

responsibility of preventing unfair competitive practices in the airline industry. While the Justice Department has the primary responsibility for enforcing the antitrust laws, Congress supplemented the antitrust laws by authorizing the Department to prohibit unfair methods of competition in the airline industry, which enables the Department to prohibit unfair competitive practices even if they do not violate the antitrust laws. The Department accordingly can block unfair competitive practices that could not be stopped through the enforcement of the antitrust laws. The implementation of the Department's authority in addition to the Justice Department's antitrust law enforcement efforts will more effectively protect competition in the airline industry.

Preventing unfair competitive practices will give more consumers the benefits of competition. Competition gives travellers lower fares and better service, and the lower fares enable many people to fly who otherwise would not have traveled at all. While deregulation has given travellers in the great majority of markets lower fares and better service, some markets have not benefited as much from deregulation since they lack competitive service. Those markets will have little hope of obtaining competitive service in the future if the incumbent airline can use unfair competitive practices in response to entry that will either deter entry or compel an entrant to exit the market.

The complaints we received about apparent unfair competitive practices and our own investigations convinced this Administration that this Department has an obligation to take action against such practices. To obtain the benefit of the ideas of all affected parties, we published a proposal whereby the Department would consider taking enforcement action in cases where an incumbent airline's competitive response to entry in one of its hub markets by a low-fare airline seemed to be motivated primarily by the goal of forcing the new competitor to exit the market. 63 Fed. Reg. 17919 (April 10, 1998). The Secretary wished to begin a national dialogue on the issues. We also knew that, without a public examination of the issues, some would question whether competitive problems did, in fact, exist and would challenge the notion that this Department could or should take any action to address the situation. We received several thousand comments on the proposal.

After we published our proposed enforcement guidelines, Congress required the National Research Council of the National Academy of Sciences to update the 1991 analysis of airline competition issues prepared by the Council's Transportation Research Board ("TRB") and to comment on our proposed policy. The TRB panel concluded that we had an important role in preserving and enhancing opportunities for competitive entry in the airline industry and that some of the complaints of unfair competitive conduct received by us involved actions that seemed "difficult to reconcile with fair and efficient

competition.” The TRB panel also believed, however, that our proposal was flawed in several respects.

Having considered the comments and the TRB’s recommendations and having undertaken further investigations, this Administration is reaffirming its initial findings that airlines have responded to new competition with apparent unfair competitive practices, that those practices eliminate or reduce competition, and that this Department has an obligation to prevent unfair competitive conduct since it harms the public. This Administration is publishing these findings to lay a foundation for future action by the Department. Publishing our economic and policy analysis will provide the industry, as well as the traveling public, with an understanding of the practices that should concern those who share the Administration’s interest in ensuring that consumers continue to benefit from airline deregulation.

If the Department decides on the basis of this Administration’s analyses and further complaints and investigations that enforcement action should be taken, this Administration recommends that the Department focus on taking action against any airline that seeks to exclude competition by responding to entry in ways that are economically irrational unless they force the entrant to exit from the market or reduce its service (we will refer to such conduct as “unfair exclusionary conduct”). Fare reductions and capacity increases implemented by major airlines in an apparent effort to eliminate new competition from a low-fare airline should not be the Department’s only concern. It should instead address unfair competitive practices in any market where an incumbent airline’s unfair competitive conduct will likely give the airline the ability to charge fares higher than competitive levels and to reduce service below competitive levels for a significant period of time if it can eliminate the entrant airline. If the Department chooses to take enforcement action, the formal hearing process will give it (and the parties) a chance to further investigate these issues and develop definitive standards in this area.

This Administration believes that the Department’s goal should be to give all airlines a fair opportunity to compete. The Department should seek to create a level playing field, not to protect any airline or class of airlines from legitimate competition. The Department has taken vigorous action to protect the ability of U.S. airlines to compete on a fair basis in international markets, and taking action against unfair competitive practices in domestic markets would be fully consistent with our actions on international markets.

This proceeding has done more than create the analytical base for further action by the Department, for it began a public debate that has both improved our understanding of the issues and educated the public, civic leaders, and the

industry on the importance of competition and the prevention of unfair practices that stifle competition.

We have decided not to publish guidelines as originally proposed, since we have concluded that publishing our analyses and developing standards through a case-by-case approach will be a more effective way of proceeding. As shown by our further studies of the issue, including the report prepared for us by two respected economists, Professors Clinton V. Oster, Jr., and John S. Strong, a determination that an airline has engaged in unfair competitive practices should involve an examination of the facts of each case due to the complexities of airline competition and the differences between markets. The nature of the individual markets and market participants will determine whether consumers may be denied competitive service and fares. Our conclusion is consistent with the TRB's recommendation that we analyze the issues further before adopting guidelines and with a number of the comments submitted on our proposed guidelines.

In addition to publishing our analysis and findings, this Administration has taken other steps to promote competition. We have, of course, obtained open skies agreements with many countries that enable U.S. airlines to enter new markets and set their fares without regulatory interference. These agreements have transformed the international aviation environment. We issued a report on airport practices that reaffirms the airports' obligation to make facilities available to airlines wishing to begin serving an airport and that recommends airport practices that will promote entry and expanded service. Taking aggressive action to open up airport facilities would make possible additional new and increased airline services and thereby promote competition. We have awarded slot exemptions to new entrant airlines that have enabled them to enter new markets and expand service, as highlighted by Jet Blue's entry in a number of markets from its hub at JFK. We are launching a website that will make readily available a series of papers and studies prepared by the staff on domestic and international issues. We are also publishing a new study of hub fares which reaffirms our past findings that fares in hub markets without low-fare airline competition are substantially higher than fares in comparable markets that do have such competition.

Our continuing efforts to provide consumers, civic leaders, and their elected representatives with information on the pricing behavior of airlines have proved to be important. By calling attention to important industry characteristics, this seemingly simple initiative has helped sharpen the focus on two industry conditions: the significant degree to which fares vary depending upon the presence or absence of a low-fare competitor, and the important role of low-fare service in generating traffic and promoting economic growth for communities.

This information has encouraged communities to actively seek low-fare service, and success stories have resulted.

This paper sets forth the analysis underlying this Administration's findings on the need to take action against unfair competitive practices. To a large extent this paper relies on the analysis presented by Professors Clinton V. Oster, Jr., and John S. Strong in their accompanying report, "Predatory Practices in the U.S. Airline Industry" (cited as Oster and Strong, "Predatory Practices").

This paper begins by describing the history of this proceeding and the developments since we proposed our policy. The paper then describes the domestic airline industry and discusses the factors that persuaded us to propose an enforcement policy – the ability of hubbing airlines to gain and keep market power in hub markets, and major airline responses to entry by a low-fare airline in hub markets that appeared to be intended only to eliminate competition. We then explain the basis for our findings, why we did not adopt the alternatives proposed by commenters for addressing unfair competitive conduct, and the likely impact of implementing our findings on consumers and airline operations.

HISTORY OF THIS PROCEEDING

Importance of Deregulation and Competition

Deregulation overall has been very successful and produced great benefits for consumers. Today, U.S. air carriers transport about 270 million more passengers a year than they did during the last year of economic regulation. On average, domestic consumers pay a third less (in constant dollars) than they did 20 years ago. These gains are largely the result of more efficient industry operating practices and the critical role played by low-fare air carriers in creating a more competitive environment. Airline operating profits and net profits reached record levels in the late 1990's, totaling roughly \$42 billion and \$23 billion, respectively, for the period from 1995 through the third quarter of 2000. The average passenger load factor was 72.6 percent in the year ended September 30, 2000. While the industry's fuel expense in the twelve months ended September 2000 was 52 percent higher than in the preceding twelve months, the thirteen major airlines obtained net income of \$3.7 billion and operating profits of \$7 billion in the later period.

The benefits of deregulation depend on competition. Particularly important for many travellers are the low-fare airlines, since they rely on a strategy of attracting customers by offering low fares. The network airlines, in contrast, tend to focus on attracting travellers more interested in a higher level of service and

less interested in price (the network airlines are the large airlines that have developed hub-and-spoke route systems). But a low-fare airline's entry into a network airline's market will normally spur the incumbent to lower its own fares. The low fares offered by the entrant can radically increase the size of the market by making air travel affordable for many more consumers.

That consumers obtain better fares and service in competitive markets is shown dramatically by the effect of entry by low-fare airlines. Our 1996 study, The Low Cost Airline Service Revolution, estimated that consumers then saved \$6.3 billion annually due to low-fare airline competition. For example, when AirTran entered the Atlanta-Buffalo market, average fares declined by 36%, from \$185 to \$119, and the number of passengers in the market increased by 65%, from 23,000 per month to 38,000 per month. And when Vanguard reentered the Kansas City-Minneapolis market in late 1996, average fares declined by 59 percent, from \$246 to \$101, and traffic more than doubled, increasing from about 12,000 passengers per month to 25,000 per month.

Competition from airlines with different operating strategies also benefits consumers. Entry into new markets by Midwest Express gives more travellers access to the relatively high level of service offered by that airline. Other airlines also compete on service factors, in some cases by offering more frequent service in dense business markets.

Travellers are not the only beneficiaries of increased competition. Regions where the lower fares and increased service options created by competition are available are better able to attract new businesses and business expansions; conversely, regions denied access to competitive service suffer economic difficulties.

By reducing fares and improving service, competition makes it possible for more people to travel by air, thereby increasing the revenues – and employment levels -- of firms that supply aircraft and other products and services to airlines and the infrastructure that supports them.

The Basis for Our Concern

We received a number of complaints from smaller airlines, communities, and consumers alleging that an incumbent airline in some cases had responded to new competition with practices seemingly designed to eliminate competition, since the incumbent airline probably could have responded in other ways that would have yielded higher revenues and profits.

The complainants charged in particular that incumbent airlines had sometimes responded to a low-fare airline's entry by sharply cutting fares and increasing capacity, which made it difficult or impossible for the new entrant to maintain service.

In response to these complaints, we reviewed confidential business documents from several airlines and analyzed service and fare changes in a number of domestic markets where an incumbent responded to a low-fare airline's entry by significantly cutting fares and making many more discount-fare seats available. Our investigation suggested that some of the low-fare airlines' complaints were valid. We have found cases where the incumbent airline responded by cutting fares, making the low fares widely available without the restrictions usually imposed on such fares, and even adding flights. As a result, the entrant often exited the market, and the incumbent airline then charged average fares at least as high as those charged before the entry occurred. The public thus benefited from the incumbent's low fares only during the period when the incumbent faced competition.

This kind of competitive response seemed designed to keep the new entrant airline from obtaining enough passengers to operate profitably. In such cases the incumbent airline incurs a substantial drop in its local revenues (and increased costs), whereas a more measured response to the new competition would have reduced the airline's revenues by a much smaller amount without increasing its costs. A network airline's other advantages -- for example, more frequent flights, an attractive frequent flyer program, and an established reputation with travellers -- should enable it to attract passengers without flooding the market with low-fare seats. By greatly reducing local revenues in the short term, a strategy of large fare cuts and capacity increases is probably economically rational only if it forces the new entrant to exit the market, after which the incumbent can cut capacity and increase fares to their original high levels. Moreover, such a response signals other potential entrants that they can expect a similar response if they enter one of the incumbent's important markets.

Our proposed policy cited an example of such a response apparently aimed at eliminating the new entrant's competition. 63 Fed. Reg. at 17921. See also U.S. Department of Transportation, "Competition in the U.S. Domestic Airline Industry: The Need for a Policy to Prevent Unfair Practices" (revised 1999) ("DOT White Paper"), Example 3 in Attachment. We did not then identify the airlines and market in that example, since we intended to apply our final policy prospectively, 63 Fed. Reg. at 17922, and did not wish to imply that we had concluded that any individual airline had engaged in unfair methods of competition. The example -- Northwest's response to Spirit's 1996 entry into the Detroit-Philadelphia market -- has been cited in a number of the comments and is

discussed in the accompanying report by Professors Oster and Strong. We are not attempting to determine in this proceeding whether any airline has acted unlawfully – we could make such a determination only after holding a hearing before an administrative law judge where all parties have the opportunity to present evidence and their legal and economics arguments. As explained by Professors Oster and Strong, determining whether Northwest’s response was illegitimate would require a more detailed examination of the incident. Oster & Strong, “Predatory Practices,” at 8-10.

