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TESTIMONY OF DR. MARK COOPER,

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ON BEHALF OF

THE CONSUMER FEDERATION OF AMERICA AND CONSUMERS UNION

ON

THE STATE OF THE AIRLINE INDUSTRY: THE POTENTIAL IMPACT OF AIRLINE MERGERS AND INDUSTRY CONSOLIDATION

BEFORE THE UNITED STATES SENATE COMMITTEE ON COMMERCE, SCIENCE & TRANSPORTATION

January 24, 2007

Mr. Chairman and Members of the Committee,

My name is Dr. Mark N. Cooper. I am Director of Research of the Consumer Federation of America. I appreciate the opportunity to address the issue of mergers in the airline industry. I appear before you today on behalf of the Consumer Federation of America[1] and Consumers Union[2] to express our deep concern about the pending merger wave in the airline industry.

In June 2000 testimony on "The Proposed United Airlines-US Air Merger" before the Senate Antitrust Committee, I opened my testimony with the following observation

> There are some mergers to which policy makers and the Department of Justice should just say "no!" This is one of them. This merger would reduce competition in an industry that already suffers from a general lack of competition. It would trigger a round of mergers that would leave consumers with fewer and fewer choices across the nation. New airlines would find it harder and harder to enter these more concentrated, integrated markets that would result.
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> There was a time when airline problems were largely problems for business travelers, but that has changed. The rapid growth of personal income over the past decade has made air travel much more common among residential consumers, in spite of sharply rising ticket prices. As a result, consumer groups such as CFA have become more and more concerned about the failures of the airline market – poor service and the abuse of market power in a highly concentrated industry.[3]

In March of 2001, we were confronted with a merger wave; I expressed consumer concern about the emerging industry structure at a hearing in the House of Representatives as follows:

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[1] The Consumer Federation of America is the nation's largest consumer advocacy group, composed of over 280 state and local affiliates representing consumer, senior, citizen, low-income, labor, farm, public power and cooperative organizations, with more than 50 million individual members.

[2] Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the state of New York to provide consumers with information, education and counsel about good, services, health and personal finance, and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers. Consumers Union's income is solely derived from the sale of *Consumer Report*s, its other publications and from noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, *Consumer Reports* with more than 5 million paid circulation, regularly, carries articles on health, product safety, marketplace economics and legislative, judicial and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

[3] Testimony of Dr. Mark Cooper, Director of Research on "The Proposed United Airlines-US Airways Merger," *Antitrust Committee, United States Senate,* June 14, 2000, p. 1.

> With two mergers pending between major airlines and a third being widely talked about, there can be no more uncertainty about the structure of the industry. The airline industry is in the process of organizing itself into a private cartel. Two or three dominant firms will control the vast majority of traffic through monopoly airports in fortress regions embedded in national networks that rarely compete with one another.[4]

Exactly six months later, testifying a few days after the events of September 11, 2001, I again urged the Congress not to forget the consumer in writing public policy to deal with the airline industry.

> In addition to ensuring a more secure air travel network, it is absolutely appropriate for Congress to require fairer competition, better service and more effective consumer protection in exchange for assistance to commercial operators. The airline industry was falling seriously short in these crucial areas before the attack.[5]

The mergers that are on the table today, such as the Delta-USAIR merger or those that are being contemplated trigger all of our concerns, and are actually worse from the competition and consumer point of view than the United –US Air merger that we opposed in 2000.[6] I again urge the Congress to keep the consumer interest front and center when it examines these mergers.

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[4] Statement of Dr. Mark Cooper, Director of Research, Consumer Federation of America, "Mergers Between Major Airlines: the Anti-competitive and Anti-Consumer Effects of the Creation of a Private Cartel," *Subcommittee on Commerce, Trade and Consumer Protection, Committee on Energy and Commerce, United States House of Representatives,* March 21, 2001.

[5] Statement of Dr. Mark Cooper, Director of Research, Consumer Federation of America on "The Financial Status of the Airline Industry," *Committee on Commerce, Science and Transportation, United States Senate,* September 20, 2001, p. 2.

