

East North Central Region

#1	United	17.3%

West North Central Region

#1	United	34.4%
#7	Frontier	3.2%

West Region

#2	United	20.5%
#15	Frontier	0.5%

Southeast Region

#7	United	4.5%

Northeast Region

#4	United	11.1%

UNITED ALLIANCE PARTNERS

Air Jamaica	Atlantic Coast	South African	Cayman
Malev	Air Wisconsin	SAS	Spanair
Trans Brasil	Trans States	British Midland	LAPA
TAP	Aloha	Air Canada	United Shuttle
Aer Mexico	Finnair	Varig	
Air France	Sabena	All Nippon	
Singapore	Virgin	Thai	
ASA Holding, Inc.	AOM of France	Air New Zealand	
Comair	Turkish	ALM Antillean	
Atlantic Southeast	Crossair	Ansett Australia	
Skywest	Lufthansa	National Airlines of Chile	
United	Lauda Air Luxair	Saudi Arabian	
Austrian	Korean	Sabena	

AMERICAN SOCIETY OF TRAVEL AGENTS,
Alexandria, VA, May 2, 2000.

Hon. MIKE DEWINE,
Chair, Senate Subcommittee on Antitrust, Business Rights and Competition, Dirksen Senate Office Building, Washington, DC.

DEAR SENATOR DEWINE: The American Society of Travel Agents (ASTA) applauds your efforts to continue monitoring competition in the aviation industry. As a proponent of airline deregulation and an advocate of the traveling consumer, ASTA is deeply concerned with the rising tide of consumer dissatisfaction with air transportation which reflects a lack of effective industry competition.

Although there are many complex issues facing the airline industry today, ASTA submits for the hearing record on Airline Competition the attached filing with the Department of Justice (DOJ) on the proposed operation of a joint airline web site. Our filing requests the DOJ to investigate and undertake enforcement action with respect to the stated plan of the major United States and foreign airlines to create a joint Internet Web-site to monopolize the provision of retail travel services on the Internet and, ultimately, in all markets. Most recently, American Airlines joined the site as the fifth equity owner. No other industry of which ASTA is aware has attempted such a frontal assault on the competitive process.

ASTA encourages the Subcommittee to closely follow the developments of this web site as it reviews all the current aspects of competition in the aviation industry.

Sincerely,

PAUL M. RUDEN,
Senior Vice President, Legal & Industry Affairs.

Attachment.

AMERICAN SOCIETY OF TRAVEL AGENTS,
Alexandria, VA, February 16, 2000.

Hon. JOEL I. KLEIN,
Assistant Attorney General, Antitrust Division, Department of Justice, Washington, DC.

DEAR MR. KLEIN: The American Society of Travel Agents, Inc. ("ASTA") respectfully requests the Department of Justice to investigate and undertake enforcement action with respect to the stated plan of the major United States and foreign airlines to create a joint Internet Web-site to monopolize the provision of retail travel services on the Internet and, ultimately, in all markets.

The agreements of which we complain, will, in the words of the recently, published Draft Antitrust Guidelines for Collaborations Among Competitors,[1]

> "involve agreements on price, output or other competitively significant variables, or on the use of competitively significant assets, such as an extensive distribution network, that can result in anticompetitive harm. Such agreements can create or increase market power or facilitate its exercise by limiting independent decision making; by combining in the collaboration, or in certain participants, control over competitively significant assets or decisions about competitively significant variables that otherwise would be controlled independently; or by combining financial interests in ways that undermine incentives to compete independently."

Whatever limited efficiency-enhancing integration of activity may be plausibly claimed for the joint Web-site cannot overcome the fact that all such benefits can be achieved "through practical, significantly less restrictive means." Consequently, these agreements are not "reasonably necessary," as defined in the Guidelines, to achieve any procompetitive benefits.[2] For example, United Airlines, the largest of the partners in this venture, has created a new company to continue operating its own Web-site, www.ual.com, which already offers booking services for over 500 airlines, 45 car rental firms, and 30,000 hotels worldwide.[3] The joint Web-site will add nothing that cannot be achieved through independent action by these giant corporations.

We believe that the proposed arrangements must inevitably lead to price fixing and on their face involve a concerted refusal to deal with travel agencies, both per se violations of the antitrust laws. For example, United owns 17 percent of Galileo, the Computer Reservation System, and is funding $5 million in advertising and promotion for a new Galileo Web-site that will undercut existing commission rates paid

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[1] 64 Fed. Reg. 54483, 54489, October 6, 1999.
[2] *Id.* at 54487.
[3] United also operates the Web-site for the nine-carrier Star Alliance at www.star-alliance.com.

to online travel agencies to induce listing of fares that also undercut the prices that United provides to those agencies for resale to the public. The new joint Web-site appears to contemplate similar arrangements from which travel agents will be excluded. How can the airlines make joint claims for what this Web-site will offer without exchanging and committing to future price understandings and policies? The desire to make this partnership, involving a huge segment of the airline industry's assets, a success at its stated goals will undermine incentives to compete vigorously and heighten the already pronounced tendency of the airlines to copy each other in almost everything they do.

In practical effect, the United States airline industry has begun to operate as a single enterprise, of which the joint Web-site is just the most recent manifestation. A graphic illustration of the extraordinary network of commercial relationships that have developed between the domestic carriers (and many of their foreign counterparts), involving most of the major industry assets devoted to the production and sale of domestic and foreign air transportation, is set out in Attachment A to this letter. It is doubtful that any industry in this country, or the world, exhibits such incestuous interconnectedness among firms that are supposed to be full-fledged competitors.