Professors Oster and Strong also discuss a second example of the type of conduct of concern to us, Northwest’s response to Reno Air’s entry into the Reno-Minneapolis market. Oster & Strong, “Predatory Practices,” at 7-8. The complaint filed by the Justice Department in its Sherman Act suit against American Airlines cites additional instances of exclusionary conduct, including American’s response to Vanguard’s entry into the nonstop Dallas-Kansas City nonstop market. United States v. AMR Corporation et al., D. Kans. Civil Action 99-1180-JTM (filed May 13, 1999).

The TRB panel similarly concluded that airlines may be engaged in predatory conduct after reviewing the list of complaints submitted by us to them. The panel stated, “[I]t is apparent that some of the actions described are difficult to reconcile with fair and efficient competition.” The panel did not determine whether any individual airline’s behavior constituted predatory conduct. TRB Report at 6.

The continuing success of airline deregulation depends on maintaining airline competition. Maintaining competition requires the assurance that airlines can enter new markets. The practices reviewed by us and the TRB appear to be efforts by incumbent airlines to thwart new entry and thereby deny travellers the benefits of competition. Congress has charged the Department with the responsibility for stopping unfair competitive practices.

Our Proposed Enforcement Policy

Because of our concerns, we published for public comment proposed guidelines announcing when we would consider taking enforcement action as a result of a major airline’s aggressive competitive response to a low-fare airline’s entry into a hub market. 63 Fed. Reg. 17919 (April 10, 1998). The Department’s authority under 49 U.S.C. 41712 (formerly section 411 of the Federal Aviation Act and still commonly referred to as section 411) to prohibit unfair methods of competition in the airline industry would be the basis of any enforcement action. Section 411 authorizes the Department to prohibit airline practices as unfair methods of competition if they violate antitrust principles, even if the practices do not

constitute monopolization and attempted monopolization under the Sherman Act.

While our investigations had given us a basis for beginning formal enforcement proceedings against one or more major airlines, the Secretary decided to propose an enforcement policy and thereby begin a national dialogue on the issues before taking enforcement action against an individual airline. Our proposed guidelines sought to enable consumers to benefit from a wider range of service options and lower fares, by encouraging new entry and competition. We intended to discourage unfair competitive responses from incumbent airlines that are designed to eliminate competition without chilling legitimate competitive responses by incumbent airlines.

Our proposed guidelines stated that a hubbing airline's competitive response to new entry could lead to enforcement action if it would increase the incumbent airline's profits only if it eliminated competition and if it would be significantly less profitable in the short run than other competitive responses if it did not eliminate competition. We stated that we expected incumbent airlines to make reasonable competitive responses to entry by a low-fare airline.

We specified three situations where we expected to take enforcement action unless we had strong reason to believe that no violation of section 411 had occurred. For example, under our proposal we would likely take enforcement action if the number of passengers carried by the incumbent airline at low fares exceeded the total number of seats operated by the entrant, if the incumbent then obtained less local revenue than it would have obtained by using a reasonable alternative response to the new entrant.

Our proposed guidelines focused entirely on pricing and capacity matters, but we recognized that dominant airlines may have engaged in other types of conduct to eliminate or reduce competition, such as the hoarding of airport gates, 53 Fed. Reg. at 17922. We stated that we would investigate these types of unfair competitive conduct as well as competitive responses involving large fare cuts and significant capacity increases.

Comments

Several thousand persons – airlines, travel agencies, other businesses, labor groups, members of Congress, state and local government officials and legislators, community groups and leaders, elected officials, and individual travellers -- submitted comments on our proposed guidelines. We have considered all of them in our analysis. In general, the network airlines and the major airline trade association, the Air Transport Association, objected to our

proposals, as did numerous labor groups. Many community groups and civic leaders opposed the proposals, but many others endorsed them, including the Attorneys General of twenty-four states. The low-fare airlines and Southwest supported our proposed guidelines. Professor Alfred Kahn, who as Chairman of the Civil Aeronautics Board urged Congress to deregulate the airline industry, largely agreed with our conclusions. We have placed in the docket a summary of all of the comments filed in this proceeding.

We also met with a number of airlines and others interested in our proposal; we have placed summaries of several of those meetings in the docket and are citing them in this paper. We additionally held community meetings on airline competition and related subjects, such as the meeting held in Rochester, New York, on February 5, 1999.

After we published our proposed policy, as described next, the Transportation Research Board issued its report on airline competition, the General Accounting Office issued a report on issues involving this proceeding, and the Justice Department filed its Sherman Act suit against American for predatory conduct. In addition, we issued a report on airport practices that discusses incumbent airline practices that may be anticompetitive, and we have been informally investigating additional complaints of predatory-type behavior.

The Transportation Research Board Report

In the 1999 fiscal year omnibus appropriations act, Congress directed the Transportation Research Board to update its previous report on airline competition, Winds of Change, the TRB's 1991 report on airline deregulation. Section 110(g) of Division C, Title I, of the 1999 Omnibus Appropriations Act. The TRB's updated report, Entry and Competition in the U.S. Airline Industry: Issues and Opportunities, Special Report 255 (1999) ("TRB Report"), discussed, among other subjects, our proposed guidelines on airline competition.

The TRB panel concluded, "DOT has an important role in preserving and enhancing opportunities for competitive entry in the airline industry." TRB Report at 9. The panel further stated that some complaints of anti-competitive practices appeared to have merit. After reviewing the list of complaints submitted by us to them, the panel stated that some of the listed actions seemed "difficult to reconcile with fair and efficient competition." The most troubling were "four reports of incumbents not only sharply lowering fares but also temporarily scheduling many more flights, some in city-pair markets in which they previously had not offered nonstop service nor jet flights." As the report noted, "[s]harp reductions in price and increases in capacity are predatory if

designed to drive out or suppress competition to gain higher future prices and profits through increased market power.” TRB Report at 7.

The TRB Report observed that the list of complaints included conduct unrelated to price reductions and capacity increases -- “limiting the availability of slots and gates; influencing [computer reservations system] listings; and offering special travel agent incentives,” for example -- that incumbent airlines could use to the detriment of smaller rivals, “possibly denying them the opportunity to compete fully on the basis of relative costs and the attractiveness of their offerings.” TRB Report at 89. See also TRB Report at 97. Although unable to assess the validity of these complaints, the panel stated that it “believes that they merit further investigation by DOT.” TRB Report at 97.

While the TRB committee recognized our responsibility to take action to preserve airline competition and the apparent validity of some complaints of predatory-type behavior, the committee expressed concerns about our proposal. The committee observed that it was generally difficult to distinguish between predatory behavior and the kind of competition that benefits consumers. TRB Report at 7. The committee recognized that our proposed test – a test based on whether the incumbent airline could have responded to entry in a way that would have been more profitable than its actual response – would consider opportunity costs and that opportunity costs are relevant costs. The committee believed, however, that the specific test proposed by us might not be administratively feasible and could have undesirable consequences. TRB Report at 8. The committee further criticized the tentative decision to have the proposed policy protect only a class of new entrant airlines, since that could lead to arbitrary enforcement and favor inefficient airlines. TRB Report at 8.

The committee members disagreed on our role in addressing predatory behavior in the airline industry. Some members “judg[ed] the problem serious enough to warrant the more active involvement of DOT” and were “optimistic that DOT can [develop guidelines] without becoming overly regulatory and without inhibiting the kind of competitive price cutting that provides lasting fare reductions.” Others thought that the Justice Department should “take the lead in enforcement,” since it would not be affected by industry-specific regulatory responsibilities and has more expertise. TRB Report at 9-10.

This Administration has determined not to develop here more specific standards defining the kind of pricing and capacity responses that may be considered unfair methods of competition. We instead believe that such standards should be created through formal enforcement proceedings. If the Department follows this view, it can thereby develop a body of caselaw based on a more thorough examination of cases of apparent predatory-type behavior. This Administration

believes that the Department should also address any kind of unfair competitive conduct designed to create or maintain market power, not just fare reductions and capacity increases. These final conclusions and recommendations reflect the recommendations of the TRB panel.

The panel additionally recommended other actions that should be taken by the Department and Congress to promote entry into airline markets and thus strengthen competition. The Department submitted its response to the panel's report on these issues in October 1999.

The General Accounting Office Study

As requested by the Chairman of the House of Representatives Budget Committee, the General Accounting Office also prepared a report on this proceeding. Aviation Competition: Information on the Department of Transportation's Proposed Policy, GAO/RCED-99-225 (July 1999) ("GAO Report"). The GAO studied three issues: why we proposed the policy, what process was used to develop the proposal, and whether the proposal would address the problems that caused us to issue it.

The GAO reported that we decided to develop the proposed policy after receiving complaints from new entrant airlines complaining about unfair fare cuts and capacity increases, that our investigations and analyses indicated that at least several major airlines had engaged in apparent unfair competitive practices, and that we had concluded that the best method for addressing our concerns was to issue policy guidance stating what conduct would be considered unfair methods of competition that would warrant enforcement action. GAO Report at 1.

The GAO stated that we developed the proposed policy through an informal process since in our view the policy would not be a rule requiring all of the rulemaking procedures prescribed by the Administrative Procedure Act. The GAO pointed out that we nonetheless published the proposal in order to obtain public comments. GAO Report at 1-2. The GAO observed that we had consulted officials from the Justice Department, the Federal Trade Commission, and the Office of Management and Budget in developing the policy. GAO Report at 13.

Finally, the GAO concluded that our proposal would generally address the complaints about unfair fare cuts and capacity increases that caused us to begin developing the proposal. The GAO noted that we were revising the policy to address some of the concerns raised by the commenters. GAO Report at 2.

The Justice Department's Antitrust Suit against American

The Justice Department has filed an antitrust suit against American Airlines that contends that American violated the Sherman Act by monopolizing DFW airline markets. United States v. AMR Corporation et al., D. Kans. Civil Action 99-1180-JTM (filed May 13, 1999). American allegedly used the combination of lower fares, wider availability of low-fare seats, and added flights to force several low-fare airlines -- Vanguard, Western Pacific, and SunJet -- to end or reduce service in DFW markets.

The complaint alleges that American has monopoly power in most DFW markets, Complaint, para. 23:

American has monopoly power in most of its DFW city pairs and faces little current competition and little prospect of entry on those routes. Its monopoly power allows it to charge supracompetitive fares. American's fares on DFW city pairs are substantially higher than its fares on otherwise comparable routes where it faces competition.

The Justice Department asserts that the only airlines that may be able to undercut American's monopoly power at DFW are the low-fare airlines, since they have much lower operating costs. Complaint, para. 24. To keep this from happening, American developed a strategy for eliminating their competition, Complaint, para. 28:

[W]hen a [low-fare airline] entered a DFW route and it appeared the [low-fare airline] would be economically viable if American simply followed a profit-maximizing business strategy, American would instead saturate the route with enough additional capacity at low fares to keep the entrant from operating profitably. American would also take further steps, such as matching the [low-fare airline's] connecting fares with its own nonstop fares, to keep traffic away from the [low-fare airline]. To evaluate the success of its strategy and determine whether to intensify its response, American would investigate the financial resources of [low-fare airlines], determine their break-even load factors, and conduct head counts at the departure gate to monitor their passenger loads.

The complaint alleges, "American implemented its strategy [of eliminating competition] in spite of the fact that it was not profitable except as a means of excluding or stifling competition." Complaint, paragraph 48. American pursued this strategy in order to preserve its monopoly fares. Complaint, para. 30, 31. The strategy worked: "[I]n each instance [the low-fare airline] was driven out of some or all of the DFW routes it was serving; in each instance, American substantially raised its fares after the [low-fare airline] exited; in most instances, American reduced its service after the [low-fare airline] exited; and in every instance American solidified its power to charge high fares on DFW routes well into the future." Complaint, para. 7.

The Department's Report on Airport Practices

Maintaining a competitive airline industry requires that airlines be able to enter new markets. Entry will be possible only if airlines can obtain access to the gates and other airport facilities needed to support new service. Our concern that airport practices could be limiting the ability of airlines to gain access to necessary airport facilities caused us to study that question and issue a report. Airport Business Practices and Their Impact on Airline Competition, FAA/OST Task Force Study (October 1999). The report reaffirmed each airport's obligation to make facilities available to airlines wishing to begin serving the airport. The report additionally stated that we could take action against airline practices that unreasonably denied competitors access to necessary airport facilities, such as unjustifiable refusals to sublease gates needed by entrants. Airport Business Practices at 26-28.

