U.S. House of Representatives
Committee on Transportation and Infrastructure
Washington, DC 20515

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May 13, 2008

SUMMARY OF SUBJECT MATTER

TO: Members of the Subcommittee on Aviation

FROM: Subcommittee on Aviation Staff

SUBJECT: Hearing on the Impact of Consolidation on the Aviation Industry, with a Focus on the Proposed Merger Between Delta Air Lines and Northwest Airlines

PURPOSE OF THE HEARING

The Subcommittee will meet on Wednesday, May 14, 2008, at 2:00 p.m. in room 2167 Rayburn House Office Building to receive testimony regarding the impact of consolidation on the aviation industry, with a focus on the proposed merger between Delta Air Lines and Northwest Airlines.

BACKGROUND

In the past few months, network carriers have been exploring possible mergers. After several months of negotiation, Delta Air Lines and Northwest Airlines announced their intent to merge. There are also reports of merger discussions between the remaining U.S. air carriers, including United and Continental, and United and US Airways. However, Continental recently announced that it would remain an independent carrier. According to press reports, exploratory discussions are still underway between United and US Airways.

I. The Delta-Northwest Proposal

On April 15, 2008, Delta Air Lines (Delta) and Northwest Airlines (Northwest) (the 3rd and 6th largest airlines) announced an agreement in which the two carriers will merge in an all-stock transaction with a combined value of $17.7 billion. The airlines claim that the transaction will generate more than $1 billion in annual revenue and cost synergies from more effective aircraft utilization, a more comprehensive and diversified route system, reduced overhead and improved operational efficiency. The combined carrier expects to incur one-time cash costs not to exceed $1 billion to integrate the two airlines, and expects to have liquidity of nearly $7 billion at closing.

Under the terms of the transaction, Northwest shareholders will receive 1.25 Delta shares for each Northwest share they own.

The new airline will take the Delta Air Lines name, and current Delta Chief Executive Officer (CEO), Richard Anderson, will be the CEO of the combined company. The new Board of Directors will be made up of 13 members, seven of whom will come from Delta's board, including Anderson, and five of whom will come from Northwest's board, including Doug Steenland, the current Northwest CEO. One director will come from the Air Line Pilots Association (ALPA).

According to the carriers, the new Delta will continue to headquarter in Atlanta, and will have executive offices in Minneapolis/St. Paul and New York, and international executive offices in Amsterdam, Paris and Tokyo. The combined carrier will have more than $35 billion in aggregate annual revenues, operate a mainline fleet of nearly 800 aircraft and employ approximately 75,000 people worldwide. However, until a deal is completed, Delta and Northwest will continue to operate as two separate airlines.

II. Roles of the Departments of Justice and Transportation

A. Department of Justice

The competitive effects of mergers and acquisitions are principally governed by Section 7 of the Clayton Act, which prohibits such transactions "where in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly."[1] Generally, Section 7 is primarily enforced by the Federal Trade Commission and the Department of Justice's (DOJ) anti-trust division. The Hart-Scott-Rodino Act requires reporting to both of these agencies by both the acquiring and acquired parties of stock and asset acquisitions where the acquiring party would hold at least $50 million (adjusted annually for inflation, currently $63.1 million). No transaction covered by this may be consummated without compliance with the reporting and waiting periods of the Hart-Scott-Rodino Act. The notice and waiting period provide an opportunity for the two agencies charged with assessing the competitive aspects of the transaction to review the proposal prior to its completion, and file suit if it is found to violate the antitrust laws.

The DOJ has primary responsibility to review proposed mergers in the airline industry. It will examine the proposed merger, conduct a market-by-market review, and determine whether the merger is likely to cause a substantial reduction in competition in any relevant market. The DOJ's main focus will be on the impact of the merger on any overlapping routes. If it finds that the merger may reduce competition, it may file suit in Federal Court. The DOJ consults with the Department of Transportation (DOT) during its investigation where appropriate (i.e., to put certain practices into context). The DOT makes recommendations, and supplies data and policy input to DOJ on these issues. The DOT will also review the transfer of international routes to assure that consolidation does not damage competition or otherwise harm the public interest, as discussed in the next subsection.

DOJ's principal concern under antitrust laws is the creation or enhancement of any one firm's market power in any relevant market. A merger between two major airlines will likely be

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[1] 15 U.S.C. § 18 (2006).

viewed as a horizontal merger. A horizontal merger typically involves competitors in the same product and geographic market.

