COMPETITION IN THE U.S. DOMESTIC AIRLINE INDUSTRY:

THE NEED FOR A POLICY TO PREVENT UNFAIR PRACTICES

REVISED

In August 1998, the Department of Transportation released a white paper titled "Competition in the US Domestic Airline Industry: The Need for a Policy to Prevent Unfair Practices." The findings in that paper were based on online market data from the Origin & Destination Survey, as were various other competition studies conducted by the Department in the past. The Air Transport Association suggested that due to the increase in interlining (both pure interlining and commuter affiliate interlining) over the past decade, that our findings would more accurately reflect the state of the industry today if we were to use true Origin & Destination data, rather than exclude interline traffic. We agreed with their assessment, and as a result, are releasing this revised version of the original white paper. In order to correct shortcomings in our original data we made two changes: 1) passengers that split their journey between a major airline and its commuter affiliate are now included as online passengers of the major airline even if reported as interline; and 2) passenger counts now reflect all true Origin & Destination traffic, including pure interline passengers.

While there are some noticeable changes in the magnitude of certain conclusions drawn between the two data sets, in all but one instance the trends reflected by the two data sets remain consistent. The one divergence in data trends can be found in the second chart (U.S. Domestic Airline Industry, Number of Markets with Two or More Competitors). The original data showed the number of competitive markets in the United States declining from 1992 to 1997. Once corrected for commuter affiliates and expanded to include interline traffic, the data show that the number of competitive markets declined between 1992 and 1996, but rebounded in 1997. We felt that this change was contradictory enough to require further investigation. For this reason, we have included two additional charts immediately following the original second chart. The additional charts show that it is the type of competitor entering new markets, rather than the number, which leads to competitive pricing. These findings are further supported throughout the revised white paper.

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"Although the airline industry has been deregulated, this does not mean that there are no limits to competitive practices. As in the case with all industry, carriers must not engage in practices which would destroy the framework under which fair competition operates."

House Report 98-793 reporting out the CAB Sunset Act of 1984

"The entry of these new low-fare carriers keeps the industry honest…I'm a strong advocate of competition and I don't want to go back to regulation. But you've got to distinguish legitimate competition from what is intended to drive competitors out and exploit consumers."

Alfred Kahn, USA Today April 6, 1998

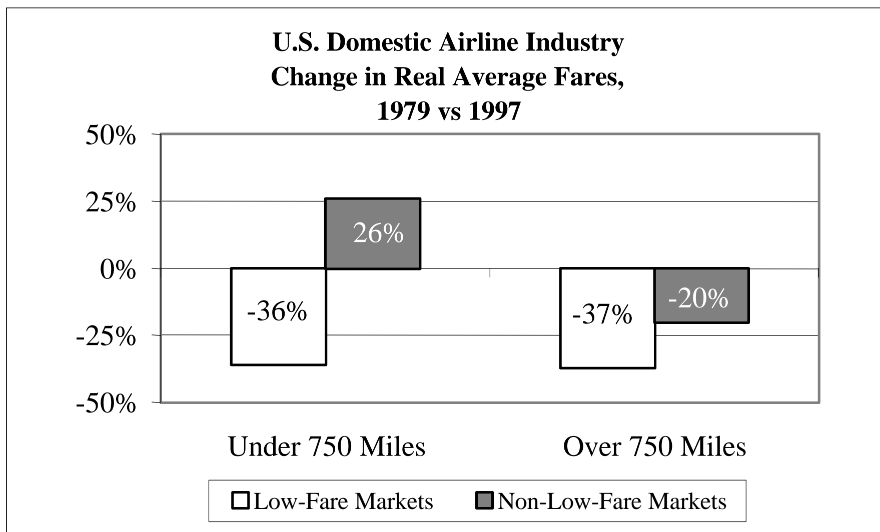
On April 6, 1998, Transportation Secretary Rodney E. Slater announced a proposed policy designed to address unfair competitive practices against new airlines. Under the proposed policy, the Department would begin an investigation if there exists evidence that a major airline has taken extreme measures to eliminate low-fare competition at its hub. If the major airline adds seat capacity on a route and floods the market with low fares to such an extent that its own revenues actually decline -- a business strategy that makes sense only if it results in the elimination of the new competitor so that fares at or above pre-competition levels can be reinstated-- DOT will act.

The Overall Impact of Airline Deregulation Has Been Positive.