While there are still some signs of competitive life left in the industry, the opportunities for their long-term survival are quickly diminishing. If the Department of Justice does not intervene immediately to stop the unification of the competitive assets and the destruction of the competitive spirit of this industry, it may be too late to do so later when the damage caused by these amalgamations is more obvious. We leave this introduction with this non-legal but insightful commentary:

> A century-old principle of antitrust is that when the same company controls both content and the carriage of content, anticompetitive abuses arise. The gate keeper (such as a railroad) can overcharge users, keep out competitors, and frustrate technological advance. This led the government to insist that companies must choose between being common carriers or providers of content. You could be railroad or shipper that uses railroads, not both, and as railroad you had to treat shippers equally. You could control the TV network, but not the production companies. If you were the phone company, you had to connect all calls.
>
> The Internet has different technologies, but similar economies principles. There is the same temptation to combine and dominate, less to achieve economies of scale than to achieve market power . . . Far from being scrapped, antitrust policy needs to be brought into the Internet Age.[4]

BACKGROUND

On November 9, 1999, four major airlines, United, Delta, Northwest and Continental, together representing more than 45 percent of the passengers carried in domestic air transportation (more than 11,482, daily flights), announced a "partnership" to operate a "multi-airline travel portal" that was self-proclaimed to "offer the most comprehensive selection of online airfares and other travel information available anywhere on the World Wide Web," a site "superior to all travel sites," a site with "the best of everything."[5]

It is important to understand the significance in this claim of the phrase "online airfares." This does not refer merely to the publication on the Internet of otherwise generally available airfares. It refers instead to the publication of fares not available anywhere but the Internet, and thus leads to the additional claim that "for the first time, online travel consumers will be able to compare and purchase the Internet fares offered by several airlines . . . by visiting just one site."[6] "It would support our business model if they supplied special Internet-only capacity."[7]

This, then, is the real goal of this venture: to combine in one retail location owned and controlled by the airlines the Internet-only fares offered to consumers and not available for sale by the independent travel agency community whose members are, in every other respect, the full and unqualified agents for these airlines for the retail sale of air transportation. The joint announcement makes clear, moreover, that this new joint site is not in lieu of the individual Web-sites provided by the partici-

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[4] "Pirates, Snoops, Monopolists: Why the Net Needs Some Cops," Robert Kuttner, Business Week, February 21, 2000, at 24.

[5] Joint Press Release of United, Delta, Northwest and Continental, November 9, 1999.

[6] *Id.*

[7] Attributed to Ben Burnett, Vice President of Boston Consulting Group, a firm retained to act as "temporary launch manager." "Nearly Two Dozen Airlines Will Join Planned Web Site of Four Big Carriers," Susan Carey, Wall Street Journal, February, 2000.

pating carriers—those will continue to operate and will continue to offer Internet-only fares also.[8]

The joint announcement refers also to "unique travel packages" that will be offered through "combined product offerings of our [non-airline] partners."

Predictably, and in keeping with the airline industry's history of advance announcements to their competitors of business intentions, additional airlines have stated their plans to join the pack, yielding a total, to date, of 27 airlines, including American and US Airways. These new airlines are called "Charter Associates," but the exact nature of their relationship to the four "founders" has never been made clear. The added participation of the new US airlines brings the combined market share of the partners to more than 68 percent of domestic passenger traffic. The other participants include some smaller U.S. airlines plus Air Canada (the monopoly route carrier in Canada), Alitalia, KLM Royal Dutch Airlines and other major foreign carriers. Press reports indicate that other participants are expected.

The latest press report is that many of the participating European carriers are now discussing a joint Web-site of their own, involving virtually all of the principal U.S.-Europe foreign airlines (including Air France, British Airways, Lufthansa, Iberia, Swissair, and Sabena. Air France has stated that its marketing alliance will also have a joint Web-site. Most of these carriers have marketing alliances and/or code-share agreements with the partners in the US carrier Web-site. How long will it be before these sites are merged?[9]

Any hopes that anyone had that the Internet would remain a vigorous and open competitive marketplace are about to be dashed on the rocks of consolidated market power in the hands of a few industry giants. For example only, research released on February 3 by Gomez Advisors states that three "dominant online travel firms . . . now take in over 40 percent of all online travel bookings."[10] One of these firms, Preview, is about to merge into one of the others, so there will two firms with a 40 percent share.

The Gomez report states that:

> "the real leaders are solidifying their dominant positions . . . the online travel giants are gobbling up as many niche companies as possible in an effort to dwarf any smaller competitors. This amount of consolidation taking place in the market is making it nearly impossible for any but the top three online travel sites to earn significant revenues."[11]

The airlines' collective attempt to cut off the online agencies at the pass may or may not ultimately leave a survivor or two. Perhaps the best outcome that can now be foreseen for retail travel completion on the Web is one in which two or three consolidated sites compete for almost all the business. All others will be shut out.

More likely, however, is the prospect that the airlines, by combining assets and special fares not available to their competitors, will succeed eventually (and in the Internet world "eventually" is not far off) in destroying all their competition online as well as offline.[12] After all, once allowed to establish themselves collectively on the Internet, what is there to stop the airlines from completely terminating the compensation they pay to their online competitors? This will leave the airlines in sole control of the supply of information on which consumers must rely to make comparisons among competing choices.

Such an outcome has no precedent. Since the earliest days of commercial aviation, there has been an independent presence in the market, offering consumers an alternative to dealing directly with the airlines for information and transactions. It may be hard to conceive that it could happen so swiftly, given the short life of the Internet, but all signs now point to the complete domination of the Internet by a handful of firms.

All of this is occurring just when traditional travel agencies are extending their customer outreach to and through the Internet. One example, previously brought to the department's attention, is Act Travel at www.actdc.com which maintains a traditional brick-and-mortar agency as well as a booking engine online. Today's travel

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[8] *Id.*

[9] Those same airlines are parties to a proposal to assign common identified numbers to corporate clients so that, among other things, airline alliances can "track corporate business across several airlines." See Application for Approval of Agreements by the International Air Transport Association, Docket OST–99–6694–1, filed December 21, 1999.

[10] See http://biz.yahoo.com/prnews/000203/ma_gomez_o_l.html.

[11] *Id.*

[12] Traditional travel agencies are declining in number in the face of the combined onslaught of reduced commissions (50% in four years) and numerous other marketing practices calculated to raise agency costs and impair their competitive flexibility. See ASTA's Complaint in "In the Matter of American Society of Travel Agents, Inc.", Docket OST–99–6410, U.S. Department of Transportation.

agencies are rapidly adapting to new means of commerce like the Internet and to hybrid business models that encompass electronic communications and booking services in a diverse array of service packages. All of these agencies, newcomers and traditional agencies, that use or will use the Internet for booking travel are considered "online agencies" for purposes of this complaint.

Both the fully online agencies and the "traditional" agents who have embraced this technology provide an efficient means to deliver the one-stop, accurate, and unbiased comparative travel information and advice that consumers value. This avenue has become increasingly important to agents as airlines' reductions in compensation to non-compensatory levels place them in a profit squeeze and threaten to deprive the public of the access that travel agents uniquely provide to comparative price information.

The airlines are not content to compete with these firms for consumer patronage. They are intent now upon massing their forces so as to dominate the medium and thereby control the message.