[6] Justin Bachman, "Airline Mergers: Ready for Takeoff?," *BusinessWeek.com,* December 22, 2006: Delta contends that such a behemoth would never pass regulatory muster and has assembled a detailed power point scenario of job cuts, reduced flights, hub domination, and higher fares that would make almost any consumer advocate cringe. Dave Carpenter, "Airline-Merger Talks: How Will Fliers Fare?" *Associated Press,* December 14, 2006: Despite numerous recent fare increases, however, ticket prices are still too low for airlines' liking as they scramble to boost profits in the face of soaring jet-fuel prices. The industry's solution? Reduce the number of available seats by gobbling each other up. A wave of U.S. airline mergers could mean higher prices for travelers as overlapping routes are eliminated, experts said Wednesday as discussions between United Airlines and Continental Airlines coincided with an announcement by AirTran of plans to buy Midwest. And just last month US Airways began a hostile bid for Delta Air Lines. W. Schoen, "Airline Mergers Won't Help Passengers: Travelers Face Packed Planes, Higher Fares as Industry Consolidates," *MSNBC,* December 14, 2006: Though it's far from certain that any of these deals will go through, such mergers would likely give the remaining carriers more clout in raising fares, according to Jerome Chandler, a contributing editor to Frequent Flyer magazine. "It's Economics 101," he said. "If you have fewer players in the industry, you are going to have higher fares. It's almost inevitable. Mergers are about what's good for the airlines – not necessarily what's good for consumers.

We have not opposed every airline merger that comes down the runway. The US Air-America West merger was generally a geographic extension merger with little overlap in route, which we did not oppose, although it has had some anti-competitive effects. However, we do oppose mergers that have significant anti-competitive effects and there can be little doubt that the mergers on the table will have severely anti-competitive[7] and anti-consumer[8] effects. The industry has repeatedly claimed that anticompetitive mergers are crucial to the viability of the industry, but that has not generally been the case. The effect over time is to leave the consumer with less competition and an industry that is no healthier.

We have had a hiatus in consolidation in the industry in the past half decade, as the industry restructured,[9] but that does not change the fundamental concerns about anti-consumer and anti-competitive effects of mergers in this industry. The elimination of competition and the reinforcement of dominant fortress hubs inevitably raise concerns about rising prices. Competitive entry in the industry, to the extent it can discipline the abuse of market power, is highly restricted, limited to selective, high volume routes and markets. The so-called low cost airlines would leave more than half the country unserved.

As travelers fall under the control of one airline, the ability of new entrants to crack markets is reduced. It becomes harder and harder to attract passengers to flight segments and the necessary scale of entry gets larger and larger. The inconvenience, and in many cases, the impossibility of inter-airline travel, give the airline enhanced market power over the traveler. Travelers thus suffer the typical effects of the abuse of market power – fewer choices, higher prices and lower quality. Low cost airlines selectively enter the high volume routes, leaving much of the country with little competition. The past history of mergers suggests that consumers will end up with higher prices, less service and the industry will remain in turmoil.

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[7] Jeff Bailey, "Big Consolidated Airline Inc.: A Wave of Merger Deals May Increase Profits, Fares and the Crowding of Flights," The *New York Times*, December 14, 2006, C-1: Mr. Leonard (Chief Executive of AirTran) may relish his role as underdog but that is not why he hopes the carriers (Delta and US Airways) merge – he just wants to see fewer jets in the sky. After all, US Airways' proposed takeover would reduce the two airlines combined jet fleet about 10 percent. That, in turn, would allow the merged Delta — and AirTran – to raise fares on many routes, significantly increasing profits.

[8] Brad Foss, "Airline Mergers Could Raise Fares in '07," *KiplingerForecasts.com:* Kevin Mitchell, however, said ticket prices would rise significantly and the public can expect service disruptions, repercussions from labor strife and more job insecurity in the airline industry if the carriers merge. He said that if all the deals in discussion come about, there will effectively be three fewer U.S. network airlines in operations…. "I would view it, if I'm a business traveler, on the customer service side as many years of unimaginable pain."