Airline deregulation, now twenty years old, has been a success. Average airfares, adjusted for inflation, have declined since 1978. Passenger traffic has more than doubled and competition has led to the innovation and efficiency that caused the continued decline in average real fares. In longer distance markets, competition between hub-and-spoke networks enables consumers to have multiple airline choices over different networks. In many shorter distance markets, the spread of competition from low-cost point-to-point airlines like Southwest has produced these positive results.

In short distance markets without low-fare competition, inflation adjusted fares are substantially higher, not lower, than pre-deregulation fares.

Overall, inflation adjusted fares have declined substantially since deregulation. This generalization holds true in long-haul markets that receive competition over multiple hub-and-spoke network systems. The opposite has occurred in short-distance markets (under 750 miles) where low-fare competition is not present. In 1979, the nominal average fares in both low-fare (by 1997 measures) and other short-haul markets were approximately $60. In 1997, short-haul markets with low-fare competition had an average fare of only $84—a 36 percent decrease in fares when adjusted for inflation. Average fares in short-haul markets without low-fare competition had risen to $175—a 26 percent increase in fares when adjusted for inflation.



Since deregulation, inflation adjusted average fares are up 26% in short-distance markets without low-fare competition. These markets account for almost one-fourth of total domestic passengers.

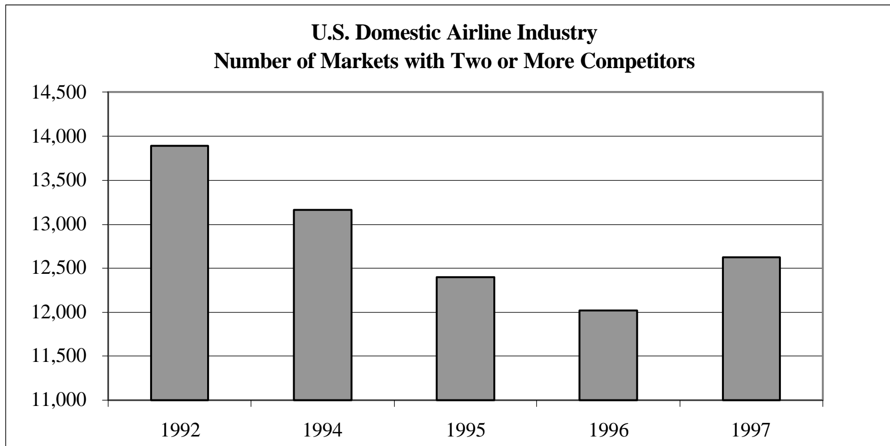
In short-haul markets with low-fare competition, passenger traffic has nearly quadrupled since 1979, a 60 million passenger increase. Traffic in other short-haul markets only grew by 48 percent, or 26 million passengers, over the same period.

Effective competition has not been universal for all cities and regions of the country and by some measures competition is on the decline.

Since at least 1990 the Department of Transportation, the General Accounting Office and other organizations have recognized that the benefits of deregulation have been unevenly distributed. In 1990 the Secretary of Transportation referred to this as "Pockets of Problems." Certain cities and regions were not receiving the benefits of lower fares and traffic was declining. The solution appeared to be the spread of more competition. The National Commission to Ensure a Strong Competitive Industry, created in 1993 by President Bill Clinton, also saw the need to maintain healthy competition in the domestic aviation industry. In its report, the commission stated, “It is apparent that the entry of new carriers and new competitors creates downward pressure on ticket prices, reduces expenses for business and individual travelers, and stimulates total traffic”. The

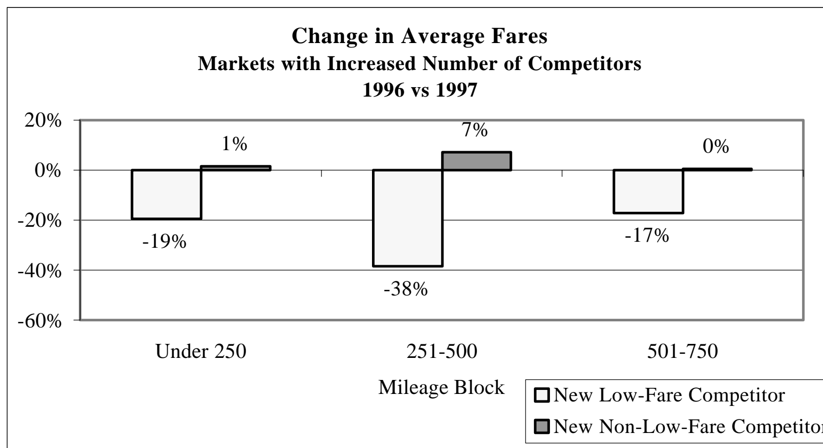
commission urged that DOT continue to be receptive to certificating new applicants that can meet the Department's fitness standards.