If the airlines can divert any meaningful amount of this business to their individual Web sites while deterring travel agencies from reaching consumers through the Web, the potential gain to them is enormous, not merely in commissions avoided, but in the higher overall prices that consumers will pay for air travel. Deprived of easy access to independent sources of comparative price and service information, consumers inevitably will end up paying more, on average, even if the airlines never raise another fare.

Clearly, the airlines would like customers to make their reservations directly on the carriers' own Web sites. Standing alone, that objective does not necessarily offend competition policy. But the airlines have gone well beyond merely luring consumers with "better deals." They have implemented commission policies and other restrictions with respect to Internet-based bookings by travel agencies that are designed to thwart travel agency use of the Internet to communicate and book travel. The more successful they are in this approach, the fewer practical options consumers will have for comparing prices and purchasing travel, leading to less competition in travel services and higher prices for consumers. We have attached to this letter a copy of ASTA's complaint to the Department of Transportation in Docket OST–99–6410, wherein we detail other competitive abuses directed at the independent travel retailer by the major US airlines.

CONCLUSION

No other industry of which we are aware has attempted such a frontal assault on the competitive process. Time is running out. The expansion of the joint Website is well-advanced.

The Department should issue a Civil Investigative Demand upon all the partners in the proposed Web-site to obtain inspection of the underlying agreements and marketing plans. That is the only way anyone can be satisfied that this scheme is not what we have alleged it is: the finishing blow in a campaign calculated to destroy public access to comparative information about air travel services and to end once and for all the hope for a vigorous competitive industry that was the promise of airline deregulation in 1978.

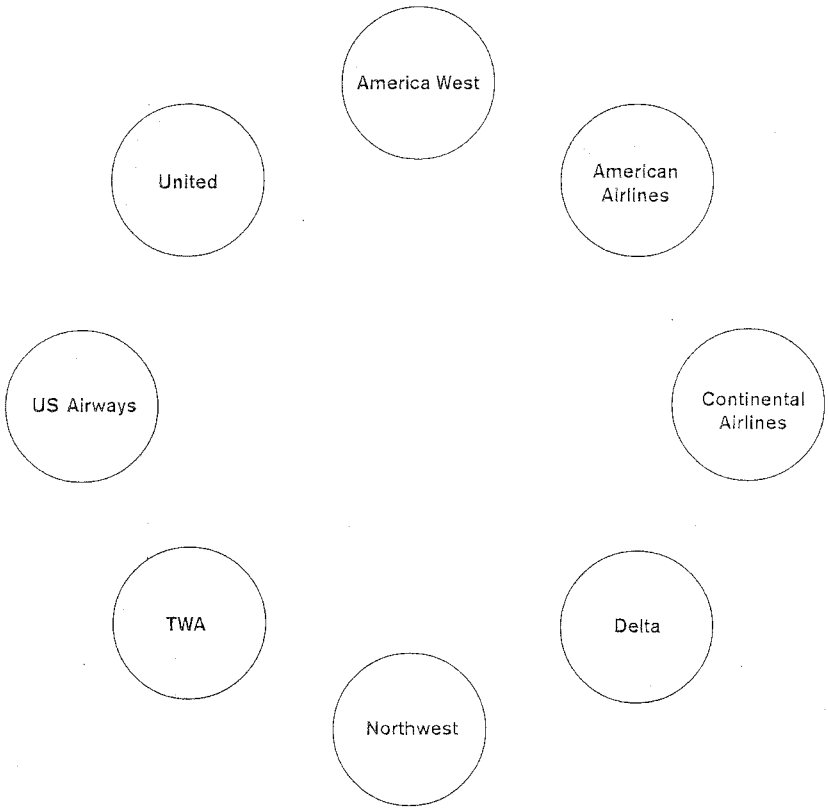
ASTA would be pleased to meet with representatives of the Antitrust Division to discuss this matter further.