Our Investigation of Additional Complaints

Our publication of our proposed policy, the Justice Department's Sherman Act suit against American, and the recent controversy over the major airlines' conduct apparently moderated the competitive responses of some incumbent airlines to entry by low-fare airlines, at least initially. Nonetheless, since we published our proposed policy, we have received several more complaints against network airlines that allegedly used fare cuts, capacity increases, and other tactics in an effort to force a new competitor to exit markets served by the incumbent. We have been informally investigating some of these complaints and have found evidence suggesting that some major airlines have engaged in conduct which may be intended to stifle competition. This Administration believes that the Department should continue investigating these complaints and consider taking action on them if appropriate, one option being enforcement action.

Our Final Decision

Our review of the comments submitted on our proposal and the TRB report, our further analyses of the airline competition, and our informal investigations of additional complaints of predatory-type behavior by a major airline against a smaller airline have confirmed our findings that airlines engage at times in unfair competitive practices designed to eliminate or reduce competition and that the Department should take action to prevent such practices. The economic and legal analysis set forth by this Administration in this paper creates a framework for taking such action. The analysis will also provide guidance on

the types of cases that could raise concerns and where enforcement action could be appropriate.

Given the Department's responsibility to protect airline competition, this Administration is convinced that the Department has an obligation to prevent anticompetitive responses to entry that deny consumers the longterm benefit of competition while giving them no longterm benefits. Taking no action on these issues would impose substantial welfare losses on consumers. The Department should consider taking action when an incumbent airline responds to entry with fare cuts, capacity increases, or other tactics that appear to be economically rational only if they force the new entrant to exit the market.

In taking action to prevent unfair exclusionary conduct, the Department must take care not to discourage legitimate competition. The maintenance of vigorous competition is necessary to ensure that consumers continue to obtain the benefits of deregulation. Reconciling the need to encourage legitimate competition with the need to prevent unfair competitive practices will be difficult, as we have learned from examining these issues. That difficulty is in large part the reason why we have decided against adopting formal enforcement guidelines at this stage and why our consideration of the comments, the TRB panel's recommendations, and our own analyses has taken as long as it has.

OUR ECONOMIC ANALYSIS

This section shows that airline responses to new competition intended to eliminate or reduce competition harm the public and are unjustifiable as a matter of economic principles applicable to the airline industry.

As discussed above, we proposed our original policy because of apparent unfair competitive responses observed by us. While we cannot be certain without further investigation that any of these responses constituted unfair methods of competition, the Department should consider investigating practices of this kind in an enforcement proceeding or taking other appropriate action that will prevent unfair methods of competition.

In essence, this Administration has found that the Department should act to ensure that as many markets as possible will obtain the benefits of competition. Without Department action, airlines dominating markets may be able to use sharp fare reductions, capacity increases, and other methods to force competing airlines to exit from those markets. As explained in this section, some markets can be dominated by an airline, entry into such markets can be difficult, and the dominant airline can benefit from conduct that reduces its profits in the short term because that conduct will eliminate or deter competition and thereby

increase that airline's profits in the long term. This Administration firmly believes that the Department's responsibility to prevent unfair methods of competition requires it to address such conduct and thereby supplement the Justice Department's enforcement of the antitrust laws.

Although the Department should not confine its efforts to conduct directed at low-fare airlines, our analysis and the comments have primarily discussed network airline responses to entry by low-fare airlines. The explanation in this section therefore focuses on examples of apparent unfair competitive conduct targeted at low-fare airlines. The underlying analysis of the industry, however, applies to unfair competitive responses directed at any kind of airline.

We will begin by outlining the industry's development under deregulation and will then show that deregulated airline markets are not contestable, contrary to the predictions commonly made at the time of deregulation, and that incumbent airlines can and do obtain market power on certain types of routes. Because incumbent airlines can obtain market power on some kinds of routes, the Department should take action against exclusionary practices that end or deter attempts by competitors to serve such routes.

The Operation of a Deregulated Airline Industry

Deregulation overall has been very successful and greatly benefited consumers, since most airline markets are competitive and the vast proportion of airline passengers travel in markets that have competitive service. Today more than eighty percent of airline passengers travel in markets that have two or more competitors. The number of domestic passengers has tripled since 1979. Traffic in competitive markets has grown even more. The number of passengers in markets with two or more competitors has almost quadrupled since 1979, while the number of passengers in markets with three or more competitors has increased almost sixfold and now account for about forty percent of all traffic. The number of passengers in markets with three or more competitors exceeds the total number of passengers in 1979. The increased competition is reflected in the fares paid by passengers, since inflation-adjusted fares have declined by about thirty-five percent since deregulation.

Deregulated airline markets, however, have not functioned as was expected at the time of deregulation. Industry analysts then assumed that in a deregulated environment any airline could enter any route and that the threat of entry would cause incumbent airlines to maintain low fares to discourage entry. The analysts assumed that the more nimble airlines able to enter the industry after deregulation would capture a large share of the traffic from the less efficient established airlines. Airlines were thought likely to offer relatively simple fare

structures.

The operation of the deregulated industry has been quite different from the forecasts in several respects. First, industry analysts had not expected every major airline to adopt a hub-and-spoke route system. Airlines generally operated linear route systems during the regulatory era, as did the intrastate airlines operating in California and Texas. Michael E. Levine, "Airline Competition in Deregulated Markets: Theory, Firm Strategy, and Public Policy," 4 Yale J. on Regulation (Spring 1987) 393, 411 (hereafter cited as Levine, "Airline Competition in Deregulated Markets"). After deregulation each of the holdover airlines established a hub-and-spoke system. Hub-and-spoke systems enable the hubbing airline to operate more frequent service in spoke markets than could be supported only by local traffic. Hub-and-spoke systems therefore benefit travellers in most markets. However, as explained below, hub-and-spoke route systems make entry in many markets difficult, for any airline serving a route from one of its hubs will have substantial competitive advantages over an entrant, unless the entrant either serves the route from one of its own hubs or has significantly lower costs than the hubbing airline.

Secondly, deregulation did not lead to the simplified fare structure anticipated by many observers. Economists had expected airlines operating under deregulation to offer unrestricted low fares, an expectation based in part on the assumption that firms entering the industry with low costs would keep incumbent airlines from being able to create a complex fare structure. Levine, "Airline Competition in Deregulated Markets," at 447; TRB Report at 28-29.

The actual result was quite different -- fare structures became extraordinarily complicated. Airlines offer many different types of fares subject to many different conditions. Airlines use yield management to determine how many seats would be offered at each fare with the goal of selling as many seats as possible at higher fares. This enables airlines to charge higher fares to business travellers interested in obtaining frequent service while offering lower fares to leisure travellers interested in saving money and less interested in the number of flights available in any market. Levine, "Airline Competition in Deregulated Markets," at 448-450; TRB Report at 26-27.

The airlines' ability to implement yield management systems resulted from the advances in information technology, which increased their ability to engage in market segmentation. The technology has enabled each airline to allocate seats among the many different fares offered on a flight in light of predicted demand for each type of fare. Levine, "Airline Competition in Deregulated Markets," at 451. In addition, computer reservations systems ("CRS's") have played an important role in airline distribution. Travel agents, who sell the great majority of airline tickets, rely on the CRS's to determine what airline services and fares

are available and to make bookings. The CRS's provide a very efficient method of carrying out these tasks. Secretary's Task Force on Competition in the U.S. Domestic Airline Industry, Airline Marketing Practices: Travel Agencies, Frequent-Flyer Programs, and Computer Reservation Systems (February 1990), at 21-22. To enable travel agents to advise their customers effectively, the CRS's contain the publicly-available fares of almost all airlines and show whether the fares are available or sold out on particular flights. An incumbent airline can learn from a CRS the fares being charged by a new rival and can plan its response. Levine, "Airline Competition in Deregulated Markets," at 459-463.

Thirdly, contrary to expectations at the time of deregulation, almost all of the current major airlines were major airlines before deregulation. Industry observers had predicted when deregulation began that the major airlines of that time would have trouble adjusting to a deregulated environment, in part because they had relatively high operating costs. As described in Professor Levine's analysis of these predictions and the actual outcome of deregulation, firms entering the industry after deregulation were expected to become a major segment of the industry since they would be more efficient and not handicapped with the high-cost practices of the airlines doing business before deregulation. Levine, "Airline Competition in Deregulated Markets," at 405-406.

The proponents of deregulation assumed that there were no economies of scale or scope in the airline industry, and they overlooked the physical barriers to entry that became important when the regulatory scheme no longer made entry and route expansion difficult. The unavailability of airport facilities, for example, has hindered expansion efforts by new entrants. DOT, Airport Practices and Their Impact on Airline Competition (October 1999) at 32-33; TRB Report at 113-114, 117-120. An incumbent airline in such a market can effectively prevent entry if it can obtain control of such scarce resources and deny them to entrants, even if it is not using them.

Significant economies of scale and scope proved to exist in the deregulated industry, as shown by the importance of travel agency override commissions and frequent flyer programs. These economies are particularly important on the revenue side, another development unforeseen at the time of deregulation. Analysts then focused on airline costs, an important factor under regulation, rather than the ability to generate revenues, a factor which has become critical since deregulation. Rono Dutta, then United's Senior Vice-President for Planning and now its President, has summarized how bigger airlines have an edge in gaining revenues, "Is Bigger Better?" Air Transport World (March 1998) at 31-32:

There are far more economies of scale on the revenue side than on the cost side. And revenue synergy, I believe, comes from a couple of different things. First, on a hub and spoke, you have 50 flights into a bank as opposed to three flights into a bank. So that creates a huge power. Secondly, customers clearly want to go to many destinations and prefer the carrier that serves all their needs, and that creates some economies from a frequent-flyer basis. So I think the economies of scale on the revenue side are really huge

As was expected, many firms entered the airline industry in the first ten years after deregulation. Contrary to expectations, few survived. Until recent years the industry included only four significant airlines that began scheduled interstate service after deregulation – Southwest, which had operated as an intrastate airline in Texas before deregulation; America West; Midwest Express; and American Trans Air, which began as a charter airline. The other new entrants generally failed, in part due to management mistakes and an inability to cope with recessions. TRB Report at 56-57. Competitive responses from stronger network airlines intended to eliminate competition may have undermined the ability of some new entrants to remain in business. Levine, “Airline Competition in Deregulated Markets,” at 472-473. Some of the major pre-deregulation airlines, of course, like Eastern and Pan American, also failed. TRB Report at 56-57.

Of the nine passenger airlines with current annual operating revenues of more than \$1 billion, all but America West and Southwest started operating interstate scheduled passenger flights long before the airline industry was deregulated (the seven that began operations before deregulation are American, Continental, Delta, Northwest, TWA, United, and US Airways). The surviving pre-deregulation airlines have become more efficient since deregulation. Even so, their ability to survive despite their higher costs – and the failure of almost all of the new entrant airlines that started up in the early years of deregulation – suggest that the major airlines’ route systems and the scale and scope of their operations gave them important competitive advantages. Levine, “Airline Competition in Deregulated Markets,” at 407-408.

Furthermore, the expected ability of virtually any airline to enter any route proved unrealistic. A number of economists had assumed that the contestability theory would apply to the deregulated airline industry. Under that theory, as described by Professor Levine, *id.* at 405:

[P]otential entry by new firms serves to discipline the behavior of participants in real-world markets where a small number of firms participate. [F]irms actually operating in a given market will

necessarily reduce their prices to levels consistent with the costs of their potential entrant rivals. Otherwise, entry will occur and they will be replaced.

Whether airline markets are contestable is important in determining whether there are threats to airline competition, since few airline markets are likely to have many competitors. If airline markets were contestable, firms outside a market could enter it so easily that the threat of potential entry would make the incumbent firms operate efficiently and charge competitive prices. *Id.* at 403, 404. But contestability could exist only under three conditions: “(1) equal access to economies of scale and to technology, whether expressed as access to competitive levels of unit costs or as equivalent access to product quality; (2) no sunk costs, a firm can enter and exit without entry and exit costs, including operating losses resulting from predation; and (3) price sustainability, there is a set of prices that can occur after the entry of at least one firm which will support profitable operation.” Levine, “Airline Competition in Deregulated Markets,” at 404.

Contestability has proven inapplicable in the airline industry. Levine, “Airline Competition in Deregulated Markets,” at 405. First, an airline entering a market incurs certain sunk costs that cannot be recovered if it exits, for example, advertising costs and the cost of setting up facilities at the new airport. Travellers will be reluctant to book an airline that exits and reenters a market, moreover, given the significant possibility that the airline may again leave the market before the date of their planned trips. As a result, airlines cannot freely enter routes.