[9] W. Schoen, "Airline Mergers Won't Help Passengers: Travelers Face Packed Planes, Higher Fares as Industry Consolidates," *MSNBC,* December 14, 2006: "We've had about 15 percent of the industry's capacity come out of the market," from the peak of 2001 to the trough this year, said airline analyst Helane Becker. "And there's still another 5 or 6 percent that could come out." Justin Bachman, "Airline Mergers: Ready for Takeoff?," *BusinessWeek.com,* December 22, 2006: After a four year struggle to survive billions in losses, the industry has finally gained a little breathing room, thanks to fundamental restructurings and somewhat higher fares. That, in turn, has more than one airline executive mulling long-term structural fixes – and less competition via consolidation might just fit the bill.

The fact that the industry goes through wild boom and bust cycles is not a justification for letting down our guard against the abuse of market power. At a minimum, the boom and bust cycles create cycles of uneven service; at a maximum, it strands consumers. Having gone through a series of bankruptcies and a large loan guarantee program to bail the industry out, we are faced with a massive consolidation and Congress must ask where is the public interest in all this? How will the consumer be served?

Backward looking analyses based on pre-2000 industry behavior that claim the so-called low cost airlines will discipline price increases are misguided. Looking in the rear view mirror, such analyses ignore the fundamental shifts in the industry that suggest low cost entrants simply will not restrain price increases on the many routes that lack sufficient competition today and would have competition further reduced by these mergers.

- Low cost carriers have not entered these lower volume routes. They are highly selective in the routes they enter. The characteristics of those routes that have led them to stay away are not likely to change sufficiently to induce entry.[10]
- Notwithstanding the expansion of low cost carriers, total capacity in the industry is down by about 15 percent.[11]
- There has been a long series of price increases over the past two years that the low cost airlines have failed to discipline.[12]
- Industry-wide prices have flattened or been rising, so the industry-wide price disciplining power of the low cost carriers is doubtful.[13]
- The so-called legacy carriers have substantially modified their cost structures, so the claim of bloat has lost its credibility. [14]

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[10] Jason Paur, "Small Airlines Fly Under The Merger Radar," *Marketplace,* December 19, 2006. Big carriers operate on the hub-and-spoke model and are looking to merge with a similar operation to complement their existing routes. Smaller carriers aren't appealing because the just don't fly to enough places.

[11] W. Schoen, "Airline Mergers Won't Help Passengers: Travelers Face Packed Planes, Higher Fares as Industry Consolidates," *MSNBC,* December 14, 2006. "We've had about 15 percent of the industry's capacity come out of the market," from the peak of 2001 to the trough this year, said airline analyst Helane Becker. "And there's still another 5 or 6 percent that could come out."

[12] Dan Schlossberg, "Airline Merger Mania, Bad News for Consumers," *Consumeraffairs.com,* December 29, 2006. The impact on consumers – already reeling from 23 hikes in airline ticket prices over the last two years – could be devastating. After all, less competition means fewer choices for budget conscious flyers.

[13] Jeff Bailey, "Big Consolidated Airline Inc.: A Wave of Merger Deals May Increase Profits, Fares and the Crowding of Flights," The *New York Times*, December 14, 2006, C-4, graph.

[14] Justin Bachman, "Airline Mergers: Ready for Takeoff?," *BusinessWeek.com,* December 22, 2006. After a four year struggle to survive billions in losses, the industry has finally gained a little breathing room, thanks to fundamental restructurings and somewhat higher fares. That, in turn, has more than one airline executive mulling long-term structural fixes – and less competition via consolidation might just fit the bill. Brad Foss, "Airline Mergers Could Raise Fares in '07," *KiplingerForecasts.com,* After several

Backward looking analyses of previous mergers do not lay our concerns to rest either, for two reasons:

- First, the underlying motivations for past mergers differs from those being contemplated today. The economic rationales offered had a more plausible basis to claim they would be consumer friendly, even though they have not work out that way.[15]
- Second, even with these more benign justifications, the history of past mergers is far from encouraging.[16]

Anti-trust analysis recognizes that the failing firm defense will allow apparently anti-competitive mergers to go forward when they would not usually pass muster. However, this defense is valid only in the context of an industry that is otherwise competitive and exhibits a healthy competitive structure. That is not the case within the airline industry.