The number of city-pair markets in the 48 states where at least two airlines compete for traffic steadily declined from 1992 to 1996.[1] Among city-pairs with daily traffic, 13,890 had competitive service in 1992 and only 12,020 had competitive service in 1996, a decrease of 16 percent over four years. In 1997, however the number of markets with competitive service had rebounded to 12,619…just over 1995 levels.



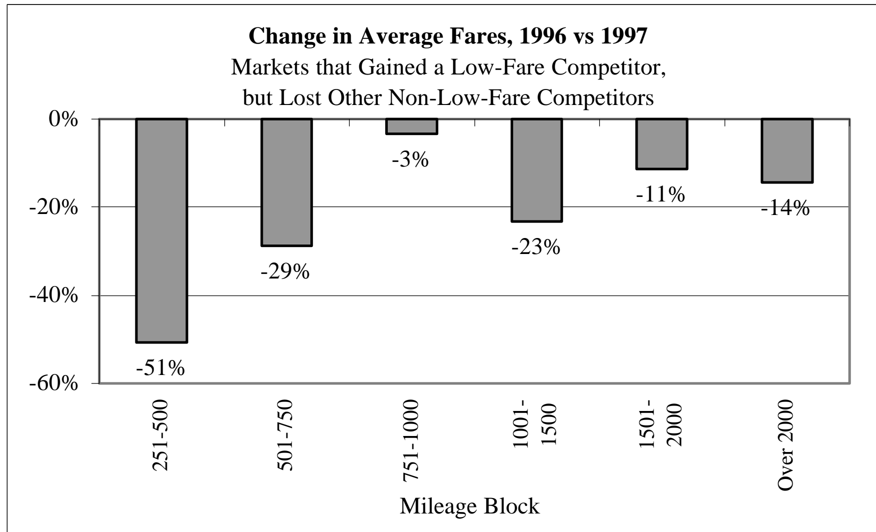
The number of competitive airline markets in the U.S. was on the decline between 1992 and 1996. The number rebounded to just over 1995 levels in 1997.

It has become increasingly evident since the Commission released its findings that the number of competitors in a market is far less important than the type of competitors in a market. As the Commission observed, one would expect an increase in the number of competitors to have downward pressure on fares. In short-haul markets, however, this is only the case if the new competitor is a low-fare carrier. The chart below shows the change in average fares between 1996 and 1997, in 1996 non-low-fare markets that received service from an additional competitor during that time frame. In the 69 markets in which the new competitor was a low-fare carrier, average fares fell between 19% and 38%. Conversely, when the new competitor was *not* a low-fare carrier, average fares actually increased slightly or stayed constant.



A greater number of competitors does not automatically result in lower fares. Average fares increased slightly in markets that experienced new entry from a non-low-fare carrier.

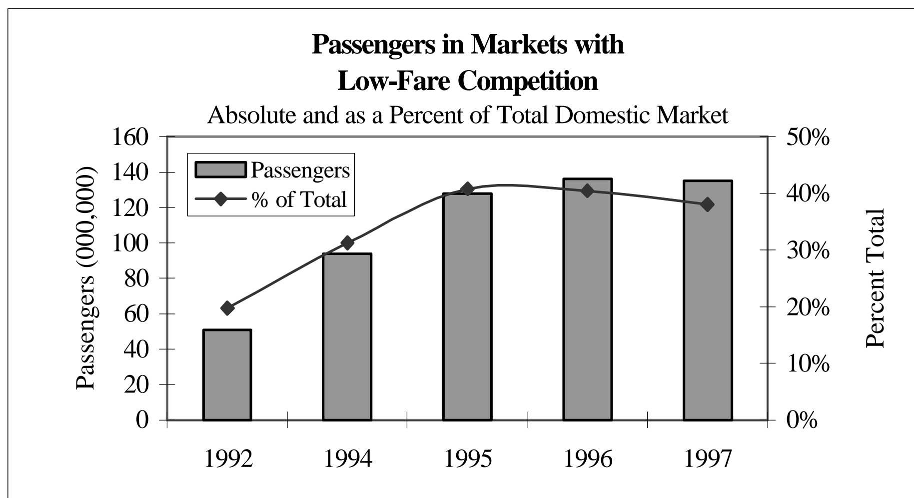
The presence of a low-fare competitor is so influential that even in cases where the entry of a low-fare competitor is accompanied by the exit of other competitors, average fares decrease. In the set of markets above, at least one other competitor dropped from the market when the low-fare carrier entered, yet average fares declined. This finding reinforces the conclusion that it is the type of competitor in a market, rather than the number, that strengthens competition.