In addition, an incumbent airline does not need to lower fares to discourage entry before it happens – an incumbent airline can immediately change its fares if another airline announces plans to enter one of its markets. The threat of entry thus puts little pressure on incumbent airlines to reduce fares. *See, e.g.*, Levine, “Airline Competition in Deregulated Markets,” at 444-446, 451-452.

Airlines developed marketing programs designed to obtain the loyalty of their customers and travel agents. Airlines, for example, created travel agency override commission programs to encourage travel agencies to book the airline offering the incentive commissions. These commission programs are usually structured so that the airline with the largest market share in a travel agency’s area will have the most attractive commission program. These programs are attractive to many travel agencies. General Accounting Office, Airline Deregulation: Barriers to Entry Continue to Limit Competition in Several Key Domestic Markets, GAO/RCED-97-4 (October 1996), at 15, 17-18.

Nonetheless, deregulation has been very successful despite the inaccuracy of many predictions on how the deregulated industry would operate. And while competition in some markets may be less vigorous than predicted, all airlines, both those operating before deregulation and those created since, have had to reshape their operations to become efficient and cope with the competitive demands of the deregulated environment.

We will next discuss in detail two of the unexpected results of deregulation – hub-and-spoke route systems and yield management – since they are crucial to an analysis of the competitive issues in this proceeding.

Yield Management

Yield management has enabled the airlines, especially the network airlines, to develop complex fare structures designed to maximize revenues on each flight through price discrimination. They try to sell as many seats as possible at the highest fares, those charged for unrestricted travel, and as few seats as possible at the lowest discount fares. Passengers paying the highest fares obtain the advantages of flexibility and last-minute access to seats. They can book seats just before the flight, change their reservation without penalty, and obtain a full refund if they do not to use the booking. Passengers travelling on most discount fares, in contrast, typically have to book seats several days or more before the flight, have to pay in advance for their seats, cannot change a reservation without paying a penalty, and cannot obtain a cash refund if they cancel their trip. Although business travellers can use some discount fares, the cheapest discount fares frequently have a Saturday night stay requirement to discourage business travellers from using them. To save seats for passengers willing to pay for unrestricted fares bought shortly or immediately before the flight, airlines limit the number of seats made available at the lower fare levels. Oster & Strong, “Predatory Practices,” at 21-23; July 29, 1998, American Meeting Notes at 2. Unlike the low-fare airlines, the network airlines have relatively little interest in attracting travellers who insist on paying low fares for air travel, even though the network airlines do sell many discount-fare seats. They have structured their operations so as to attract travellers willing to pay more for better and more frequent service. See, e.g., July 29, 1998, American Meeting Notes at 2, 3. If an airline charges higher fares to those travellers, it may be able “to generate sufficient revenue to provide the product, but no more than that if competition is effective.” TRB Report at 23.

The airlines’ yield management systems mean that passengers on the same flight will have paid different fares, depending on how far in advance they made their booking and how many restrictions they were willing to accept in return for a lower fare. No airline has been able to maintain a simple fare structure. The

discrimination in fares also reflects the willingness of business travellers, but not leisure travellers, to pay for frequent and convenient flights. Levine, “Airline Competition in Deregulated Markets,” at 446-452; TRB Report at 28-30. Low-fare airlines, however, have less complex fare structures than the network airlines.

Although network airlines serving a market allocate different numbers of seats to each fare level, they tend to charge similar amounts for each type of fare offered in a market (for example, 21-day advance-purchase fares and unrestricted coach fares). Each network airline usually matches the fare levels offered by its network competitors in a market, although not necessarily the number of seats made available at each fare. An airline that has a competitive advantage in a nonstop market will be able to sell more seats at unrestricted fares and so can afford to make fewer seats available for discount fare passengers. Dr. George Eads thus states, “[A] hubbing carrier is able to offer a service advantage relative to a non-hubbing carrier” which permits it “to attract a relatively larger portion of time-sensitive (primarily business) travelers, serving to raise its average yield.” Northwest Comments, Statement of George Eads at 6.

Even if both airlines serving a route have a hub at one of the endpoints, the airline with a competitive advantage can obtain significantly higher yields. American told us, for example, that United and American charge the same fares in the Chicago-Denver/Reagan Washington National nonstop markets but that United obtains higher average fares because it has a better mix of traffic. July 29, 1998, American Meeting Notes at 3. See also Frontier Comments at 26 (the average fares charged by United in the Denver-Philadelphia market and by Northwest in the Minneapolis-St. Paul-Cleveland market are substantially higher than those charged, respectively, by US Airways and Continental).

Hub-and-Spoke Route Systems

Airlines with hub-and-spoke route systems carry most travellers in longhaul markets by flying them from their origin point to a hub, where the passengers transfer to other flights bound for their destination. This enables a hubbing airline to attract both local traffic (passengers flying between the hub and another point) and flow traffic (passengers travelling from one point to another over the hub). For example, United’s flights between its Denver hub and Portland, Oregon, attract both Denver-Portland travellers and travellers flying between Portland and points beyond Denver served by United from that hub. By combining local and flow traffic on the same flight, a hub airline can operate more flights in the spoke markets (and often can use larger aircraft, which are more efficient). The spoke points thereby receive more flights than they would if the flights carried only local passengers.

The network airlines' hub-and-spoke systems give flow passengers more connection options for travel from their origin point to their destination. Travellers in the long-haul markets benefit from increased service options, since several airlines compete for flow traffic with connections over their hubs. Portland residents flying to points in the East thus can choose between competing connecting services operated over such hubs as Chicago, Denver, Minneapolis-St. Paul, and Salt Lake City.

The network airlines' major domestic hubs are Chicago O'Hare and Dallas-Fort Worth for American; Chicago O'Hare, Denver, and Washington Dulles for United; Atlanta, Cincinnati, and Salt Lake City for Delta; Detroit, Minneapolis-St. Paul, and Memphis for Northwest; Cleveland, Houston, and Newark for Continental; St. Louis for TWA; and Charlotte, Philadelphia, and Pittsburgh for US Airways.

A network airline will have a large share of the traffic and flights at its hub. It typically will carry at least half of the local traffic at each of its hub airports. TRB Report at 74-76.

While hub-and-spoke systems benefit travellers in the flow markets (and make possible more frequent service for travellers in the local markets), they also create substantial competitive advantages for a network airline in its hub markets. Those advantages make it difficult for other airlines to compete in those markets and enable the incumbent hub airline to charge higher fares.

First, the combination of local and flow traffic enables the hubbing airline to offer more flights in all of the markets at its hub. This gives it a substantial competitive edge. Non-hubbing competitors will capture little flow traffic and so cannot operate as many flights. The airline that offers the most flights in a market typically obtains a disproportionate share of the traffic in that market, so the inability of a competitor to operate as many flights will likely reduce its ability to attract passengers for the few flights that it does operate. Levine, "Airline Competition in Deregulated Markets," at 443-444.

Secondly, since the hubbing airline serves the most destinations from the hub and offers the most flights in all or almost all of its hub markets, the hub city's residents will find its frequent flyer program more attractive than programs offered by competing airlines who serve fewer destinations and operate fewer flights from the city. Residents flying on the hub airline will accumulate award miles more quickly and have a better choice of destinations for awards. Levine, "Airline Competition in Deregulated Markets," at 452-454. And since award benefits are non-linear, residents will prefer the hub airline since they will obtain awards more quickly.

Similarly, the hub airline's travel agency override commission program will be the most attractive program for travel agencies in the hub city. An airline that dominates a city typically will structure its override commission program to leverage its dominant share of the local airline market. The airline that is most often booked by the agency will offer the most remunerative override commission program for the travel agencies in the area and thereby gain a larger share of their bookings. Levine, "Airline Competition in Deregulated Markets," at 457; General Accounting Office, Airline Deregulation: Barriers to Entry Continue to Limit Competition in Several Key Domestic Markets, GAO/RCED-97-4 (October 1996), at 15-19.

Finally, the hub airline's dominance of the local market at the hub city gives it greater name recognition. Travellers will be more likely to call that airline when they wish to book airline seats. Levine, "Airline Competition in Deregulated Markets," at 429-430. In addition, the hub airline can spread advertising costs over a greater number of markets, so it will have lower advertising expenses than will an airline serving fewer markets at the hub city. July 23, 1998 Northwest Meeting Notes at 3; September 17, 1998, Southwest Meeting Notes at 3.

Because a hubbing airline obtains these competitive advantages, its hub markets tend to have little competition. Frontier points out, for example, that United has a monopoly in almost thirty nonstop Denver markets. Frontier Comments at 44-46 (a number of other Denver markets are a monopoly for United's commuter airline affiliate). Indeed, the virtual disappearance of hubs with two hubbing network airlines suggests that the competitive advantages possessed by the larger hubbing airline make it difficult for a second airline to operate a hub at the same city. Only O'Hare now serves as a hub for two competing network airlines.

By the same token, since a hub airline can operate most efficiently in its hub markets, it will likely add new routes from its hub, not from cities that are not hubs. TRB Report at 93, n. 16. Each network airline focuses on routes that have one of its hubs as an endpoint, and it rarely serves a competitor's nonstop hub markets. U.S. Department of Transportation, Secretary's Task Force on Competition in the U.S. Domestic Airline Industry (February 1990), Executive Summary to Industry and Route Structure at 16-17. Thus, while Northwest serves both Chicago and Cincinnati from its own hubs, it would not operate nonstop Chicago-Cincinnati service when it has a hub at neither city and United and American each have a hub at Chicago while Delta has a hub at Cincinnati.

The few instances where a network airline enters a competitor's hub route seem to represent signalling – as described below in our discussion of recoupment, the airline entering another airline's hub market probably is doing so as retaliation against the latter airline's increased competition in one of the first airline's major markets. For example, American began serving the New York City-Houston nonstop market in response to Continental's operation of flights at Dallas' Love Field that created competition for American's flights from DFW. The competitive advantages enjoyed by a network airline at its hub, after all, preclude other network airlines from operating as efficiently or profitably as the hubbing airline.

Hub airlines therefore usually have market power at their hubs, as shown by hub premiums – average fares in most hub markets are substantially higher than in comparable non-hub markets. Professors Oster and Strong cite figures presented by Professor Severin Borenstein to the Transportation Research Board on January 21, 1999, that show hub premiums as high as 62 percent at Charlotte, 51 percent at Cincinnati and Pittsburgh, and 41 percent at Minneapolis-St. Paul. Oster & Strong, "Predatory Practices," at 31-32. Professor Borenstein's estimate of the hub premium is consistent with our own studies. On the other hand, little or no hub premium exists at network airline hubs that receive a significant amount of service from Southwest, such as St. Louis and Salt Lake City. U.S. Department of Transportation, The Low Cost Airline Service Revolution (April 1996) at 28-30; Oster & Strong, "Predatory Practices," at 33-34.

Other studies have also documented the existence of hub premiums. See, e.g., TRB Report at 78-80; Minnesota Planning, "Flight Plan: Airline Competition in Minnesota", at 6; Transportation Research Board, National Research Council, Winds of Change: Domestic Air Transport since Deregulation (1991), at 107-118 (but the Transportation Research Board then believed it was uncertain whether hub fare premiums resulted from the lack of competition in hub markets or from other factors).

Hub premiums have persisted over time, as shown by the table prepared by Professors Oster and Strong from Professor Severin Borenstein's data. Oster & Strong, "Predatory Practices," at 31-32. Our 1990 study of domestic airline competition demonstrated that travellers in local markets at the eight most concentrated hubs (where one airline had more than 75 percent of the enplanements) typically paid fares almost 19 percent higher than those paid by travellers in comparable markets at other cities. Secretary's Task Force on Competition in the U.S. Domestic Airline Industry, "Pricing" (February 1990), Executive Summary at 4. Hubs without a significant level of low-fare airline service had larger fare premiums in 1997 than they did in 1988. Oster & Strong, "Predatory Practices," at 33. Travellers in markets with low-fare airline

competition, on the other hand, obtain both the low fares offered by low-fare airlines and the more frequent service and wider range of destinations offered by a hubbing airline. While hubs give travellers better service, the ability of network airlines to continue operating hubs after entry by a low-fare airline indicates that the higher fares charged by network airlines in hub markets without competition reflect in part market power, not costs, demand characteristics, or service features.