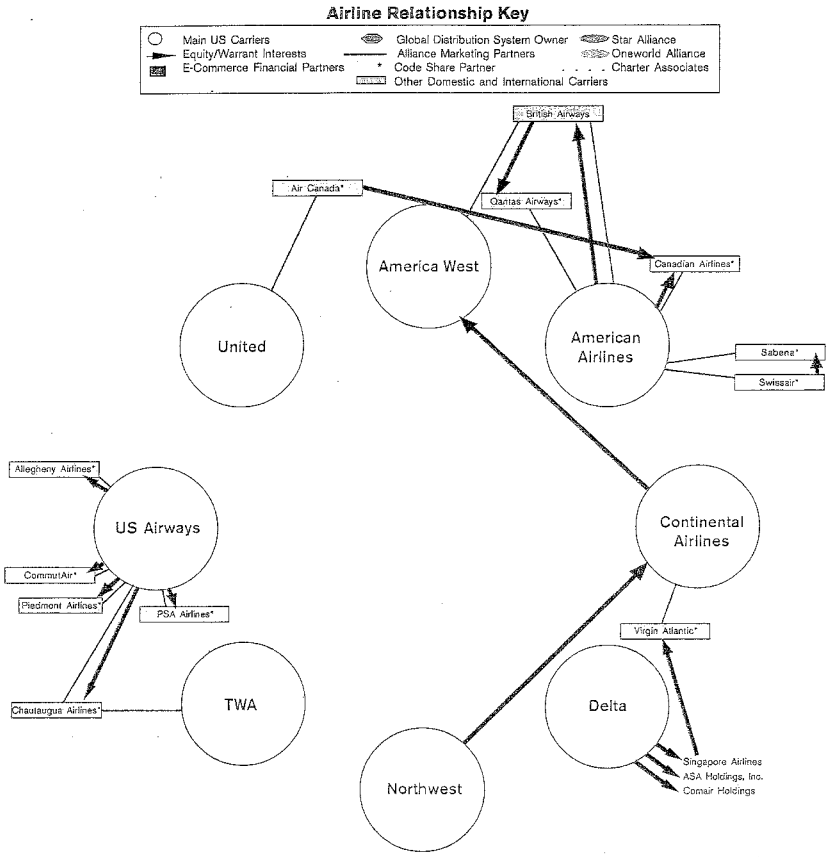
Respectfully submitted,

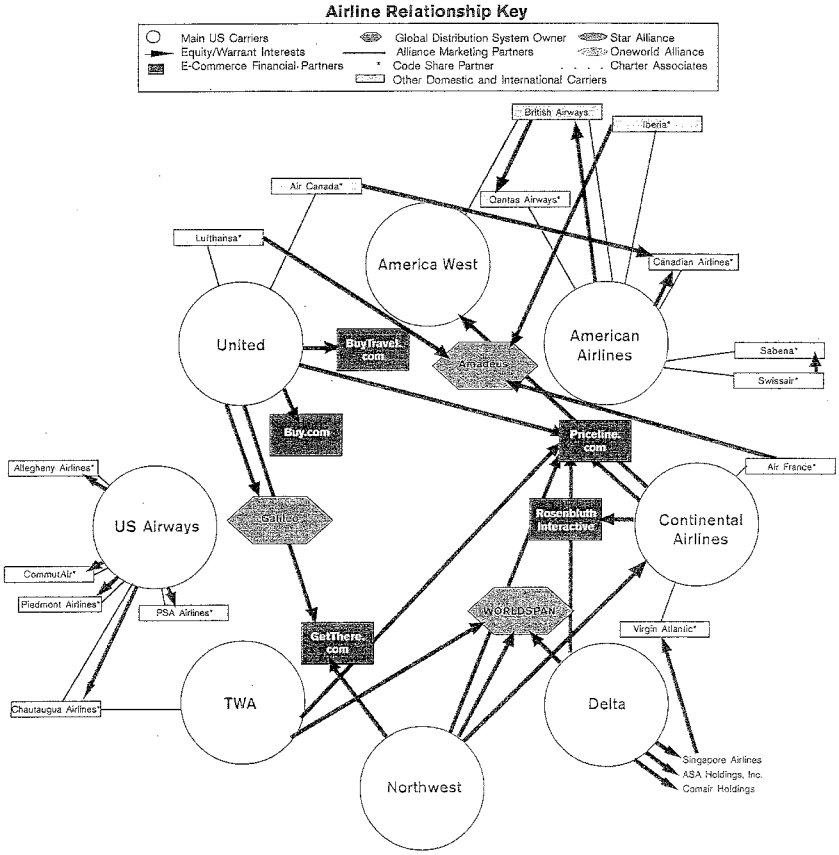
AMERICAN SOCIETY OF TRAVEL AGENTS, INC.

Airline Relationship Key

Main US Carriers	Global Distribution System Owner	Star Alliance
Equity/Warrant Interests	Alliance Marketing Partners	Oneworld Alliance
E-Commerce Financial Partners	* Code Share Partner	. . . . Charter Associates
	Other Domestic and International Carriers	