The entry of a low-fare competitor causes average fares to drop -- even if there are fewer carriers competing.

There is a reversal of growth in low-fare competition in the past two years.

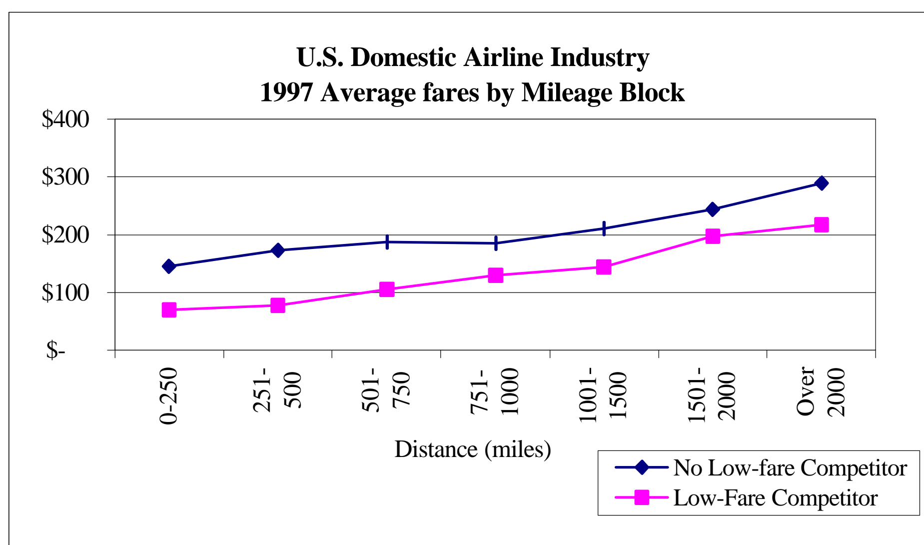
While the number of passengers benefiting from low-fare competition has grown steadily for years, this trend was reversed in 1997. In 1997 both the absolute and relative number of passengers in markets with low-fare competition declined.



136.5 million passengers benefited from low-fare competition in 1996, up from just 50 million four years earlier. But the passengers benefiting in 1997 dropped to 134.5 million.

Growth in low-fare competition is of great importance because fares are significantly lower in city-pair markets with such competition, particularly in markets below 750 miles.

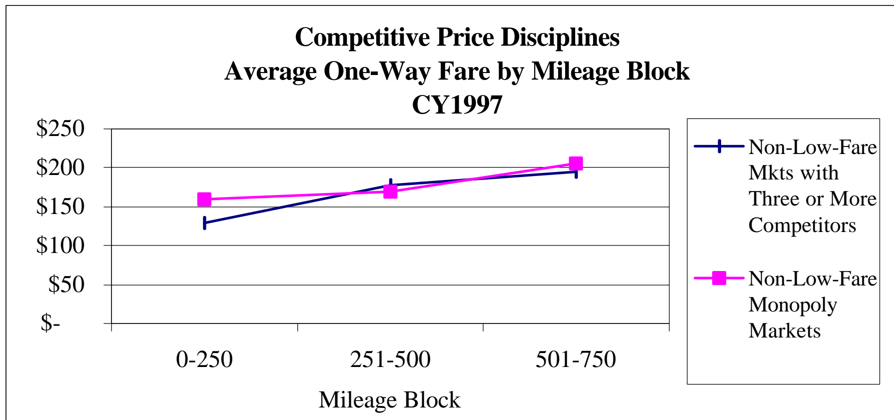
In 1997 the average air traveler in the U.S. saved from $75 to $95 per one way trip when he or she traveled in markets below 750 miles, if that airline trip was between cities with competing service from a low-fare airline. The savings were much larger in markets that involved network hub cities. Business travelers have been forced in recent years to bear the brunt of higher fares in markets where network carriers are not exposed to low-fare competition, and business fares continue to rise. According to the American Express Business Airfare Index the average price paid by American Express business travelers in a variety of fare categories in 1997 was nine percent higher than 1996 levels.[2]



Markets with low-fare competition have dramatically lower fares on average--often less than one-half –than similar markets without such competition.