There are several possible consequences of a horizontal merger. One possible economic outcome is that the merged company's market power may grow to such a degree that it would have an undue level of control over pricing. This would also be the case if a merger results in a reduction in the number of competitors and, as a result, an increased concentration in the relevant product and geographic market area.

In addition, a reduction in the number of competitors in a market may make it easier for the remaining firms to collude on prices or other competitive terms. Another potential consequence of a horizontal merger is that with relatively few companies in a given market, it becomes possible for firms to predict accurately how rivals will react to changes in price without any explicit agreements. Further, an increase in concentration may also enhance a company's ability to engage in predatory conduct toward competitors, producing new barriers to entry for new firms, leading ultimately to higher prices.

To assess the competitive impact of a transaction, DOJ must identify the relevant market and market participants, assess market concentration resulting from the merger, and determine the likely competitive effects for the increase in market concentration resulting from the merger. DOJ's review is likely to take 3-6 months at a minimum.

In undertaking its competitive review, the DOJ normally begins by determining the relevant markets. Relevant airline markets are usually scheduled airline service between one city and another ("city pairs"), while non-stop and connecting service in the same city pair may be considered as separate markets. As such, DOJ is generally more concerned about mergers between airlines with more overlapping networks, because the number of overlapping city pairs will be larger. If a merger presents few city pair overlaps, DOJ may agree to settle if the merged carriers divest assets (including airport gates and aircraft) to other carriers to take over competitive service in those city pair markets. Generally, the courts and the DOJ do not rely exclusively on this data but also look at the likely competitive effects of a transaction based on real life experiences, taking into account airline-specific practices such as loyalty programs and online reservation systems with instantaneous fare information. In addition, DOJ evaluates the ease of entry into competitive markets by other competitors as well as the potential future consequences of the proposed merger, including "downstream" effects such as whether the merger will lead to other mergers.

As to the timing of a merger evaluation, after the two carriers file notice with the DOJ, the agency will have 30 days to conduct a preliminary review. After a preliminary review, DOJ will most likely request extensive information from the carriers. The carriers have as much time as they want to compile the requested information and submit it to the DOJ, depending on how quickly they want to move forward. Once the information has been submitted to the DOJ, the agency has 30 days under the statute before the carriers can consummate the transaction, though this waiting period can be extended under the statute for another 30 days, or through a timing agreement with the parties. If DOJ determines the merger violates the Clayton Act, it may file suit to block the merger. If the carriers agree to the conditions that DOJ imposes to correct competitive problems, DOJ may settle the suit and enter into a consent decree, which is subject to public comments and court approval. The DOJ may also decide not to take any action, in which case the parties can consummate the transaction immediately.

B. The Department of Transportation

Overall, the DOT's role in the process of determining whether a merger should proceed or not on antitrust grounds is secondary to DOJ's lead. According to the DOT, in some past merger cases, it has given its views privately to DOJ on the possible competitive consequences of proposed mergers.

Independently, the DOT would consider whether to approve the transfer of the acquired air carrier's international routes to the surviving entity. The air carriers must file a joint application requesting that the DOT transfer the economic authorities under 49 U.S.C. § 41105 (transfer of the certificate).

The DOT may approve a transfer of international routes only if it finds that it is consistent with the public interest. By statute, the DOT must specifically consider the transfer's impact on the viability of the parties to the transaction, on competition in the domestic airline industry, and on the trade position of the United States in the international air transportation market. The DOT would also examine any other public interest issue raised by the transfer and whether it is inconsistent with international policy. The DOT's decision on the route transfer would be subject to Presidential review under 49 U.S.C. § 41307.

While the transfer application is pending before the DOT, the air carriers could request that the DOT grant them an exemption from the provisions of 49 U.S.C. § 41105 to allow them to consummate the merger at their own risk pending the DOT's decision on their route transfer application. The DOT's decision on the exemption request would be conditioned upon the air carriers remaining separate and independently operated entities under common ownership.

From an economic fitness perspective, both air carriers must provide DOT updated fitness information on the merged entity, and DOT would also have the authority to review any code share arrangements or alliances involving the two carriers that would be affected by a merger between the two airlines.