This is an infrastructure industry of vital importance to the nation and there is serious doubt that the current approach to industrial organization can provide the full, nation-wide service that a continental, world class economy needs. Policy makers face a fundamental challenge. If these mergers go forward under the claim that they are necessary to save the industry, then the basic premises of the approach to public policy must be questioned because the fiction of competition can no longer be maintained for a large part of the nation.

This Committee does not review mergers, but it has the ultimate responsibility for the public policy that deeply affects the industrial organization of the industry. I urge you to send a strong signal that if the industry tries to go down the path of massive consolidation it will

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years of financial darkness, U.S. airlines are seeing rays of hope. Passenger demand is stronger and costs are under control.

[15] Ed Perkins, "Are Airline Mergers Good of Bad for Consumers?," *Smarter Travel,* November 30, 2006: One overriding fact governs the outcome: The Incentive for the merger is almost solely to reduce competition. In the past, airlines have merged for three basic reasons:
The earliest focused mainly on extended geographic scope, such as Delta with Western, US Airways with PSA, American with Reno, and even the recent America West with US Airways.
A few prior mergers were designed to rescue a failing line, such as American with TWA.
And some of the earlier mergers were designed to take advantage of the economics so scale, such as the consolidation of several smaller lines into Hughes Airwest.
But even the industry now admits that future mergers among mega-carriers will be aimed almost solely at reducing competition. They're already so big that extra size doesn't help lower costs, and they already cover most of the nation. But reduced competition would likely produce many rewards, allowing the remaining airlines to hike rate – and probably reduce service levels – even further. Also, mergers would probably involve the shutting down of several adjacent "hubs," where local travelers would see substantial reductions in service.

[16] Jerry Chandler, "Airline Mergers? Not So Fast," *Cheap Flights Limited,* December 15, 2006: Of the six major mergers I just touched on, four essentially failed to live up to their purported promise – US Air/Piedmont, US Air/PSA, Northwest/Republic, and Pan Am/National. A fifth, American/TWA, resulted in the downsizing of St. Louis. Only Delta/Western really worked for airlines and airline passengers alike.
No, past history doesn't dictate present success.

find a Congress ready, willing, and able to prevent the abuse of consumers that inevitably follows from such a concentrated market.

The assumption that markets are the best way to organize an industry is just that, an assumption. The assumption must be rebuttable, if economics is to be an empirical science. Policy makers must accept that sometimes there are market failures and take the appropriate actions to ameliorate the problem.[17] In the airline industry, with its boom and bust cycles, its fits and starts of competition, and fortress hubs, where half the markets are competitive and half are captive monopolies a potential merger wave demands close scrutiny.

There are a range of policies that could be pursued.

First, if the Congress wants to stick to the market model, it must urge regulatory authorities to just say no to those mergers that are anticompetitive. Certainly, the US Air-Delta and United-Continental mergers fit the bill. Close analysis of route overlap and hub proximity suggests that these mergers will have substantial anti-competitive effects that will be impossible to ameliorate with traditional antitrust remedies.[18]

Traditional antitrust remedies for the anticompetitive effects of mergers are not likely to be effective in these cases. The spin-off of some assets to repair the competitive harms in the markets would occur in city-pairs that are already insufficiently competitive. They have not experienced competitive entry and it is difficult to see how the spin off will result in sustained competition if these mergers are approved. Consumers would suffer severe price increases before entry might occur.[19]

The antitrust authorities will also have to micro-manage the gates and slots at regional hubs where the merger eliminates competition to ensure that they result in sustained competition on a large number of routes. If not, consumers would be left

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[17] Marilyn Geewax, "Key Legislator Says Airline Mergers Threaten Competition," *Cox News Service,* December 15, 2006, p. 1: With six U.S. airlines now involved in merger discussions, the trend "runs afoul of the very purpose of deregulation," incoming House Transportation Committee Chairmen James Oberstar, D-Minn., told reporters

[18] Brad Foss, "Airline Mergers Could Raise Fares in '07," *KiplingerForecasts.com:* Regulators could look at the combined airlines added strength in the Northeast as detrimental to competition, with continental's Newark hub and United's at Washington-Dulles. Marilyn Geewax, "Key Legislator Says Airline Mergers Threaten Competition," *Cox News Service,* December 15, 2006, p. 2: For example, Delta and US Airways have many overlapping routes along the East Coast, with Hubs in Atlanta and Charlotte, N.C. Justin Bachman, "Airline Mergers: Ready for Takeoff?," *BusinessWeek.com,* December 22, 2006: Delta contends that such a behemoth would never pass regulatory muster and has assembled a detailed power point scenario of job cuts, reduced flights, hub domination, and higher fares that would make almost any consumer advocate cringe.