Airline Relationship Key
Main US Carriers
Equity/Warrant Interests
E-Commerce Financial Partners
Global Distribution System Owner
Alliance Marketing Partners
Code Share Partner
Other Domestic and International Carriers
Star Alliance
Oneworld Alliance
Charter Associates
British Airways
Air Canada*
Qantas Airways*
Canadian Airlines*
America West
United
American Airlines
Sabena*
Swissair*
Allegheny Airlines*
US Airways
CommutAir*
Piedmont Airlines*
PSA Airlines*
Chautaugua Airlines*
TWA
Continental Airlines
Virgin Atlantic*
Delta
Singapore Airlines
ASA Holdings, Inc.
Comair Holdings
Northwest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Other Domestic and International Carriers
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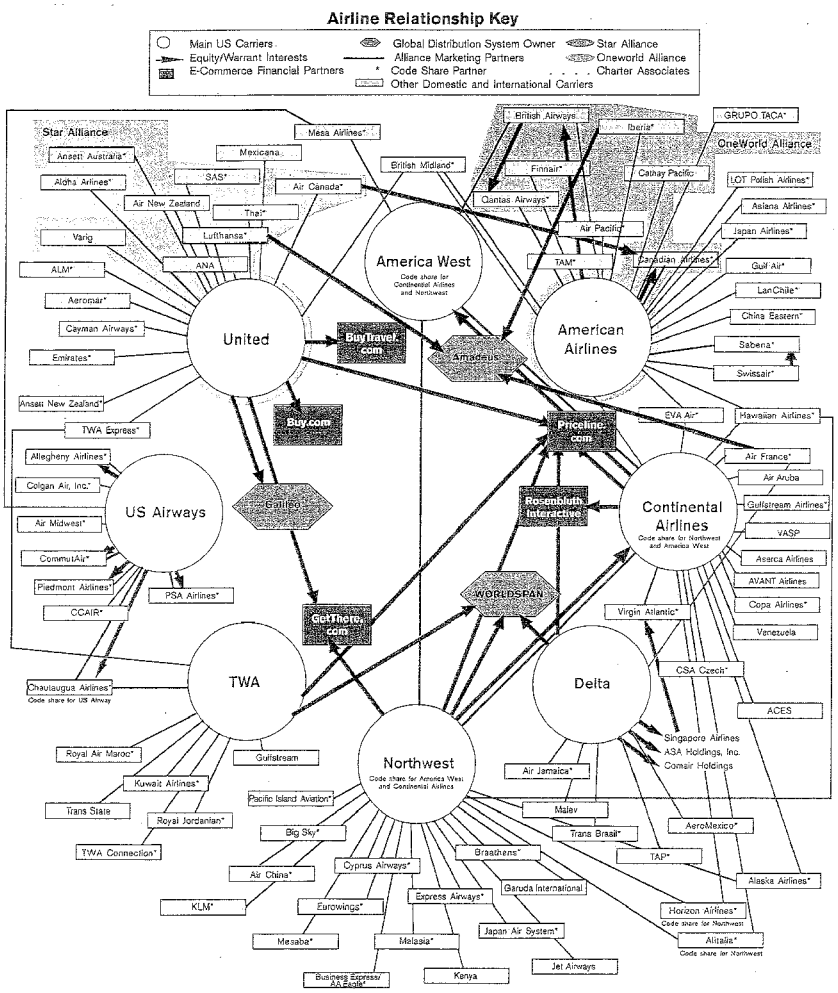
Oneworld Alliance
Charter Associates
British Airways*
Iberia*
Air Canada*
Qantas Airways*
Lufthansa*
Canadian Airlines*
America West
United
American Airlines
BuyTravel.com
Amadeus
Sabena*
Swissair*
Buy.com
Priceline.com
Air France*
Allegheny Airlines*
US Airways
Galileo
Rosenbluth Interactive
Continental Airlines
CommutAir*
Piedmont Airlines*
PSA Airlines*
WORLDSPAN
Virgin Atlantic*
GetThere.com
TWA
Delta
Chautauqua Airlines*
Northwest
Singapore Airlines
ASA Holdings, Inc.
Comair Holdings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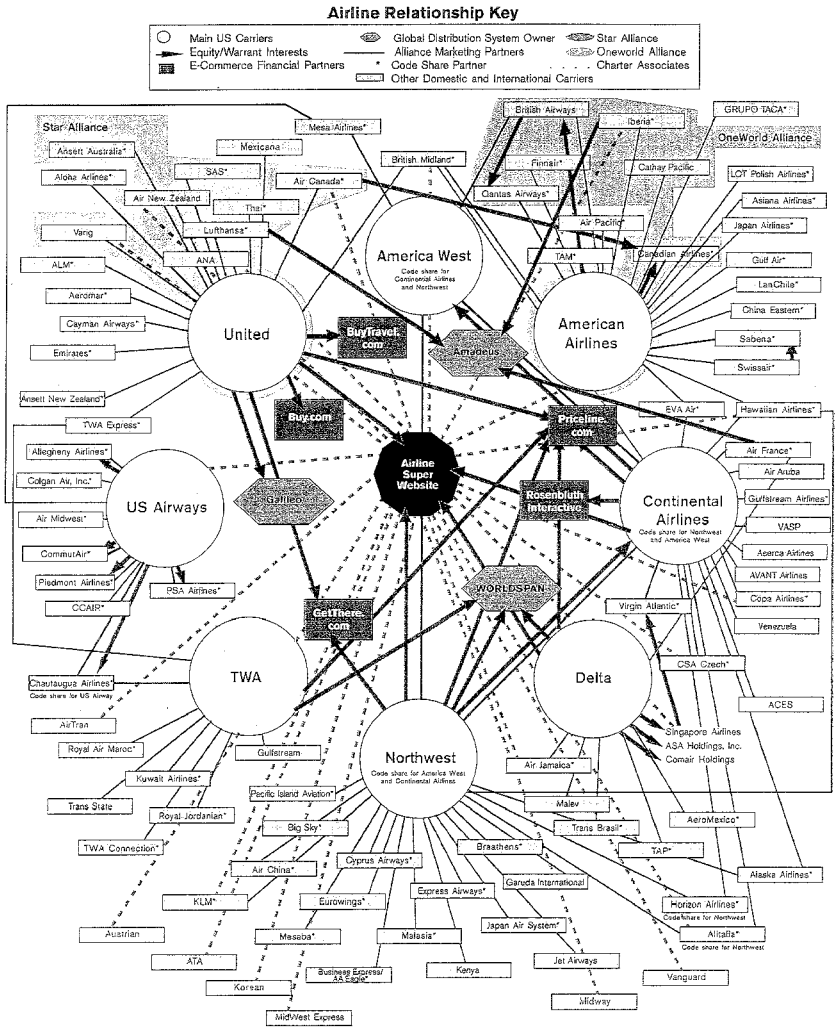
Oneworld Alliance
Charter Associates
Star Alliance
Ansett Australia*
Aloha Airlines*
Air New Zealand
Varig
ALM*
Aeromar*
Cayman Airways*
Emirates*
Ansett New Zealand*
TWA Express*
Allegheny Airlines*
Colgan Air, Inc.*
Air Midwest*
CommutAir*
Piedmont Airlines*
CCAIR*
Chautauqua Airlines*
Code share for US Airway
Mesa Airlines*
Mexicana
SAS*
Air Canada*
Thai*
Lufthansa*
ANA
PSA Airlines*
Royal Air Maroc*
Kuwait Airlines*
Trans State
Royal Jordanian*
TWA Connection*
Gulfstream
Pacific Island Aviation*
Big Sky*
Air China*
KLM*
Eurowings*
Mesaba*
Business Express/ AA Eagle*
Cyprus Airways*
Melasia*
Kenya
Express Airways*
Garuda International
Japan Air System*
Jet Airways
Braathens*
Malev
Trans Brasil*
Air Jamaica*
British Airways
British Midland*
Finnair*
Qantas Airways*
Air Pacific*
TAM*
Canadian Airlines*
Iberia*
GRUPO TACA*
Cathay Pacific
LOT Polish Airlines*
Asiana Airlines*
Japan Airlines*
Gulf Air*
LanChile*
China Eastern*
Sabena*
Swissair*
EVA Air*
Hawaiian Airlines*
Air France*
Air Aruba
Gulfstream Airlines*
VASP
Aserca Airlines
AVANT Airlines
Copa Airlines*
Venezuela
Virgin Atlantic*
CSA Czech*
ACES
Singapore Airlines
ASA Holdings, Inc.
Comair Holdings
AeroMexico*
TAP*
Alaska Airlines*
Horizon Airlines*
Code share for Northwest
Alitalia*
Code share for Northwest
United
US Airways
TWA
Delta
Northwest
Code share for America West and Continental Airlines
America West
Code share for Continental Airlines and Northwest
American Airlines
Continental Airlines
Code share for Northwest and America West
BuyTravel.com
Buy.com
Priceline.com
Rosenbluth Interactive
Amadeus
Galileo
WORLDSPAN
GetThere.com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Code Share Partner
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Oneworld Alliance
Charter Associates
Star Alliance
Ansett Australia*
Aloha Airlines*
Mesa Airlines*
Mexicana
SAS*
Air Canada*
Air New Zealand
Thai*
Lufthansa*
ANA
Varig
ALM*
Aeromar*
Cayman Airways*
Emirates*
Ansett New Zealand*
TWA Express*
Allegheny Airlines*
Colgan Air, Inc.*
Air Midwest*
CommutAir*
Piedmont Airlines*
CCAIR*
PSA Airlines*
Chautauqua Airlines
Code share for US Airway
AirTran
Royal Air Maroc*
Kuwait Airlines*
Trans State
Royal Jordanian*
TWA Connection*
Austrian
ATA
Korean
MidWest Express
Guilstream
Pacific Island Aviation*
Big Sky*
Air China*
KLM*
Eurowings*
Masaba*
Business Express/
AA Eagle*
Cyprus Airways*
Express Airways*
Malasia*
Kenya
Braathens*
Garuda International
Japan Air System*
Jet Airways
Midway
Vanguard
Horizon Airlines*
Code share for Northwest
Alitalia*
Code share for Northwest
Alaska Airlines*
AeroMexico*
TAP*
Trans Brasil*
Malev
Air Jamaica*
Singapore Airlines
ASA Holdings, Inc.
Comair Holdings
ACES
CSA Czech*
Virgin Atlantic*
Venezuela
Copa Airlines*
AVANT Airlines
Aeerca Airlines
VASP
Gulfstream Airlines*
Air Aruba
Air France*
Hawaiian Airlines*
EVA Air*
Sabena*
Swissair*
China Eastern*
LanChile*
Gulf Air*
Japan Airlines*
Asiana Airlines*
LOT Polish Airlines*
Cathay Pacific
Finnair*
Qantas Airways*
Air Pacific*
TAM*
Canadian airlines*
British Airways*
Iberia*
GRUPO TACA*
British Midland*
America West
Code share for Continental Airlines and Northwest
United
American Airlines
US Airways
Continental Airlines
Code share for Northwest and America West
TWA
Delta
Northwest
Code share for America West and Continental Airlines
BuyTravel.com
Amadeus
Buy.com
Priceline.com
Airline Super Website
Galileo
Rosenbluth Interactive
WORLDSPAN
GetThere.com

Airline Relationship Chart

This chart reflects airline relationships, excluding announced changes, as of February 4, 2000.