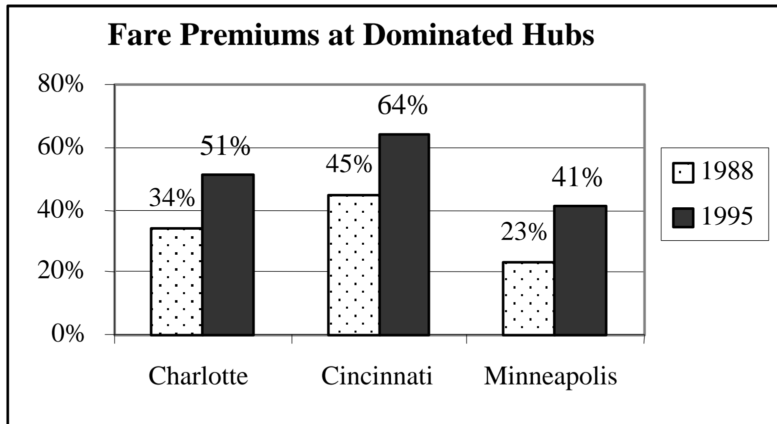
In short distance markets, low-fare competition provides the only significant price discipline.

As shown below for all markets under 750 miles distance that do not have low-fare competition, fares in markets even with three or more non-low-fare competitors are very similar to fares in monopoly markets. If limited to network hub markets served only by the major network airlines, prices for monopoly service and "competitive" service are virtually the same, showing that the large network airlines often do not price compete with each other at their hub cities as do major network carriers with low-fare competitors.



In the absence of low-fare service, very little price competition takes place among large network carriers in markets under 750 miles.

High fares in shorter distance markets come about at hub airports where one major network airline has a dominant market share. Average fares at some of these airports can be 50 to 60 percent higher when compared to more competitive markets. Hub premiums were high ten years ago, and continue to get worse.



A 1996 DOT study used three dominated connecting hubs as an example of hub premiums.[3] A number of other airports experience this same effect.

The impact of low-fare competition at dominated hubs is also pronounced when viewed at the individual market level.

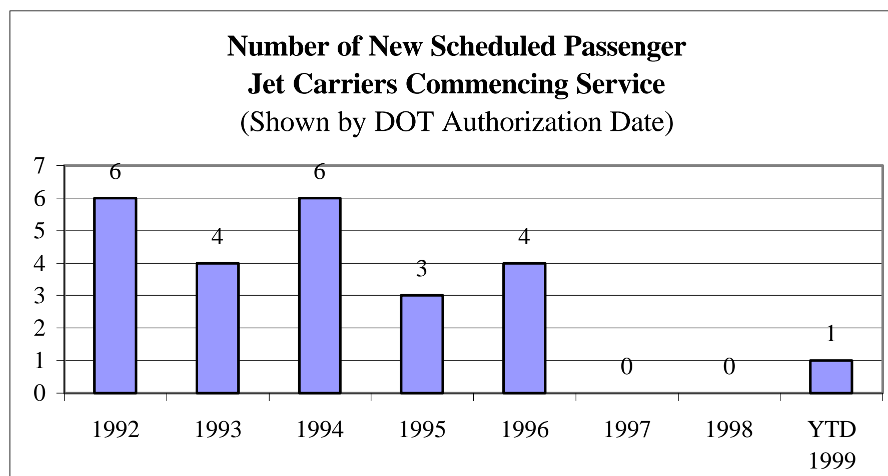
DOT regularly publishes fare data for the top 1,000 domestic city-pair markets.[4] In city-pair markets of comparable distance it is common to see fares associated with a dominant large carrier at its hub airport that are up to five times higher than fares involving low-fare carriers. Even at hub cities where low-fare service is available in some markets, fares remain very high in other markets where low-fare service is not available. The following markets, selected from the fourth quarter 1997 report, show that low-fare competition at hubs goes a long way to lowering fares.