[19] Ed Perkins, "Are Airline Mergers Good or Bad for Consumers?," *Smarter Travel,* November 30, 2006: Not all air travelers, however, will feel the pinch equally. On many of the nation's busiest routes, low-fare lines such as AirTran, JetBlue, and Southwest will continue to set the ceiling on fares, en even the largest old-time airline can't raise fares much. Travelers on those routes will probably see little effect. But travelers to or from smaller cities, where no low-fare line flies, are likely to get stung, big time. If US Airways acquires Delta, travelers in the Southeast are particularly likely to be gouged.

with reduced competition and declining service, but this is an approach the antitrust authorities hesitate to take and generally refuse to engage in for the long term.

Broader policies to protect consumers in an industry were competition is weakened generally fall outside of the purview of the anti-trust authorities.[20] Occasionally, an antitrust consent decree will set prices for a short period of time, although that is frequently for inputs in a vertically integrated production chain, not retail prices to the public.

Merger waves start with one deal and the antitrust authorities tend not to take a broad view of the wave.[21] They simply cannot see the forest for the trees. It is the Congress that must take the broad view and recognize that when it comes to competition, a forest with too few trees is very bad for consumers. The best way to stop the wave is to stop the first merger, which would be Delta-US Air in this case, particularly when it has such pervasive anticompetitive effects.

In sum, the antitrust authorities cannot approve mergers, like Delta-USAir or similar mergers and pretend that competition will protect consumers in the large number of markets that are presently inadequately competitive and in which competition will be further reduced. If antitrust authorities conclude that consolidation is necessary to restore the financial health of the industry, then they, along with the Congress, must give up the fiction of market competition as the primary approach to industrial organization for the airline industry. They must provide consumers with much greater non-market protections against the abuse of the market power that will inevitably result from a merger wave in this industry.

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[20] Ed Perkins, "Are Airline Mergers Good of Bad for Consumers?," *Smarter Travel,* November 30, 2006: When it approves big airline mergers, the government often imposes conditions to protect at least some level of competition…In my view, however, it is time for a different government focus. Route adjustments are no longer as important as the once were. Instead, I'd like to see regulators accept the inevitability of reduced competition and require merged line to provide other offsetting benefits. Among the possibilities:
Increased compensation for involuntary bumping.
Expanded definition of bumping to include factors other than overbooking.
Compensation for delayed baggage delivery.
Guaranteed levels of seats for frequent flyers.

[21] Jeff Bailey, "Big Consolidated Airline Inc.: A Wave of Merger Deals May Increase Profits, Fares and the Crowding of Flights," The *New York Times*, December 14, 2006, C-1: Discussions about a possible deal between United Airlines and Continental Airlines came to light this week. And if one big merger goes through, other airlines will probably feel compelled to pair off as well or wind up at a competitive disadvantage because the have higher costs or smaller route networks. Marilyn Geewax, "Key Legislator Says Airline Mergers Threaten Competition," *Cox News Service,* December 15, 2006, p. 1: The merger wave was launched last month when US Airways Group Inc. made an unsolicited bid, now worth $8. billion, for Delta Air Lines Inc. This week, UAL Corp., parent of United Airlines, and Continental Airlines Inc., announced they are holding talks on a possible merger. In addition, AirTran Holdings Inc, has offered to buy Midwest Air Groups Inc. for about $290. Brad Foss, "Airline Mergers Could Raise Fares in '07," *KiplingerForecasts.com:* Analysts say other potential deal permutations that my be explores – if they haven't already – include AMR Corps's American Airlines linking up with Northwest Airlines Corp.