	Airline Frequent Flyer Partners	Airline Alliance Marketing Partners	Airline Code-Share Partners	Subsidiaries /Affiliates	E-Commerce Partners
America West Airlines (America West Holdings Corporation) [Owned 9% by Continental Airlines]	British Airways Continental Airlines Northwest Airlines Virgin Atlantic	British Airways Continental Airlines Northwest Airlines Mesa Airlines	Continental Airlines Northwest Airlines Mesa Airlines		
American Airlines (AMR Corporation)	Aer Lingus Aero California Aerolineas Argentinas Air Pacific Alaska Airlines Asiana British Airways British Midland Canadian Airlines Cathay Pacific Crossair El Al Finnair Grupo TACA Hawaiian Airlines Iberia Japan Airlines LanChile Midway Qantas Sabena Swissair TAM Turkish Airlines US Airways Shuttle	Air Pacific Asiana Airlines British Airways British Midland Canadian Airlines Cathay Pacific China Eastern Eva Air Finnair GRUPO TACA Gulf Air Hawaiian Airlines Iberia Japan Airlines LOT Polish Airlines LanChile Qantas Airways Sabena Swissair TAM	Air Pacific Asiana Airlines British Midland Canadian Airlines China Eastern Eva Air Finnair GRUPO TACA Gulf Air Hawaiian Airlines Iberia Japan Airlines LOT Polish Airlines LanChile QANTAS Sabena Swissair TAM	*Airline*: Canadian Airlines (25% voting, 34% equity)	

Continental Airlines, Inc. [Owned13.5% by Northwest Airlines]	ACES Alaska Airlines Alitalia America West Avant British Midland BWIA China Ailrines Copa CSA Czech EVA Frontier Airlines Hawaiian Airlines Horizon Air Northwest Airlines Qantas	ACES Air Aruba Alaska Airlines Alitalia America West Aserca Airlines Venezuela AVANT Airlines British Midland Copa Airlines CSA Czech EVA Air Gulfstream Airlines Hawaiian Airlines Horizon Air Northwest Airlines VASP Virgin Atlantic	Air France Alaska Airlines America West British Midland Copa Airlines CSA Czech EVA Air Gulfstream Airlines Hawaiian Airlines Northwest Airlines Virgin Atlantic	*Airline*: America West Airlines 9%	Priceline.com (warrants) Rosenbluth Interactive (equity stake) Airline Super Website
Delta Air Lines, Inc.	AeroMexico Air France Air Jamaica China Southern Korean Airlines Malaysia Singapore South African Airlines TAP United	AeroMexico Air France Air Jamaica Korean Air Lines Malev TAP Trans Brasil	AeroMexico Air France Air Jamaica TAP Trans Brasil	*Global Distribution System (GDS)*: WORLDSPAN *Airlines*: ASA Holdings, Inc. Comair Holdings Singapore Airlines	Priceline.com (equity stake, warrants) Airline Super Website
Northwest Airlines Corporation	Air China Alaska Aloha America West Big Sky Airlines Braathens Business Express Continental Eurowings Garuda International Hawaiian Airlines Japan Air System JetAirway Kenya Airways KLM Malasia Airways Midwest Express (redemption only) Pacific Island Aviation	Air China Alaska Airlines Alitalia America West Big Sky Braathens Business Express/AA Eagle Continental Airlines Cyprus Airways Eurowings Express Airways Garuda International Hawaiian Airlines Horizon Airlines Japan Air System Jet Airways Kenya KLM Malasia Mesaba Pacific Island Aviation	Air China Alaska Airlines Alitalia America West Big Sky Braathens Business Express/AA Eagle Continental Airlines Cyprus Airways Eurowings Express Airway Hawaiian Airlines Horizon Airlines Japan Air System KLM Malasia Mesaba Pacific Island Aviation	*Global Distribution System (GDS)*: WORLDSPAN *Airline*: Continental Airlines	GetThere.com (warrants) Priceline.com (warrants) Airline Super Website

Trans World Airlines, Inc.	Air India Alaska Airlines Horizon Airlines Icelandair LatinPass partners Royal Air Morac Royal Jordanian Trans World Express	Chautaugua Airlines Gulfstream Kuwait Airlines Royal Air Maroc Royal Jordanian Trans State TWA Connection TWA Express	Kuwait Airlines Royal Air Maroc Royal Jordanian TWA Connection TWA Express	*Global Distribution System (GDS)*: WORLDSPAN	Priceline.com (warrants)
United Airlines (UAL Corporation)	Aeromar Air Canada Air New Zealand Aloha Airlines ALM ANA Ansett Australia British Midland Cayman Airways Delta Air Lines LAPA Lufthansa Mexicana SAS Saudi Arabian Airlines Singapore Thai Varig	Aeromar Air Canada Air New Zealand Aloha Arlines ALM ANA Ansett Australia Ansett New Zealand British Midland Cayman Airways Emirates Lufthansa Mexicana SAS Thai TransWorld Express Varig	Aeromar Ansett New Zealand Air Canada ALM Aloha Ansett Australia British Midland Cayman Airways Emirates Lufthansa Mexicana SAS Thai TransWorld Express	*Global Distribution System (GDS)* Galileo	GetThere.com (equity stake) Buy.com (joint venture) BuyTravel.com Airline Super Website
US Airways Express, US Airways Shuttle, Metrojet (US Airways Group, Inc.)	Alitalia American ANA Austrian LatinPass partners Northwest Qantas Sabena Swissair	Air Midwest Allegheny Airlines Colgan Air, Inc. CCAIR Chautauqua Airlines CommutAir Mesa Airlines Piedmont Airlines PSA Airlines	Air Midwest Allegheny Airlines Colgan Air, Inc. CCAIR Chautauqua Airlines CommutAir Mesa Airlines Piedmont Airlines PSA Airlines	Allegheny Airlines, Chautauqua Airlines, CommutAir, Piedmont Airlines, PSA Airlines	