A network airline with market power at a hub can obtain higher yields in the hub markets largely by limiting the capacity of its flights, with the result that business travellers willing to accept high fares will fill up most of the relatively limited number of seats offered by the network airline. The limited number of seats offered means that the network airline has little incentive to make seats available to passengers willing to fly only if they can obtain low fares. Hub markets, of course, still have frequent service, since frequent connecting banks of flights are a necessary part of hub-and-spoke operations, but they would have even more service in a competitive environment.

The Development of a New Generation of Low-Fare Airlines

As noted above, deregulation from the start has provided major benefits for travellers. A 1990 Department report, U.S. Department of Transportation, Secretary's Task Force on Competition in the U.S. Domestic Airline Industry (February 1990), Executive Summary at 1, thus stated:

[A]ir travelers have benefited from the changes brought about by deregulation by receiving more service at lower cost. Air service networks have expanded, providing more departure frequencies to more airports and travel markets. The wide use of discount fares has made it possible for more people to afford air travel.

That same report pointed out, however, that there were also "pockets of problems," particularly at some concentrated hub airports. *Ibid.* In addition, almost all of the firms that had entered the industry after deregulation had failed, and few new firms were entering the industry. As a result, when Professor Levine wrote his 1987 article on airline competition in deregulated markets, the ten largest airlines were all holdover airlines. Levine, "Airline Competition in Deregulated Markets," at 406.

Since Professor Levine wrote his article, the holdover airlines' dominance has declined. In the 1990's one low-fare airline -- Southwest -- became one of the largest airlines serving most regions of the country, and other firms entered the industry, usually with a low-fare strategy. Southwest has prospered by offering

low fares and operating multiple flights in markets using uncongested airports. TRB Report at 49-52. Southwest for some years has been the airline industry's most consistently profitable firm. As measured by the number of domestic passengers carried, Southwest is now the fourth largest U.S. airline. Markets served by Southwest have substantially lower fares than do comparable markets without Southwest service. See, e.g., Statement of Steven Morrison, Hearing before the House Aviation Subcommittee (April 23, 1988), at 2.

In recent years other firms have attempted to compete by offering relatively low fares like Southwest, although the newer low-fare airlines have not duplicated all aspects of Southwest's operating strategy. TRB Report at 52-53. This newer generation of low-fare airlines has included AirTran, Frontier, JetBlue, Sun Country, and Reno. While a number of these entrants are operating successfully as independent airlines, American has acquired Reno, and others -- Western Pacific and Kiwi, for example -- have failed.

While the low-fare airlines generally use yield management, they offer a smaller range of fares than the network airlines and impose fewer restrictions on their lowest fares. TRB Report at 30-34. The more recently-established low-fare airlines have more limited route systems than Southwest and do not have Southwest's financial strength or as much of a brand reputation. While Southwest enters new routes with frequent flights, the newer low-fare airlines often enter markets by operating relatively few daily flights. September 17, 1998, Southwest Meeting Notes at 2. Some of the newer low-fare airlines, unlike Southwest, rely on hub-and-spoke route systems.

The low-fare airlines have lower operating costs than the network airlines, except for America West and possibly the network airlines' low-fare subsidiaries. In the 1998 calendar year the total domestic operating cost in cents per available seat-mile for the network airlines, adjusted for distance, ranged from 7.737 cents for America West and 9.123 cents for Delta to 11.582 cents for US Airways. The comparable costs for the low-fare airlines ranged from 6.083 cents for Southwest to 8.626 cents for Frontier. Thus every low-fare airline had adjusted costs per available seat-mile that were significantly below the costs of any network airline except America West. To some extent an airline's costs reflect the costs of operating in the regions it serves, since operations at some airports and in some regions are significantly more costly, but these figures indicate the low-fare airlines' cost advantages.

While the network airlines do not focus on carrying low-fare traffic, several of them have developed low-cost subsidiaries that seek to compete with Southwest and other low-fare airlines for price-sensitive travellers -- Shuttle by United,

Delta Express, and US Airways' MetroJet. See, e.g., US Airways Comments; Northwest Comments, Statement by Laura Tyson at 15-16.

The services offered by Southwest and the newer low-fare airlines greatly benefit many consumers: they both give travellers access to substantially lower fares and greatly increase the size of the market by stimulating traffic. In 1997 short-haul markets (markets under 750 miles) with low-fare service had a nominal average fare of \$84, while short-haul markets without such service had a nominal average fare of \$175. Traffic in short-haul markets with low-fare service has quadrupled since 1979, while traffic in short-haul markets without such service has grown only by 48 percent since 1979. DOT White Paper at 2.

A comparison of average fares in markets of similar length shows the dramatic impact of low-fare airline competition on both fare and traffic levels. In the fourth quarter of 1999, the average one-way fare between Atlanta and Pittsburgh, a market dominated by Delta and US Airways, was \$218, while the average fare between Atlanta and Newport News, a route served by AirTran, was \$84.

Similarly, the average fare between Chicago and Cincinnati was \$252 during the fourth quarter of 1998, when Delta dominated the market, but dropped to \$124 one year later after Vanguard entered the market. The fares then compared more favorably with the average fares between Chicago and Louisville and between Chicago and Columbus, Ohio, markets dominated by Southwest, \$70 and \$92, respectively.

The low-fare service offered by Morris Air and continued by Southwest after it acquired Morris had similar effects in Salt Lake City markets. The traffic in those markets tripled, while the average fares in those markets dropped by about fifty percent when fares in other Salt Lake City markets were increasing somewhat. By late 1995 the average fares in the markets served by Morris and Southwest were only one-third the level of fares in other Salt Lake City markets. 63 Fed. Reg. at 17921, citing U.S. Department of Transportation, "The Low Cost Airline Service Revolution" (April 1996) at 11-12. In 1999 the average fares in Salt Lake City markets with low-fare service were \$106 but \$198 in Salt Lake City markets without low-fare service.

Comparable results occurred when Southwest began serving Providence in October 1996. Between 1995 and 1999, the average fares in Providence markets served by Southwest dropped by 32 percent while traffic grew by 308 percent. In other Providence markets, fares rose by 3 percent and traffic grew by 43 percent. See also Southwest Comments at 13.

In sum, low-fare airlines provide important service and competitive benefits: fare levels are much lower, and traffic levels are much higher, on routes served by low-fare airlines. DOT White Paper at 5-6, 9.

Of course, while competition by the low-fare airlines provides obvious benefits, especially for cost-sensitive consumers, consumers benefit from all forms of airline competition. Midwest Express, for example, has chosen to compete by offering service features not matched by other airlines and considered attractive by many travellers. Midwest Express has operated successfully by offering premium service at fares comparable to those charged by other airlines.

Potentially Unfair Competitive Responses to Entry by Low-Fare Airlines

While network airlines cannot practicably compete at another network airline's hub, a low-fare airline with lower costs than network airlines and effective management can compete effectively in such hub markets, which typically have relatively high fares. New service by a low-fare airline is therefore likely to be the only way that many hub markets will ever benefit from competitive airline service. Since a hubbing airline will likely have only limited competition in most of its hub markets if it can deter entry by low-fare airlines, it is profitable for an incumbent airline to attempt to eliminate actual competition if it can. As explained by Professors Oster and Strong, the low-fare airline's presence in a hub market takes away the hubbing airline's ability to charge fares above competitive levels. Oster & Strong, "Predatory Practices," at 23. If the low-fare airline becomes established in one hub market, it may well expand into other markets at the hub.

Several low-fare airlines, often supported by communities and airports, have complained that a low-fare airline's entry into a network airline's market, typically a hub market, has led the incumbent to sharply cut its fares and increase the number of seats sold at low fares (and often its capacity on the route) with the intent of making the route unprofitable for the entrant. We have received complaints about other behavior, not just pricing and capacity strategies, seemingly designed to make entry impossible or at least unprofitable. TRB Report at 87-89, 171-185. This is not surprising -- as explained by Professors Oster and Strong, airlines compete in multiple ways, not just on price and schedules. Oster & Strong, "Predatory Practices," at 21-27.

For example, low-fare airlines (and other airlines) have complained that incumbent airlines have awarded bonus override commissions to travel agencies that book the incumbent airline rather than the airline entering the market, thereby making it more difficult for the entrant to obtain bookings from those

agencies' customers. Incumbent airlines have taken other steps as well that assertedly prejudice the competitive position of an entrant airline, for example, refusals to sign joint baggage and ticketing agreements with the entrant, even though airlines typically have such agreements with most other airlines.

Incumbent airlines have assertedly refused to sublease gates and other airport facilities to entrants, even though they are not being fully used, when comparable facilities are not available from any other source. Similarly, to keep entrants from obtaining slots at slot-restricted airports, incumbent airlines have allegedly purchased the slots that come on the market. Incumbent airlines additionally "babysit" slots – they use the slots in relatively unprofitable markets in order to keep from losing them to a potential entrant.

The TRB panel agreed that incumbents could use such tactics as "limiting access to airports by restricting the availability of slots and gates; influencing CRS listings; and offering special travel agent incentives" "to the detriment of smaller rivals, possibly denying the opportunity to compete fully on the basis of relative costs and the attractiveness of their offerings." TRB Report at 89. The panel stated that this Department "has an important role in preserving and enhancing opportunities for competitive entry in the airline industry." It stated that we "should ensure that airlines are not exploiting their relationships with airports, air traffic control access, CRSs, and travel agents to hinder competition and to limit entry opportunities." TRB Report at 9.

Questionable Responses Involving Price and Capacity

The most controversial competitive responses to entry have involved sharp fare cuts, a large increase in the number of seats sold at low fares, and often an increase in total capacity. An incumbent airline will often need to cut its fares when a competitor enters the market. A low-fare airline's entry should not usually require the incumbent airline to match the new entrant's fare levels and make large numbers of seats available at those levels or to eliminate restrictions on its discount fares. Network airlines, after all, typically offer service features unmatched by most low-fare airlines.

In some cases the incumbent network airline has nonetheless responded to entry in ways that appear to be economically irrational unless the entrant exits the market or reduces its service. In these cases the hubbing airline cuts its fares and increases the availability of its lowest fares by so much that it obtains much lower revenues and profits than it would have obtained if it had chosen a more moderate response. In extreme cases the incumbent airline cuts its fares to match the new entrant's fare levels, eliminates all or most of its restrictions on discount fares, and greatly expands the availability of discount-fare seats. The

incumbent airline often adds flights as well. Traffic jumps, as always happens when low fares become widely available. The incumbent airline, however, incurs a substantial amount of self-diversion – it sells so many seats at low fares with minimal restrictions that it no longer sells significant numbers of higher fare seats (self-diversion means a reduction in revenues caused by the airline's own actions, not by its competitor's actions). Thus, although the incumbent carries many more passengers, its total revenues are well below the revenues realizable through a more moderate response to entry.

When the incumbent airline responds to entry by slashing fares and making low discount fares much more available, the new entrant airline usually cannot obtain enough traffic to sustain its service. The ready availability of low fares on the incumbent airline, which offers service features not offered by the new entrant airline and has an established reputation, dries up the traffic available to the entrant. The entrant must exit the market, and the incumbent airline then often increases its fares and sharply reduces the availability of its lowest discount fares. The entrant's exit can occur within several months of entry.

An incumbent airline, like any firm, would normally prefer to obtain as much revenue as possible for the services it has chosen to provide. The airline would be unlikely to voluntarily reduce its own revenues by charging lower fares than it could have charged unless it intended to keep travellers from booking the entrant airline.

Our investigation into competitive responses by network airlines to entry by a low-fare airline has shown that network airlines can and sometimes do respond to entry with the apparent intent of eliminating or reducing competition. One airline's internal documents clearly show its intent to eliminate new competition through fare reductions, a greatly increased availability of low-fare seats, and some added capacity. The network airline expected that it would then attract almost all discount fare travellers away from the new entrant and compel its exit. The network airline knew that it would thereby reduce its short-term revenues more than was necessary to meet the new competition, but it accepted those losses as the price to pay for regaining its market power in its hub markets.

This kind of competitive response harms consumers over the long term. In the short run the public benefits – fares are much lower and discount-fare seats are easily obtained from both airlines. Travellers can enjoy both low fares and the service features offered by the hub airline, such as more frequent flights and more attractive frequent flyer program benefits. In the long run, however, the public loses – the new entrant's competition is eliminated and fares go up to their previous levels or even higher.