III. Issues Associated with a Merger

A. Competition

Delta/Northwest state that the combined carrier (and its regional partners) will provide passengers access to more than 390 destinations in 67 countries. Domestically, Delta/Northwest state that there would be little overlap in the nonstop routes the two airlines serve, with direct competitive service on 12 of more than 1,000 nonstop city pair routes currently flown by both airlines. However, there will be impacts on competition in these 12 markets. Currently, Delta and Northwest offer direct service from Cincinnati to Minneapolis. With the merger, however, there will be only one airline offering direct service. The only other alternatives are connecting services. This will impact 21,450 passengers. The same is true on the Detroit to Salt Lake City route, which will impact 34,840 passengers and on the Minneapolis to Salt Lake City route, which impacts 54,500 passengers. With regard to the Cincinnati to Detroit route, where there is no alternative air service other than the new merged airline; 118,634 passengers will be affected.[2] Some believe that these

[2] Bureau of Transportation Statistics (BTS) data (May 9, 2008).

routes would attract low cost carriers, to provide competitive service in the markets. These are issues that the DOJ will consider in its review of the merger proposal.

Concerns have been raised that a merger between these two carriers could raise fares substantially. Fewer large carriers could mean more monopoly power at the hubs these carriers dominate. Delta currently operates four hubs, including Atlanta, Cincinnati, Salt Lake City, and New York-JFK. Northwest operates hubs at Minneapolis-St. Paul, Detroit and Memphis. The carriers state that they do not intend to close any of the seven hubs as a result of the merger. Therefore, a combined Delta/Northwest would be a generally bigger competitor at these hubs, and have a greater ability to discourage competitors from entering the market. In 1993, the Government Accountability Office found that fares at concentrated hubs are higher than fares elsewhere.[3] Moreover, the Transportation Research Board noted in a 1999 report on competition in the airline industry that: "[h]igher average fares in concentrated hub markets compared with unconcentrated hub and nonhub markets have been observed in several studies" and that "the consistency with which hub markets appear among the highest fare markets is noteworthy and raises the possibility that hub carriers are exploiting market power in ways that would not be sustained if they were subject to more effective competition."[4]

Delta/Northwest in its merger briefing papers state that the growth of low cost carriers has created new competition that would offset historical regulatory concerns with mergers. However, opponents argue that over-reliance on low cost carriers is not the answer. This is because low cost carriers do not serve many of the same markets that the large network carriers serve. In addition, for some traffic, low cost carriers may be non-competitive because they do not offer the same benefits as network carriers, such as frequent flier benefits to foreign destinations. Moreover, many low cost carriers are struggling financially, with several going out of business or having filed for bankruptcy. Due in part to increased fuel prices, in the last few weeks, low cost carriers MAXjet, BigSky, Aloha, ATA, Skybus, Champion and Eos have ceased operations. Frontier Airlines has filed for Chapter 11 but is continuing to fly. Faced with larger network carriers, some low cost carriers may well be driven out of the industry or into a merger with a network carrier.

As to small community service, Delta/Northwest states that it will serve more than 140 such communities in the United States. Recently, however, many carriers, including Delta and Northwest, have reduced capacity in an effort to save on fuel costs. Delta has announced that it plans to cut 10 percent of its capacity during 2008, while Northwest has stated that it will cut capacity by 5 percent. Some of the routes that have already been cut by these carriers served small communities. Given high fuel costs and a slowing economy, there is no guarantee that, whether this merger is approved or not, the combined carrier or individual carriers will continue to serve all 140 or so markets that they now serve. Those small communities that do lose service may find it difficult to attract successor carriers to the market. In addition, as capacity and competition is reduced, fares will invariably increase.

Concerns have also been expressed that if this merger goes forward, other major carriers may propose mergers of their own, and the airline industry would be reduced to three or four large network carriers. As noted above, United and US Airways are purportedly in merger discussions. With only a few remaining carriers, opponents of the merger are concerned that competition will be

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[3] *See* Government Accountability Office, *Airfares at Concentrated Airports* (GAO/RCED-93-171).

[4] Transportation Research Board, *Entry and Competition in the U.S. Airline Industry: Issue and Opportunities* (1999) at 96.

limited, and that each carrier will concentrate on areas where it is strong and not challenge others by increasing capacity or lowering fares. Fewer competitors could mean that it may be more likely that fare increases will stick.

Last, consolidation of U.S. carriers could also impact international markets. Delta/Northwest argue that a merger will allow them to compete on a more equal footing with other larger international carriers. Specifically, they believe that by combining the domestic and international routes of Delta and Northwest that they will have a network breadth that is as strong as that of other international carriers, such as Lufthansa and British Airways.