Examples of Low-Fare Carrier Price Discipline, Fourth Quarter 1997

City-Pair	Nonstop Distance	Daily Passengers	Average One-Way Fare	Participants with Greater than Five Percent Market Share
Atlanta - Greensboro	306	325	$224	Delta 91%
Atlanta - Mobile	302	290	$110	Delta 81%, Airtran 18%
Chicago - Cincinnati	264	618	$259	American 5%, Delta 59%, United 34%
Chicago - Louisville	271	904	$72	Air Wisconsin 12%, Southwest 70%, United 12%
Denver – Des Moines	590	106	$255	United 92%
Denver – Kansas City	532	979	$104	United 60%, Vanguard 29%
Detroit - Philadelphia	453	705	$226	Northwest 58%, US Airways 38%
Detroit – St. Louis	440	982	$81	Northwest 41%, Southwest 33%, TWA 24%
Houston - Memphis	485	173	$206	Northwest 43%, Continental Express 38%
Houston - Lubbock	472	400	$86	Continental 33%, Southwest 62%

Since May 1996, when the tragic Valujet crash occurred, new entry has virtually stopped.

Following the Valujet crash, a number of small new entrants complained to the DOT about unfair competitive practices on the part of large network carriers. The alleged increase in anti-competitive behavior appears to have had a chilling effect on new entry. Only one new scheduled passenger jet operator has applied to DOT for a certificate and started scheduled passenger jet service since the Valujet crash.[5]



Only one new entrant has applied to DOT for a certificate and started scheduled passenger jet service since 1996.

The difficulty of new entry and the downturn in low-fare competition is due to a number of factors, which are generally characterized as barriers to entry.

In addition to the higher frequency service made possible by hub-and spoke systems, other competitive advantages and barriers to entry make it difficult for new airlines to enter a hub market. These include: computer reservation system advantages in the hub cities, frequent flyer programs, travel agent commission bonuses (overrides), and lack of gates, ticket counters or takeoff and landing slots for new competitors at certain airports.[6] (Of course some new entrants fail due to their own shortcomings such as poor management or inadequate business planning.) After careful study, DOT has also concluded that unfair exclusionary practices have been a key reason that competition from new low-fare carriers has not been able to penetrate concentrated hubs and has proposed guidelines as to what constitutes such unlawful behavior.

"Unfair exclusionary conduct" refers to specific airline behavior that goes well beyond normal vigorous competitive responses.

DOT's proposed policy was developed over an extended period based on a detailed review of carrier records and industry-wide data and with the help of the Antitrust Division at the Department of Justice and the staff of the Federal Trade Commission. The policy defined conduct that would violate section 41712 of DOT's governing statute, which authorizes the Secretary of Transportation to prohibit unfair methods of competition after notice and hearing. Essentially, if a major airline responds to new entry at its hub by a low-fare airline with a strategy of flooding the market with low-fare seats to the extent that its local revenues actually decline—a business strategy that only makes sense if it eliminates competition so fares can be raised to or above pre-competition levels—DOT will initiate an investigation. The proposal gives three examples of observable extreme behavior likely to trigger an investigation. Only after an investigation and hearing (or a negotiated settlement) can DOT issue a cease and desist order and only after such an order is violated can fines be assessed.

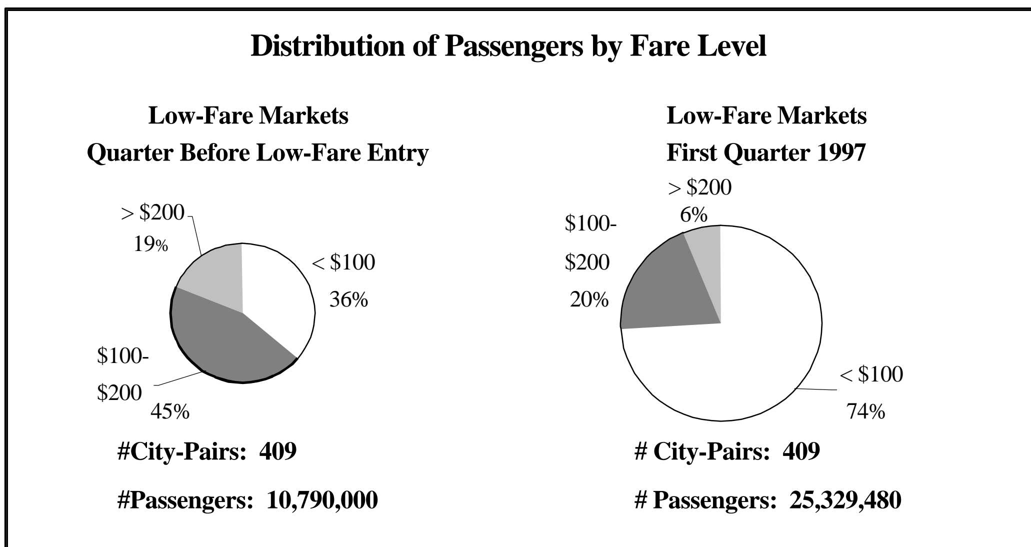
DOT has investigated complaints of unfair competitive conduct and observed behavior that would appear to violate our proposed guidelines in routinely reported data. There are a number of examples of such extreme behavior over the past few years.