International Airline	Subsidiary
British Airways	25% owner of Qantas
Singapore Airlines	49% owner of Virgin Atlantic
Swissair	49.5% owner of Sabena

Super Airline Web Site

Collaborators
Delta Air Lines
United Airlines
Northwest Airlines
Continental Airlines

Domestic Charter Associates
American
US Airways
ATA
AirTran
Hawaiian
Midwest Express
Midway
Vanguard

Foreign Charter Associates
Air Canada
Air Jamaica
Air New Zealand
Alitalia
All Nippon Air
Austrian
British Midland
COPA
CSA Czech
Iberia
KLM
Korean
Mexicana
Singapore
Varig

PREPARED STATEMENT OF T. ALLAN MCARTOR, PRESIDENT AND CEO, ON BEHALF OF LEGEND AIRLINES

On behalf of Legend Airlines, I would like to thank you for holding this hearing and addressing airline competition issues. We appreciate the opportunity to provide the information on the status of competition in the airline industry from a new entrant's perspective. Let me begin by stating that I thought that my prior experiences as a combat pilot, head of Federal Express Airline and Administrator of the FAA had prepared me for my current assignment. Well, I can now assure you that nothing prepares one for attempting to start a new entrant airline carrier, particularly in a city dominated by one of the world's largest air carriers. We never could have imagined that a carrier that fought so hard against us and our right to fly under federal laws in multiple forums would then turn around and duplicate our premium service at Love Field and nowhere else. American continually switches its positions—one day arguing that it and DFW Airport would be destroyed and that it would be best if the Supreme Court blocked flights out of Love Field, the next day arguing that they owe it to the people of Dallas to offer service at Love Field. It would not be surprising if American changes its story again tomorrow. The bottom line is, if a carrier is allowed to go to such extremes to drive a new entrant out of business, the future of competition indeed looks bleak.

Legend Airlines is a new entrant carrier operating out of Dallas Love Field that started service on April 5 to Washington Dulles, Los Angeles, and Las Vegas. We fly jet aircraft reconfigured to hold only 56 seats (consistent with federal law), offering premium service at coach fares. Since Legend was founded in 1996, American Airlines and its surrogates have been waging a multi-million dollar litigation and media campaign to put us out of business. It is difficult enough to start out in a market where the incumbent carrier has a 75 percent market share, but Legend was willing to compete in accordance with federal law and DOT orders. From the sheer magnitude of American's response, you would have thought Legend was a 400 aircraft operation with multiple alliances—certainly not what it is, a four aircraft startup with jets limited to 56 passengers. (For comparison's sake, American has 32 alliance partners, a 641 aircraft fleet and approximately 1,000 slots at O'Hare Airport.)

When Legend and Continental Express first announced plans to fly out of Love Field—consistent with federal law known as the Wright Amendment, American's CEO Robert Crandall announced that "if the Wright Amendment is ever changed, we'll sue everybody in America to close Love Field." The headline in the October 4, 1996 Dallas business Journal stated, "AMR chief promises to fight to the death on Love Field." They were not exaggerating. Before Legend even filed for DOT certification, American was intent on destroying it. In October 1997, Congress passed the Shelby Amendment, which amended the Wright Amendment expressly allowing jets reconfigured to carry no more than 56 passengers to any destination. Before the President had signed the Shelby Amendment into law, American sued Legend, Continental Express and the City of Dallas in Texas state court to prevent us and Continental Express from operating out of Love Field.

While many cities throughout this country—including Houston, New York, Washington, D.C., Los Angeles, Miami—have many multiple airports that compete, as a part of American's campaign, it spread misleading information throughout the Dallas area that American and its DFW hub would be destroyed by any level of competition introduced at Love Field.[1] American opposed allowing nonstop flights to Mississippi, Alabama and Kansas and use of 56-seat aircraft to any destination. Such oppressive restrictions exist nowhere else in the country. Such restrictions exist nowhere else in the world.

To demonstrate that it is not just a one-carrier predator, American also challenged Continental Express' right to fly 50-seat regional jets from Love Field to Cleveland. It announced that it would use 12 LGA commuter slots to serve LaGuardia-Cleveland—one of Continental's hubs, a market where Continental already operated six daily roundtrips.[2]

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[1] An example of American's misinformation campaign: "Because more than 90% of Dallasites and more than 50% of Metroplex residents live closer to Love Field than DFW, airlines will add service at Love and reduce it at DFW. With fewer local customers, in the long term DFW will not compete with hubs like O'Hare, Atlanta, and Denver. DFW will become a second-tier hub." [Dear Colleague Letter from American Chairman, Don Carty, July 6, 1998.]

[2] The following news reports describe a series of actions taken by American to drive Continental Express out of Love Field:

Continued

Because these were federal issues and impacted the national aviation system and interstate commerce, DOT tried to resolve the conflict by instituting an Interpretive Proceeding wherein it considered whether federal law permits Legend's proposed operations. On December 23, 1998, DOT issued a Declaratory Order finding that Legend's proposed service is authorized under federal law. American and its partners appealed that decision to the Fifth Circuit Court of Appeals. On February 1, 2000, the Fifth Circuit rendered a decision affirming DOT's Orders and upholding Legend's authority under federal law to operate at Love Field. (Fort Worth has petitioned to bring this case before the Supreme Court. It is expected that American will file as well.

Within two hours of the Fifth Circuit decision, American announced plans to reconfigure Fokker 100 jets and MD–80 jets (normally seating 135 passengers) to combat Legend. As reported by the February 2 Dallas Morning Star, "American's plan is to create a special fleet of jets that will be used at Love Field only." Therefore, in its effort to copy Legend, American is spending millions of dollars to reconfigure each of the aircraft it will utilize at Love Field (this is in addition to the expenses it will incur at Love Field to build and upgrade facilities,[3] add personnel, build catering facilities, and create a specialized marketing program) in Legend's markets with the sole intent of driving Legend out of Love Field.

American has admitted that it will not use these aircraft in other markets. If American were to utilize these aircraft elsewhere in this system or halt this service, they would again reconfigure these aircraft to restore the original interiors. Although this would add millions of additional dollars to its costs, American is prepared to do so.

American has made it very clear that it would prefer that all service from Love Field to destinations beyond the four border states be prevented, regardless of the million they are spending.