A hubbing airline need not respond so aggressively if its goal is to maximize its revenues rather than eliminate competition. A hubbing airline, after all, has substantial competitive advantages that should enable it to retain higher-yield traffic. Professors Oster and Strong correctly point out that airlines compete on many service features, not just price. A network airline operates more frequent service and has an established brand. It also offers more attractive frequent flyer and travel agency override commission programs. Business travellers often choose an airline in order to obtain frequent flyer miles. General Accounting Office, Airline Deregulation: Barriers to Entry Continue to Limit Competition in Several Key Domestic Markets, GAO/RCED-97-4 (October 1996), at 18-19. The incumbent likely also has the advantage of a reputation for reliable service, whereas a new entrant would not have such a reputation. Levine, "Airline Competition in Deregulated Markets," at 473, 476-477. Finally, the hub airline's flow traffic attracted by its network operations will support its service even if it loses some local passengers to an entrant; the entrant could not capture the flow passengers unless it also operated a hub at the same city. Levine, "Airline Competition in Deregulated Markets," at 451-452. See also Spirit Reply Comments, Statement of John Haring and Jeffrey Rohlf at 9.

The record demonstrates the competitive advantages held by a hubbing airline over a new entrant, especially with respect to business traffic. Northwest cites 1997 surveys of corporate travel managers which show that fewer than half considered booking their travellers on low-fare airlines. Northwest Comments, Laura Tyson Statement at 14.

Experience in other markets demonstrates that network airlines can compete with low-fare airlines without flooding the market with low-fare seats. As stated in our proposed policy, network airlines have found ways of coexisting with low-fare competitors: "[A]t cities like Dallas and Houston, the major carriers tolerate Southwest's major presence in local markets by not competing aggressively for local passengers," for they instead "focus on carrying flow traffic to feed their networks." 63 Fed. Reg. at 17921. Frontier similarly provides examples of markets where network airlines coexist with Southwest. Frontier Comments at 27-28. In these cases the hubbing airline did not try to deny Southwest a significant share of the market by offering a large number of discount-fare seats at low fares.

In addition, network airlines do not invariably respond to entry by low-fare airlines other than Southwest by sharply cutting fares and making the low fares available on large numbers of seats. Delta has cited examples where it responded to AirTran's entry into Atlanta markets in a way that was purportedly designed to maximize Delta's profits rather than force AirTran's exit from the routes. The figures given by Delta indicate that its local traffic revenues

increased significantly after it lowered its fares and made them more widely available. Delta Comments at 12-14.

Even an airline as successful as Southwest cannot necessarily expect to obtain large profits from competing with the network airlines in their hub markets, which indicates that network airlines have substantial competitive strengths of their own in competing against a successful low-fare airline. For example, Darryl Jenkins, who opposes our proposed policy, stated that Southwest, despite its success and efficiency advantages, “deliberately avoids” confrontations with the major airlines. Darryl Jenkins Comments at 3. Southwest itself has stated, “[B]arriers to entry remain high at many concentrated airports due to competitive advantages of the incumbent carriers that potential new entrants cannot begin to match,” and “[T]hese barriers to competition are overwhelmingly the result of powerful marketing advantages and tactics used by dominant incumbent carriers to protect their concentrated markets from low-cost competitors.” Southwest Comments at 4.

Our conclusion that an incumbent airline can effectively eliminate competition through predatory-type behavior is consistent with recent economic thought. A recent article described our approach as “consistent with modern economics.” Patrick Bolton, Joseph F. Brodley, & Michael H. Riordan, “Predatory Pricing: Strategic Theory and Legal Policy,” 88 Georgetown Law Journal (August 2000) 2239, 2263. While economists for some time viewed predation as an ineffective strategy, they have reexamined the question of predation and concluded that predation is more likely to occur and to be more rational than thought earlier. See Jonathan B. Baker, “Predatory Pricing after Brooke Group: An Economic Perspective,” 62 Antitrust Law Journal (Spring 1994), 585, 589-592; “The Economics of Antitrust,” The Economist (May 2, 1998), 62, attached to Comments of Alfred Kahn. Thus, “[I]t is now the consensus view in modern economics that predatory pricing can be a successful and fully rational business strategy.” Patrick Bolton, Joseph F. Brodley, & Michael H. Riordan, “Predatory Pricing: Strategic Theory and Legal Policy,” 88 Georgetown Law Journal at 2241. “[S]ound empirical and experimental studies, as well as modern economic theory,” have shown that predation is not rare. Id. at 2249. See also TRB Report at 85-86.

Predatory-type behavior may be effective in the airline industry precisely because aircraft are so mobile and can be moved from one route to another. The mobility of aircraft was originally thought to be a guarantee that airline markets would be competitive. However, as shown, airlines incur significant sunk costs in entering a new airport, a factor which can discourage entry. On the other hand, when entry occurs, the incumbent hub airline can easily shift aircraft from other markets to increase capacity in the market served by the new competitor.

An airline that dominates a market thus can quickly expand its capacity on a route without making an irretrievable investment, since it can easily redeploy the aircraft to other markets when the entrant has been forced to exit or reduce service. Spirit Reply Comments, Statement of John Haring and Jeffrey Rohlf at 27-28. See also TRB Report at 7-8; Patrick Bolton, Joseph F. Brodley, & Michael H. Riordan, "Predatory Pricing: Strategic Theory and Legal Policy," 88 Georgetown Law Journal at 2262.

In addition, the ready availability of fare and availability information on competing airlines through the computer reservations systems facilitates an airline's ability to engage in anti-competitive conduct. The CRS's, moreover, generally sell route-by-route booking data on individual airlines to airlines participating in a system, which enables each airline buying the data to learn how many seats are being sold on its competitors by each travel agency using the system. See Patrick Bolton, Joseph F. Brodley, & Michael H. Riordan, "Predatory Pricing: Strategic Theory and Legal Policy," 88 Georgetown Law Journal at 2261-2262.

As a result, this Administration has concluded that the potential for predatory-type behavior by incumbent airlines is great enough that the Department should implement strategies, such as enforcement action, that will effectively prevent such conduct (and other conduct intended to eliminate or reduce competition).

The Decline in Airline Competition

We began this proceeding because we had seen cases where an incumbent airline responded to entry (or proposed entry) in a manner seemingly designed to reduce or eliminate competition. While we wished to eliminate unfair competitive conduct in individual city-pair markets, we also wanted to ensure that the overall industry remains competitive. If new entrants are unable to enter markets at hubs, which include several of the nation's largest cities, firms are less likely to enter the industry and smaller airlines will not expand as much.

There are signs that competition has declined in recent years, even though most markets remain very competitive. The number of routes with competition between airlines having a significant presence in the market has declined. The number of markets where at least two airlines each had at least ten percent of the traffic declined steadily from 13,890 in 1992 to 11,702 in 1998. Similarly, the number of markets where at least three airlines each had ten percent of the traffic declined steadily from 4,502 in 1992 to 3,566 in 1998. While the number of markets with at least two competitors increased in 1999, as did the number of markets with three or more competitors, each number remains significantly below those for earlier years.

In addition, travellers in some markets have benefited significantly less from deregulation. Inflation-adjusted fares have declined substantially since deregulation in long-haul markets (markets over 750 miles in length) and in short-haul markets that have low-fare airline service. The nominal average fare in all short-haul markets in 1979 was \$60. In 1997 short-haul markets with low-fare airline service had a nominal average fare of \$84, while other short-haul markets had nominal average fares of \$175. When adjusted for inflation, average fares in short-haul markets with low-fare airline service have fallen by 36 percent since 1979 and have increased by 26 percent in other short-haul markets over the same period. Passengers in the short-haul markets without low-fare airline service make up almost one fourth of all domestic passengers. DOT White Paper at 2.

The TRB panel similarly found signs indicating that the airline industry has become somewhat less competitive in recent years. From 1996 to 1998 airlines exited from more routes than they entered, although during the six-year period beginning in 1992 more routes were entered than exited. TRB Report at 41. In 1997 75 percent of travellers in shorter-haul markets (defined as markets under 1,000 miles in length) flew in markets with no more than two competitors. In contrast, only 68 percent of such travellers flew in markets with no more than two competitors in 1992. TRB Report at 69.

Furthermore, after the May 1996 ValuJet crash, new entry into the airline industry virtually stopped until we proposed our enforcement policy. No firm applied to us for the authority needed to operate scheduled passenger service with jet aircraft in 1997 or 1998 and actually began service, except for National Airlines, which applied after the proposed policy's publication. See also TRB Report at 41. Entry ceased around the time when, according to the low-fare airlines, network airlines became much more aggressive in responding to competition by the low-fare airlines. Frontier Comments at 3-4. After we published our proposed policy, several low-fare airlines began operating, including Access Air, Sun Country (Sun Country had been operating only charter service until 1999), and Jet Blue. Our publication of our proposed policy and the Justice Department's suit against American may have encouraged the renewed interest in entering the industry. The number of passengers in markets with low-fare airline service declined in 1997 for the first time in recent years, but in 1999 both the absolute and relative number of such passengers reached record highs. This suggests that our proposed guidelines and the Justice Department suit have benefited competition.

Market Power in Airline Markets

Experience with the deregulated airline industry has shown that in some markets, especially short-haul hub markets, an incumbent airline that forces the exit of a new competitor will likely be able to charge fares above competitive levels for quite awhile. This would not happen if entry into all airline markets were easy and relatively costless, as was widely predicted when the industry was deregulated.

As discussed earlier, entry is instead difficult in a number of markets dominated by one or two airlines, particularly short-haul markets at hubs. Various factors – the unmatched advantages offered by the dominant airline’s more frequent flights and its more attractive override commission and frequent flyer programs, for example – make it difficult for airlines to compete in another airline’s hub markets. An airline without an offsetting competitive advantage of its own, such as the low costs of the low-fare airlines, will find it difficult to operate profitably in such a market. Exclusionary conduct in hub markets, accordingly, is of great concern due to the hubbing airline’s ability to charge supracompetitive fares if it can eliminate one competitor, for airlines will in any event be reluctant to enter a spoke market at that airline’s hub.

The incumbent airline in such markets can safely assume that the forced exit of an entrant will not be followed by another airline’s entry. If the incumbent airline can force an entrant to withdraw, it will regain the ability to charge fares higher than the fares charged in comparable markets where no airline has market power. The incumbent airline’s exclusionary response to entry thus would be rational because the airline could recoup the revenues lost through its efforts to eliminate the entrant.

An incumbent airline that successfully eliminates competition in one of its markets obtains benefits in its other markets. As explained by Professors Oster and Strong, it signals to all would-be entrants that it will respond so aggressively to entry in any of its spoke markets that entry will likely be unprofitable. Oster & Strong, “Predatory Practices,” at 35-36. That will discourage other airlines from even trying to enter one of its hub markets. Alternatively, the entrant may focus on predominantly leisure markets rather than the predominantly business markets of greater importance to network airlines. Spirit Comments, Statement of Mark Kahan before the House Judiciary Committee at 2. The fear of the incumbent airline’s likely reaction to entry may cause future entrants to enter one of the incumbent airline’s markets on a small scale in the hope of avoiding an aggressive response. See, e.g., Sun Pacific Comments at 9 and Reply Comments at 4. Sun Pacific thus states that, because of the possibility of predatory responses to entry, a new entrant “never enters the market in the first place, or it keeps its schedules meager so as to “fly under the radar’ of the incumbent.” Sun Pacific Reply at 4.

The incumbent airline thus obtains advantages from its aggressive response to entry in other markets, not just the market where it successfully forces an airline's exit. TRB Report at 85-86. Signalling works in the airline industry, judging by the airlines' conduct. The Justice Department filed an antitrust suit against the major airlines because they were unlawfully using their electronic system for exchanging fare information as a means of negotiating fare changes. United States v. Airline Tariff Publishing Co. et al., Public Comments and Response on Proposed Final Judgment, 58 Fed. Reg. 27338 (May 7, 1993). In other cases, a network airline has entered a competitor's hub market to retaliate against the latter's increased competition in one of the first airline's major markets and to encourage the second airline to end that competition. For example, American's introduction of service from New York City to Houston's Hobby Airport was widely seen as a response to Continental's introduction of service at Dallas' Love Field; Love Field services compete with American's hub at Dallas-Fort Worth International Airport, while flights to Hobby compete with Continental's flights at its hub at Houston's Bush Intercontinental Airport. Air Carrier Ass'n Reply Comments at 15-16; Woodside Travel Trust Comments at 9. Similarly, Continental's chairman has stated that United began operating flights between Newark and Boston as retaliation for Continental's decision to offer better discount fares in the Newark-Los Angeles/San Francisco markets. Continental replied by entering the Los Angeles-San Francisco market, an important United market. This caused United to eliminate most of its Newark-Boston flights. Air Carrier Ass'n Comments at 21. See also Spirit Reply Comments, Statement of John Haring and Jeffrey Rohlf's at 29 (a network airline that increases competition in one of the more profitable markets of a second network airline will likely face retaliatory entry into one of its own more profitable markets). These cases suggest that airlines believe that signalling is effective and that conduct that would otherwise be irrational will be attractive because it persuades a competitor to tone down its competition.