Attached are just four examples of competitive behavior on the part of incumbent airlines that would trigger a DOT investigation into unfair exclusionary behavior. In each instance, the incumbent carrier increases traffic carried at low fares to the point that local revenues fall dramatically despite a substantial rise in passenger levels. The loss in revenue and profits far exceeds what would have resulted from various alternative responses available to the incumbent airlines. This loss in operating revenue, accompanied by an increase in traffic, is justified from a business standpoint only if the incumbent airline intends to recoup lost income through higher fares after the elimination of competition.

The examples chosen involve several low-fare competitors and several different major network carriers.

The potential public benefits of this policy are tremendous, particularly to passengers traveling to and from dominated hub markets.

The high fares charged by network carriers in dominated hub markets prevent large numbers of passengers from flying each year. The high level of untapped demand that exists in these markets is evident when current low-fare markets are examined. In 409 markets out of the top 1,000 identified as having low-fare competition in the first quarter of 1997, traffic has increased over 140% since the introduction of low-fare service. This represents an increase of about 15 million passengers per quarter, or approximately 60 million new passengers flying every year as a result of the introduction of low-fare service. The percent of passengers in those markets paying under $100 air fare each way increased from 36 percent before low-fare entry to 74 percent in the first quarter of 1997, resulting in enormous savings to the traveling public.



An estimated 60 million new passengers fly every year as a result of low-fare service.

Almost five hundred city-pairs in the first quarter 1997 top 1,000 markets were served by network airlines only. The lack of price competition in these markets has left a large portion of consumer demand untapped. If these markets were also exposed to low-fare service, the ensuing consumer benefits would be similar to those illustrated above. Given the opportunity, new entry is likely to be introduced in these markets at a slow but steady pace, giving the network carriers adequate time to adjust to the new competition.

The aviation competition policy, when made final, will provide guidance for the Department, as well as the aviation industry and the general public as to the types of practices that are unfair and exclusionary and will be subject to enforcement action. DOT will work closely with the Department of Justice in evaluating these allegations and will apply the enforcement policy only to future cases.

[1] The primary strength of network systems is the ability to efficiently connect many thinly traveled markets over a hub. Therefore a market has been defined as any city-pair in which at least an average of one passenger travels each day (rounded up from 0.5). A competitor is defined as any airline that carries ten percent or more of the Origin & Destination passengers in a city-pair market.
[2] "Business Airfares in January Were 9% Higher Than January 1997, New American Express Data Reveals." American Express Press Release, March 20, 1998. This article may be found on the Internet at http://www.americanexpress.com/corporateservices/news/press/.
[3] Concentrated hub market fare premiums are calculated by comparing concentrated hub data against industry wide data (excluding concentrated hubs). Thus, average prices in concentrated hub markets are compared to average prices in non-hub markets, adjusted in terms of distance and density. *The Low Cost Airline Service Revolution* (USDOT, April 1996) can be accessed on the Internet at http://dms.dot.gov/ost/aviation/. Telephone inquiries should be made to (202) 366-1032.
[4] Current and past issues of the *Domestic Airline Fares Consumer Report* can be accessed on the Internet at http://ostpxweb.dot.gov/aviation. Telephone inquiries should be made to (202) 366-1032.
[5] Since the original publication of this paper, Access Air has begun operating on the west coast. Service began in 1999.
[6] For more information on barriers to entry and their effects on competition see Barriers to Entry Continue to Limit Competition in Several Key Domestic Markets (GAO/RCED-97-4, October 18, 1996).