American's spokesman explained its actions in the Dallas Morning News:

> "If Legend is allowed to fly out of Love Field, we will also fly out of Love Field, and we will fly in competitive markets and at competitive fares," said American spokesman Tim Doke, adding that American can offer more flights than Legend to the same destinations.
>
> "We are confident that a court will step in and enjoin Legend from selling tickets," Mr. Doke said.
>
> Fort Worth has appealed a lower court ruling that allows long-haul service from Love. If the Supreme Court takes the case and rules in Fort Worth's favor, it means that American would have to "undo all that we've done—all the planes we've reconfigured and so forth," Carty said.
>
> But, even so, "For a whole variety of reasons, we continue to believe that from American's perspective, that's better for us, even though it would cost us some

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American said Monday that it is starting service from Austin to Houston's Hobby Airport on September 9, the same day American also plans to launch three daily flights from Hobby to New York's LaGuardia Airport.

The new service comes as Continental presses its own plans to fly from Dallas Love Field to Continental's hub in Cleveland. A state district judge in Fort Worth has blocked that service at the request of Fort Worth and Dallas/Fort Worth International Airport board.

Analysts said American's new Houston Service appears to be simply retaliation against Continental's Love field plans.

"It's spite," said Joseph Berman, senior aviation analyst at Avmark Inc. "They're saying, 'If you're going to go into our market and do that, we're going to go into your market and do this.'" [Dallas Morning News, Tuesday, July 21, 1998.]

In commenting on American's action to stop Continental Express' proposed flights at Love Field, David Siegel, President of Continental Express, Inc., stated in Commuter/Regional Airlines News (July 20, 1998): "It is refreshing to see new leadership at DFW's flagship airline. Many hoped that with the easing of the dress code at American Airlines would be more than symbolic. But whether dressed up or dressed down, the same old anticompetitive, protectionist actions continue to thrive and deny consumers their rights to choice convenience and reasonable fares."

Analysis of American's Houston-LaGuardia service is similarly enlightening: ". . . but Carty is 'no pushover by a long shot,' the [American] official said, describing him as tough and aggressive, particularly when it comes to competitive response. 'Don [Carty] doesn't like to sit there and take it,' he said, 'He wants to retaliate' . . . its unusual for us to fly nonhub-to-nonhub routes,' an official said. 'It's a signal to anyone who comes messing around with our market.'" ["American Builds on Crandall's Legacy," Aviation Week & Space Technology, August 24, 1998.]

[3] American spent close to $100 million to block the use of certain passenger facilities at Love Field, claiming that they would use the facilities for office space. In 1997, American entered a 25-year lease for "office space" in a former Love Field terminal at an annual lease price of $3.5 million. The facility needs approximately $8.5 million in asbestos work and several million dollars worth of general renovations.

money," Carty told reporters after a speech yesterday at the SMU Management Briefing Series at the Fairmount Hotel.

Carty said earlier that it would be better for the region if the Supreme Court were to overturn the 5th U.S. Circuit Court of Appeals' Feb. 1 ruling. (Forth Worth Star Telegram, April 20, 2000.)

American has never utilized aircraft with one level of service and never shifted operations to Love Field to combat Southwest. Nor has American added flights to Cleveland to challenge the operations of Continental Express out of Love Field. Moreover, when Midwest Express (another carrier with an upscale interior and special flight amenities) entered the DFW market American did not reconfigure aircraft to match Midwest Express' cabin configuration.[4]

The markets selected by American for its Love Field service further demonstrate that it is focusing on Legend. Although American serves the DFW–LAX market with 18 roundtrips per day, after hearing that Legend would operate to LAX, American immediately announced LAX as the first market it would serve from Love Field, offering four roundtrips. As a result of American's DFW–LAX schedules, American has a total of 20 flights in the same time period. For example, Legend has a 5:10 p.m. departure at Love Field which is surrounded by American flights at 3:50, 4:00, 4:30 (Love Field), 5:15, and 6:00. This is a prime example of an already dominant carrier adding to its market presence to leave little room for a new entrant. To dissuade Legend from entering the Chicago market after Legend announced its intent to serve Chicago, American will increase its roundtrips to 33.[5] In addition, American is matching fares, offering discounts and turning the heat up on travel agencies and corporations.

While Legend's officers and stockholder fully understand the competitiveness of the air carrier industry and the enormous advantages that American already holds in the Dallas-Fort Worth marketplace, American's overall actions amount to much more than competition. If this is not a classic case of predation, then it is hard to imagine what would cross the line. As the Department of Justice in United States of America v. AMR Corporation, Civil Action N. 99–1180–JTM, May 13, 1999 accurately surmised:

> American is under investigation for a series of actions taken against new entrants. American dominates DFW and charges monopoly fares on many DFR routes. When small airlines try to compete against American on these routes, American typically responds by increasing its capacity and reducing its fares well beyond what makes business sense, except as a means of driving the new entrant out of the market. Once the new entrant is forced out, American promptly raises its fares and usually reduces its service. Through its predatory and monopolistic conduct, American deprives consumers of the benefits of competition in violation of the antitrust laws.

As American, its affiliates and alliance partners control 75 percent of the Dallas/Fort Worth market, it makes it very difficult for a new entrant to compete. In addition to its other advantages, if a carrier with that much control over the marketplace can add any number of flights in a new entrant's market and add a type of service it has never before operated, then new entrants may be a thing of the past. For these reasons, it is essential the DOT and DOJ actively pursue carriers who engage in anticompetitive behavior and threaten to destroy the benefits of deregulation. I urge this Committee to remind both DOT and DOJ that it must move aggressively to ensure that deregulation is not just a distant memory.

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[4] American now codeshares with Midwest Express.

[5] American has over 1,000 slots at O'Hare; therefore, it can adjust schedules at will. Since O'Hare is a high density airport, Legend was blocked from entering that market. Now American has 33 scheduled roundtrips from Dallas to Chicago, Therefore, American will make it difficult for Legend to enter that market.

As to why American is increasing its O'Hare frequencies: "If a simple price match is insufficient to deprive an entrant of enough local traffic to survive, the hub carrier can shift enough capacity to the local markets to accomplish that goal. Moreover, where service in a market is constrained by slot availability, a hub carrier with access to a large pool of slots has even greater ability to respond to entry in this way because the entrant will be unable to add capacity on its own. American's president has referred to such strategic responses as predatory scheduling. The net result of predatory scheduling is to discourage a new entry in the first place, or render it unprofitable where it occurs. [Department of Justice Comments on Joint Application of American Airlines and British Airways' Application for Antitrust Immunity and Alliance Agreement (OST–97–2058), May 21, 1998.]