Both because entry may not be probable in hub markets and other markets dominated by an incumbent airline, and because unfair competitive actions designed to eliminate competition in one such market will likely deter competition in similar markets, an incumbent airline can likely recoup the revenues lost in an effort to eliminate competition. We therefore disagree with the network airlines' argument that recoupment is not possible in airline markets. The network airlines base their argument in part on some of the examples of apparent exclusionary conduct given in the DOT White Paper, since they note that Vanguard still flies from Kansas City to Dallas-Fort Worth and Minneapolis-St. Paul and that ProAir entered the Detroit-Philadelphia market after Spirit's exit. See, e.g., United Reply at 11 and Dennis Carlton and Gustavo Bamberger Statement at 13.

We think that recoupment would be likely. ProAir entered the Detroit-Philadelphia market in May 1998, but did so twenty months after Spirit's exit on October 1, 1996. ProAir has now suspended all service, although it plans to resume operations. Moreover, no low-fare airline has entered the Detroit-Boston market, from which Spirit also withdrew. Northwest itself states that no competitor has entered eleven of the nineteen Northwest hub routes that a low-fare airline served and then exited since 1990. Northwest Reply Comments at 24. While Vanguard continues to fly between DFW and Kansas City, Vanguard ended its DFW-Wichita service after American's aggressive response to Vanguard's entry into the Kansas City-DFW market. Furthermore, even if entry continues to occur on some routes, the signalling effect of the incumbent's overly aggressive competitive response discourages entry on other routes and encourages new competitors to enter on a smaller scale.

If predatory behavior occurs, it will operate as a barrier to entry, Patrick Bolton, Joseph F. Brodley, & Michael H. Riordan, "Predatory Pricing: Strategic Theory and Legal Policy," 88 Georgetown Law Journal at 2265:

[S]uccessful past predation can itself operate as an entry and reentry barrier, particularly where reputation effects are present. In such cases, the would-be entrant anticipates that any attempt to enter the market will evoke a predatory response from the incumbent. Anticipating that response, the firm declines to enter.

See also id. at 2302.

The Network Airlines' Challenges to Our Rationale

We proposed a policy because incumbent airlines in markets dominated by one or two airlines can obtain and maintain market power if they can prevent or terminate entry by a competitor, and because we have seen markets where the incumbent airlines seemingly engaged in conduct that was designed to eliminate competition, since the conduct appeared to be economically irrational if the entrant were not eliminated.

The network airlines along with some other commenters generally contend that airline markets are inherently so competitive that no airline would rationally engage in anticompetitive practices like predation and that the examples of apparent anticompetitive behavior cited by us actually represent vigorous competition rather than efforts to eliminate competition. We have considered the arguments of the parties who opposed our proposal but do not find them convincing.

The Contention That Fares in Hub Markets Are Not Relatively High

As discussed above, we concluded on the basis of our investigations and analyses that in some types of markets, primarily short-haul markets at hubs, an incumbent airline that successfully excludes entry by one airline can reasonably expect that no other airline will enter. In addition to the competitive advantages held by hubbing airlines cited by us, we noted that fares in hub markets without low-fare airline competition are typically significantly higher than fares in comparable non-hub markets. Others have made similar findings, as discussed above. The TRB stated, for example, “For nearly two decades now, the literature consistently has shown higher fares in city-pair markets that include a concentrated hub as either the origin or destination point; this especially applies to short-haul markets in which one or two hubbing carriers handle most of the local traffic.” TRB Report at 72.

Network airlines contend that there is no significant hub fare premium or that any difference in fares is justified by the better service offered hub travellers and by the greater proportion of business travellers in hub markets. Their arguments are unpersuasive.

A hub airline faces only limited competition in most of its nonstop hub markets, although connecting service in longhaul markets provides some discipline for the nonstop fares. As a matter of economic theory, a firm will ordinarily charge supracompetitive prices when it has no competition (this is not true in industries where the threat of potential entry compels incumbent firms to offer low prices, but potential entry does not significantly limit airline fares). The network airlines themselves have relied on this principle by arguing that our proposed policy would cause low-fare airlines to charge higher fares by limiting the network airlines’ ability to lower their own fares in response to entry by a low-fare airline. Two network airlines thus point out that Vanguard raised its fares between Minneapolis-St. Paul and Kansas City when a strike at Northwest eliminated its major competitor on the route. American Additional Reply at 6; Northwest Reply Comments at 37-38. A Department study similarly suggested that Southwest would raise its fares in markets where it had no effective competition. U.S. Department of Transportation, The Airline Deregulation Evolution Continues: The Southwest Effect, at 7. We have no reason to believe that a network airline would behave differently in hub markets where it has no competition. We therefore expect fares to be higher in short-haul hub markets that lack competition.

In addition, the parties who object to our findings on the market power possessed by a hubbing airline neither dispute the substantial competitive advantages held by an airline at its hub nor seriously claim that a network

airline can easily enter a second airline's hub markets, except on routes from the first airline's hubs. Northwest itself asserts that the hubbing airline has substantial competitive advantages on a spoke route over non-hubbing airlines. Northwest Comments at 28. Northwest nonetheless challenges the existence and relevance of hub fare premiums. Northwest Comments at 15-18 and Eads Declaration. Northwest claims both that hub fare premiums are small or non-existent and that they reflect consumer demand and service benefits, not market power. We find that Northwest has failed to show that significant fare premiums reflecting market power do not exist at hubs without low-fare airline service.

Northwest cites the testimony given by Professor Steven Morrison at the April 23, 1998, Senate aviation subcommittee hearing. Professor Morrison stated that fares at concentrated hub airports are on average lower than fares at other airports not served by Southwest, although higher than fares at airports served by Southwest. Northwest Comments, Eads Statement at 17-18. The aggregate numbers cited by Northwest hide the impact of low-fare airline service. The figures calculated by Professor Morrison for individual hubs in fact support our findings. In calculating the aggregate figures, Professor Morrison used several hubs – Salt Lake City, Denver, St. Louis, and Detroit – that are dominated by one network airline but have a significant level of low-fare airline service. The inclusion of these hubs in his aggregate calculations makes the data less useful for analyzing individual markets. His data for hubs without low-fare service are consistent with our findings. As he stated, his data indicated that fares at several such hubs – Pittsburgh, Minneapolis-St. Paul, Cincinnati, and Charlotte – are significantly higher than fares at other airports not served by Southwest. Morrison Testimony at 3 and Figure 2. And at Salt Lake City and St. Louis, fares are relatively high in the markets not served by Southwest or another low-fare airline.

Delta claims that its fares cannot be too high because ninety percent of its passengers travel on discount fares. Delta Comments at 6. This claim does not show that airlines do not charge supracompetitive fares in markets without competition, such as many hub markets. Whether or not most Delta passengers travel on discount fares, the fares in Delta's hub markets are significantly higher than its fares in comparable non-hub markets, except on routes where Delta competes with a low-fare airline like AirTran. While few of its passengers pay the standard coach fare, the discount fares offered by Delta in markets without competition are significantly higher than the fares offered in competitive markets.

We also cannot agree with the claims that hub fare premiums reflect the nature of the demand at hub cities and the costs of providing hub service. Hub cities with a significant level of low-fare airline service – Atlanta and Salt Lake City, for

example – have low fares on the routes served by a low-fare airline and the numerous flights and connecting banks typically offered by network airlines. Travellers at these cities benefit from both the services offered by the hubbing airline and the low fares attributable to competition from the low-fare airline. That travellers at these cities have low fares – and travellers at hubs without low-fare airline competition do not have low fares – shows that fare levels at hub cities reflect competition, not the inherent characteristics of the service offered by hubbing airlines and the nature of the demand at hub cities.

Northwest therefore errs in claiming that the higher fares in hub markets largely reflect the higher quality of service provided by the hub airline and the willingness of business travellers to pay more for superior service. Northwest Comments at 18. We recognize that business travellers benefit from the hubbing airline's more frequent service, but the fare premium does not primarily result from the higher level of service. In markets where network airlines have low-fare airline competitors, the fare premium either disappears or is much smaller. The network airlines have not claimed that the service provided by a hubbing airline at such cities is worse than the service provided by hubbing airlines at cities without low-fare airline competition. The quality of the hub airline's service may be better in markets where the hubbing airline competes with a low-fare airline. It is therefore the presence or absence of low-fare airline competition that determines the fares, not the demands of travellers for superior service.

Northwest and American contend that hub fare premiums largely reflect the mix of traffic at hub markets. They allege that the fares are higher because flights at hubs carry a larger proportion of non-discretionary business travellers, who pay higher fares than discretionary travellers but benefit from the frequent service and other features created by hub operations. Northwest Comments, Statement of Dr. George Eads at 4-5; American Comments at 41. We cannot agree. Entry by low-fare airlines in all kinds of markets has shown that their low fares will greatly increase the number of leisure travellers, who gain access to more affordable airfares (of course, the fares charged business travellers will also decline when low-fare airline entry occurs, and service increases). High hub fare premiums discourage many leisure travellers from flying. A hub airline with market power will use its yield management system to greatly limit the number of seats available to travellers interested in obtaining the airline's low discount fares and to reserve a larger portion of its seats for travellers, mainly business travellers, willing to pay high fares to obtain a seat. As a result, a larger portion of the airline's customers will be business travellers.

In addition, the contention that hub markets have higher fares because hubs have more business travellers is belied by the experience of three cities that ceased to be hubs. The TRB panel noted that fares at Dayton, Raleigh-Durham, and

Nashville declined after these cities stopped being hubs. Presumably changes in the demand for business travel at these cities did not cause these changes in fares. TRB Report at 76.

We also wish to comment on the hub fare study prepared by Professors Darryl Jenkins and Robert Gordon and funded by Northwest, "Hub and Network Pricing in the Northwest Airlines Domestic System." The study was presented at an October 21, 1999, House Aviation Subcommittee hearing. The study compared the fares charged by Northwest in its nonstop hub markets with its fares in markets served by connecting flights over one of its hubs. The study purportedly shows that Northwest charges higher fares in the competitive markets than it does in its monopoly markets.

This study has not convinced us that hub fare premiums do not exist. The study's methodology prevents us from accepting it as valid evidence that airlines do not charge higher fares in hub markets. First, the study does not distinguish between hub markets with and without low-fare airline competition. Low-fare airlines serve a number of markets at Northwest's hubs, particularly Detroit, and Northwest's fares in those markets should be significantly lower than its fares in its other hub markets. Secondly, the study made no adjustment for density. Differences in density significantly affect fares, for fares are normally lower in denser markets. Northwest's connecting markets over its hubs tend to be much less dense than its nonstop hub markets. Our own analysis of Northwest's reported data show that, adjusted for density, Northwest's hub fares are substantially higher than its fares for passengers connecting over a hub.

We have also been unable to test the study's validity. The study's conclusions depend on its regression analysis, but the study never explains how that analysis was done. The study additionally made unexplained adjustments in the data. For example, the study does not treat a connecting passenger that traveled to or from the hub on a Northwest commuter airline as a passenger connecting over the hub. Instead, the study treats such passengers as local hub passengers for the Northwest flight and allocates the fare paid by the passenger between the Northwest flight and the Northwest commuter flight under an unexplained formula.

Several of the study's statements are unpersuasive. The study, for example, notes that a larger share of passengers in Northwest's hub markets pay the higher unrestricted fares than do its passengers in the connecting markets. "Hub and Network Pricing" at 14. That a smaller share of hub passengers travel on the discount fares suggests to us that Northwest limits the availability of the lower fares in markets where it has no competition, as would be expected. Professors

Jenkins and Gordon nonetheless contend that market power cannot be responsible for that result, because 86 percent of Northwest's discount fares are available to travellers in hub markets thirty days before the date of travel compared with 88 percent of those fares being available to travellers in the connecting markets thirty days before the date of travel. *Id.* at 17. The availability of those fares thirty days in advance of travel says nothing about their availability on days closer to the date of travel or about the number of seats allocated for discount fares at any time in hub markets as compared to non-hub markets.