However, many U.S. carriers, including Delta and Northwest, already belong to international alliances with strong market presence in Europe. Currently, Delta and Northwest belong to the SkyTeam alliance, which also includes KLM, Air France, Czech Airlines and Alitalia. United and US Airways belong to the Star Alliance, along with Lufthansa, SAS, and bmi, among others, and American belongs to the oneworld alliance, which also includes British Airways. In addition, many of these alliance partners have antitrust immunity, which allows them to coordinate on prices, capacity and customer service issues. [5] In particular, concerns have been expressed that in the United States -- Continental Europe market, where immunized alliances (i.e., SkyTeam and Star) already control a significant share of the traffic, the consolidation of U.S. air carriers would further concentrate the market share within these alliances, thereby making it more difficult for new competitors to enter the market.

C. Employee Integration/Customer Service Issues

According to Delta/Northwest, frontline employees of both airlines will be provided seniority protection through a seniority integration process, if the airlines are combined. In addition, U.S.-based non-pilot employees of both companies will be provided a 4 percent equity stake in the new airline upon closing. The company also states that there will be no involuntary furloughs of "frontline" employees as a result of this transaction and the existing pension plans for both companies' employees will be protected. [6]

To date, the only employee group that has reached agreement with Delta and is supportive of the merger is its pilots union, represented by ALPA. The Northwest pilots, also represented by ALPA, are not included in this agreement. The Northwest pilots seek a joint pilot contract. Until such time as a joint contract is agreed to, Delta/Northwest will be able to integrate their route structures but limitations will remain in international markets currently served by Northwest.

Other employee groups that will be affected by this proposed merger include flight attendants and ramp, customer service, reservation agents, among others. In addition to the pilots, only the dispatcher workforce at Delta is unionized. This is not true for the Northwest workforce. The Northwest flight attendants are represented by the Association of Flight Attendants-CWA (AFA-CWA) and ramp service, store clerks, customer service agents, reservation agents, flight

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[5] Note that on April 9, 2008, the DOT tentatively approved an application by SkyTeam members for an immunized alliance in transatlantic markets.

[6] In March 2008, Delta announced a separation package, in the hopes that 2,000 employees will leave the company voluntarily. This is 4% of its workforce and is the largest mass reduction since 2005. They want to cut 1,300 "front line" jobs such as flight attendants and airport agents as well as 700 administrative staff.

simulator technicians and plant protection employees are represented by the International Association of Machinists and Aerospace Workers (IAM).[7] The AFA is currently seeking to organize Delta's approximately 13,500 flight attendants. The IAM states that it is currently assessing the interest of Delta's ramp service and customer service agents (approximately 14,000 employees) in unionizing.

On April 24, the National Mediation Board (NMB) mailed voting instructions to Delta flight attendants and the voting will end on May 28th. Should the Delta flight attendants choose to join the AFA-CWA, and the merger is implemented, then the flight attendants can move forward on integrating their two groups through the AFA-CWA's constitution and bylaws, and eventually negotiating a new contract with the merged carrier.

If the flight attendants choose not to join AFA-CWA at this point then, assuming a merger takes place, a union election would automatically be triggered if 35 percent of the combined workforce is represented by a union (in this case, AFA-CWA). The same would hold true for the rest of the workforce. However, if the 35 percent threshold is not met upon consummation of a merger, any union seeking to organize a newly-combined workforce would have to initiate a new organizing campaign.

Historically, integration of employee groups has presented serious hurdles to airline mergers. Consumer service generally suffers while management grapples with merging two cultures, and dealing with employee concern and morale issues over potential closing of facilities and the integration of seniority lists. For example, US Airways and America West merged in 2005. Three years later, there is still considerable employee unrest, especially with the pilots who have yet to agree on a final uncontested seniority list. In addition, there have been many press reports about the decline in customer service and infrastructure issues immediately following that merger.[8]

As the *Weekly Standard* recently opined:

> History is on the side of the pessimists. In the period immediately following every airline merger, chaos is the order of the day – or year. Pilots find that the control panels on the merged carriers differ; baggage losses mount, as they did when Northwest acquired Republic Airlines in 1986; the merging of reservation systems causes kiosks and websites to malfunction, as US Airways and America West discovered; strikes occur as disgruntled employees find the new pension package inferior to the old one. All of these are in the new Delta's future . . . .[9]

D. Other Integration Issues

In addition to integrating different employee cultures, Delta/Northwest would have to merge several fleet types. Every type of aircraft, even if it is made by the same manufacturer, has its own unique requirements in terms of operations, training, and maintenance. A highly diversified fleet mix can be a significant cost. Delta and Northwest have substantially different fleet mixes. In

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[7] Note that a small group of Northwest mechanics is represented by the Aircraft Mechanics Fraternal Association (AMFA).

[8] *See e.g.* Dan Reed, *US Airways highlights drawbacks of consolidation*, USA Today, March 5, 2008.

[9] Irwin M. Stelzer, *Come Fly With Us*, The Weekly Standard, April 28, 2008.

response to concerns about the expense of incorporating Northwest aircraft into the Delta fleet, Delta has maintained that the merging of the fleets does not present a problem. Rather, Delta has referred to it as an opportunity for "fleet maximization," which would allow the combined carrier to better match the right aircraft with demand on a certain route. A recent *Wall Street Journal* article noted that "although it's possible the new airline could tailor many of its routes in such a way, certain expenses wouldn't disappear. Not only would the airline have to keep separate maintenance programs for each of the plane models, managers would have to make sure all their bases had adequate equipment and crews on hand to handle the difference among jets."[10]

Interestingly, when Delta's former President and CEO, Gerald Grinstein testified before the Senate Commerce, Science and Transportation Committee in opposition to the proposed takeover of Delta by US Airways in 2007, he expressed his concerns about merging with an airline that had a different fleet mix. Noting that Delta is an all-Boeing fleet and US Airways fleet was 57 percent Airbus, Mr. Grinstein stated that "...you can screw up a lot of things in the airline industry, but you have to have fleet simplification. And by having a consistent manufacturer and supplier it gives you that opportunity." Currently, 72 percent of Northwest's fleet are aircraft other than Boeing; 42 percent are Airbus, representing the largest number of aircraft supplied to the airline by one manufacturer. On the other hand, 70 percent of Delta's fleet is Boeing. The only aircraft the two airlines have in common is the Boeing 757.

E. Financial Condition

Over the last five years, the U.S. airline industry has lost over $35 billion. These losses are the result of many different factors including the economic slowdown, a decline in business travel, the aftermath of the 9/11 terrorist attacks, the SARS epidemic, increased competition from low-cost carriers and, most recently, dramatically increased fuel prices. However, in 2006 and 2007, the airline industry turned a corner, including "the *first back to back net profit for the U.S. airlines since 1999-2000.*" [11] For 2008, however, it is widely expected that industry will suffer steep losses as a result of increased fuel prices. Many experts believe that the industry must cut capacity one way or another.

Fuel prices have hit unexpectedly high levels and this added expense has impacted the cost of airline operations. Many airlines, though not all, are reporting a loss in the first quarter of 2008.[12] Delta and Northwest reported losses of $274 and $191 million respectively.[13] As of May 9, 2008, the price per gallon for jet fuel was $3.57 per gallon. Last year at this time, the price was $ 2.08 per gallon. As a rule, the Air Transport Association estimates that each fifty cent increase in the price of jet fuel adds $10 billion to the airline industry's expenses. The industry has reacted to these changes by reducing capacity.[14]

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[10] J. Lynn Lunsford, *Fleet Could Be Just Plane Trouble*, Wall Street Journal, April 16, 2008, at B1.

[11] Air Transport Association, 2008 Outlook: "A Global Perspective,." (emphasis in original).

[12] Southwest Airlines reported a profit of $34 million.

[13] Both Delta and Northwest, unique amongst the airlines in their financial reporting, also show a goodwill write down in the market value of their companies, of $6.1 billion and $3.9 billion, respectively. However, this does not reflect their before tax operating profits or losses.

[14] Despite the increased fuel costs, passenger load factors are at an all time high. According to the BTS load factors have increased each year for the past five years and in 2007 reached an average of 79.1%, with load factors as high as 86 percent during June and July. BTS states that first quarter 2008 load factors, show a slight increase in domestic markets, but overall are considered steady.

Delta states that merging the two carriers will "create a financially stronger airline . . . that will help it weather the impact of fuel prices . . ."[15] However, it is not clear that the merger will help with fuel costs. The carriers acknowledge that they will not be able to purchase fuel more cheaply. Rather, any ability to weather fuel increases, according to the carriers, will come from integration savings, capturing high fare business traffic, and profits from international routes. Moreover, much of the increase in fuel costs will be passed on to consumers. Just last week, both Delta and Northwest levied a $20 per round trip fuel surcharge on passenger tickets.

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[15] The State of the Airline Industry and the Potential Impact of a Delta/Northwest Merger Before the S. Comm. on Commerce Science and Transportation, Subcomm. on Aviation Operations, Safety and Security, 110th Cong. 1 (May 7, 2008) (Statement of Richard Anderson CEO of Delta).

WITNESSES

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