We have twice asked Professor Jenkins to provide us a detailed description of their methodology but have not obtained that information. We therefore cannot judge the validity of its assumptions and formulas. The study's conclusion, moreover, seems implausible – a rational firm will presumably charge higher prices in its monopoly markets than it would in its comparable competitive markets.

As a result, like most of the analysts who have considered the issue, we believe that fares are higher in hub markets without low-fare competition than they are in comparable non-hub markets.

The Contention That Network Airlines Must Match the Fare Levels and Discount-Seat Availability Offered by Low-Fare Airline Entrants

The network airlines claim that aggressive competitive responses to entry by a network airline are rational – assertedly the incumbent will incur heavy traffic losses if it does not match the entrant's fares and make low discount fares available on a large number of seats. We find this claim unpersuasive. We recognize that the incumbent airline must respond to the entrant's lower fares in some way, but we do not agree that it must make a large number of its seats available at the same fares offered by the new competitor, and still less do we agree that the incumbent must add capacity on the route (either by adding flights or using larger aircraft for its existing flights).

The network airlines claim that their capacity increases are necessary to meet the greater demand created by their fare cuts. See, e.g., Northwest Comments, Statement of Dr. Laura D'Andrea Tyson at 24-25. This explanation is implausible. Network airlines have failed to show that increasing capacity and the availability of discount-fare seats to meet the demand for low-fare travel and eliminating restrictions on discount fares become rational goals after entry by a low-fare airline but not before entry. *Cf.* Alfred Kahn Comments at 19-20. As discussed above, the network airlines (except for their low-fare subsidiaries) traditionally do not focus on offering fares and seats to attract travellers willing

to pay only low fares. Although they offer many discount-fare seats, they focus on attracting travellers willing to pay higher fares for unrestricted tickets, frequent flights, and other advantages. See, e.g., July 29, 1998, American Meeting Notes at 1-2. Network airlines use yield management to limit the number of seats sold at discount fares, because they do not wish to meet that demand in the absence of low-fare airline competition, even in markets with competition from other network airlines. Spirit Reply Comments, John Haring and Jeffrey Rohlf, “Public Policy to Deter Exclusionary Practices in the Airline Industry,” at 13-14; Alfred Kahn Comments at 19-20.

The network airlines further assert that an incumbent airline must respond with deep fare cuts and a large increase in the availability of discount seats to entry by a low-fare airline since the latter is allegedly capable of taking away all of the incumbent’s local traffic. See, e.g., ATA Reply Comments, Reply Statement of Janusz Ordover and Robert Willig at 8 (Vanguard’s unfilled seat capacity on the Kansas City-Minneapolis-St. Paul route meant that Vanguard “was in a position to divert to itself from NW most, if not all, of the local traffic on the route”); Northwest Reply Comments, Statement of Michael Carnall at 19.

This assertion ignores the reality of the market. The claim that the existence of seats offered by a low-fare airline necessarily will cause the incumbent airline to lose a large share of its traffic is unconvincing. Incumbent airlines will keep much of their traffic due to their service features that are important to many travellers, especially business passengers, such as attractive frequent flyer programs and more frequent flights, and their reputation for good service. The network airlines themselves justify hub fare premiums by contending that the superior service offered by the hubbing airline makes business travellers and others willing to pay the higher fares. Northwest Comments, Statement of George Eads at 4-5. In addition, the corporate fare discount programs offered by dominant airlines typically require a large share of the corporate customer’s travellers to use that airline in order to qualify for the discounts, with the result that such corporate travellers will be unlikely to use the services of a new entrant. And the established airline will have a reputation for providing service that cannot be matched by a small airline just beginning service to a city. See also July 28, 1998, Continental Meeting Notes at 1 (Continental’s response to entry depends on the relative quality of the entrant’s service).

Thus the mere existence of seats offered by a competitor does not guarantee that all travellers will book that airline, even if it has lower fares. For example, in one case cited by Professors Oster and Strong, American’s entry into the Dallas Love Field-Austin market dominated by Southwest, Southwest continued to carry a large majority of the traffic even though American offered somewhat lower fares on the Love Field route. Oster & Strong, “Predatory Practices,” at 13-14.

Experience demonstrates that a network airline can attract a substantial number of passengers, especially business travellers, even if a low-fare airline offers lower fares. We therefore are not persuaded by Northwest's statement that the service features ordinarily preferred by business travellers make no difference when a competitor offers a lower fare. July 23, 1998, Northwest Meeting Notes at 2. Thus, for example, during the first quarter of 1996, when Spirit entered the Detroit-Philadelphia market and Northwest did not slash fares in response, Northwest carried more travellers paying fares above \$300 than it had carried in the last quarter of 1995, although they tended to pay somewhat lower fares. The average yield obtained by Northwest and US Airways, the other hubbing airline in the market, increased, since Spirit's service primarily attracted travellers paying low fares. In other words, those aspects of Northwest's service sought after by its higher-fare passengers continued to make them patronize Northwest, despite Spirit's low fares. See also Spirit Reply, Statement of John Haring and Jeffrey Rohlf's at 25. Pro Air's initial inability to attract any General Motors customers despite the airline's base in Detroit additionally indicates the competitive advantages held by the hubbing airline. ProAir Reply Comments at 6.

Moreover, as noted, above, United obtains higher yields than American in markets dominated by United. And Frontier has cited nonstop markets served by one network airline where that airline was able to charge significantly higher average fares than another network airline that entered the market. Frontier Comments at 26. Southwest's entry into other nonstop routes served by a network airline did not prevent the network airline from obtaining higher average fares than Southwest. Id. at 27-28.

Several of the network airlines base their claim that they are entitled to both match an entrant's low fares and increase the availability of low-fare seats on the extraordinary contention that they need to preserve their market share in their local hub markets. United, for example, states, "Because local traffic makes an essential contribution to the profitability of these segments, any diversion of the major carriers' traffic to the entrant could jeopardize the route's economic viability." United Comments at 19 (emphasis added). Delta similarly asserts, Delta Comments at 11:

By reducing its fares, and/or matching the new entrant fare, the incumbent is seeking to retain traffic that might otherwise be diverted from the major carrier to the new entrant. The major carrier cannot rely only on product-differentiated service factors, but must also compete directly on price or risk losing traffic and market share to the other carrier.

The implied claim that an incumbent airline is entitled to keep all of its traffic and even its market share should not be a goal of public policy. Nonstop hub markets typically are, as shown, monopoly markets. We cannot agree that a hub airline is entitled to respond in a way which denies the new competitor any of the incumbent's traffic or market share. This is particularly true where the network airline would deny access to a demand sector that it had not focused on serving.

Similarly, we see little validity to the contention by some network airlines that their responses must take into account the likelihood that a new entrant will increase its presence over time. See, e.g., ATA Comments at 16; Northwest Comments at 42-45. Incumbent airlines usually do not significantly change their current fares and schedules in response to anticipated future changes in a competitor's service pattern, because the incumbent can quickly adjust its operations when the competitor puts its own changes into effect. Levine, "Airline Competition in Deregulated Markets," at 451-452. The allegation that incumbents must take into account future capacity increases by new entrants implies that incumbents seek to ensure that an entrant never obtains a significant share of the market. This is not a legitimate goal.

The network airlines' contention that they must both match the low-fare airline's fares and greatly increase the availability of discount-fare seats is additionally belied by their responses to entry by Southwest, a more formidable competitor than more recently established low-fare airlines. Oster & Strong, "Predatory Practices," at 13, n. 12. Southwest presents more of a competitive threat, given its established reputation for good service and its frequent flights. As a logical matter an incumbent airline competing on the merits should respond more vigorously to the airline that presents the greater competitive threat. Southwest's entry into a market should prompt a more vigorous response than entry by a newer low-fare airline. Cf. ATA Reply Comments, Reply Statement of Janusz Ordover and Robert Willig at 20-21.

In some cases, as would be expected, the incumbent airline's response has reflected the strength of the entrant – an entrant that offers more service will cause the incumbent to respond with lower fares. U.S. Department of Transportation, The Low Cost Airline Service Revolution (April 1996) at 13-15 (Delta initially cut fares in Atlanta markets less than it cut fares in Salt Lake City markets because ValuJet, the competitor at Atlanta, presented less of a threat than Morris and Southwest, the competitors at Salt Lake City). But in other cases network airlines have responded much more aggressively when a low-fare airline other than Southwest begins competitive service. When an incumbent airline sharply cuts fares and increases the availability of discount-fare seats in

response to entry by a newer low-fare airline, but not to entry by Southwest, the airline's apparent goal would be the elimination of the new competition.

Except for Northwest, network airlines usually do not respond very aggressively when Southwest enters a hub market. Frontier Comments at 27-28; September 17, 1998, Southwest Meeting Notes at 2. In proposing our policy, we pointed out that at Dallas and Houston – cities where Southwest has extensive operations -- the hubbing network airlines focus on carrying flow traffic and passengers willing to pay higher fares for premium service. 63 Fed. Reg. at 17921. Those airlines – American and Continental – have not disputed our statement nor demonstrated that they always respond to entry by Southwest as they do to entry by other low-fare airlines.

Slashing fares and greatly increasing the availability of discount-fare seats is an effective tactic against a new entrant airline that lacks Southwest's financial strength and extensive route system, since the new entrant airline is much less able to withstand the losses caused by the incumbent's competitive response. Among other things, low-fare airlines often have difficulty in obtaining adequate capital. ProAir Comments at 5; Sun Pacific Comments at 7, 8, 16, 18. Most hubbing airlines do not use competitive responses designed to force Southwest to exit since they usually would not work. Trying to eliminate Southwest through fare reductions and large increases in the availability of low-fare seats would be unlikely to succeed (however, an aggressive response could well deter Southwest from entering other hub markets, and Northwest seems to have discouraged Southwest from entering two of its hubs, Minneapolis-St. Paul and Memphis). Southwest has greater staying power than most of the newer low-fare airlines and a stronger financial position than most, if not all, of the network airlines. In addition, Southwest typically enters a market with a substantial level of service, thereby undercutting the incumbent's usual advantage of offering many more flights.

The Contention That Aggressive Network Airline Responses to Entry Are Not Anticompetitive

Network airlines additionally assert that a competitive response will be legitimate, even if it involves adding capacity in a market, as long as the incumbent airline's load factors remain stable or increase. See, e.g., ATA Comments, Statement of Janusz Ordover and Robert Willig at 27. Focusing on the airline's load factors is mistaken. Whether an airline's service in a market contributes to its overall profits depends on the fares charged for its seats, not just on the percentage of seats sold. An airline could always increase its load factor by giving away tickets. If the incumbent airline sells so many seats at very low fares that it reduces its own revenues by much more than it would with a

more measured response, the airline's response will be economically irrational, even if it maintains high load factors, unless it eliminates the competition. A business' success, after all, depends directly on its profitability, not on its volume. Increased sales in one market usually will not benefit a firm when the firm could have earned higher profits in another market.

Northwest asserts that it considers the same factors in developing its response to entry in one of its markets without regard for whether the new competitor is a network airline, Southwest, or another low-fare airline. Northwest Comments at 48. On this basis Northwest contends that its responses cannot be designed to eliminate competition, since Northwest presumably could not force Southwest to exit a market.

While Northwest may well respond as aggressively to entry by Southwest as it does to entry by any other low-fare airline, that fact alone does not prove that Northwest's responses are legitimate. Southwest, after all, did withdraw from one Detroit market due to Northwest's response (in that case due to Northwest's override commissions). General Accounting Office, Airline Deregulation: Barriers to Entry Continue to Limit Competition in Several Key Domestic Markets, GAO/RCED-97-4 (October 1996), at 16. More importantly, Northwest's conduct could suggest that Northwest believes that a combination of sharp fare cuts and significant capacity increases will eliminate entry by any new competitor, even Southwest.

There are indications that Northwest's responses to entry may have discouraged competition at its hubs. One of Northwest's hubs – Minneapolis-St. Paul -- had relatively little entry until 1999, when Sun Country began operating scheduled service from Minneapolis-St. Paul. Southwest, moreover, has thus far chosen not to enter Minneapolis-St. Paul or Memphis, both Northwest hubs, even though both cities have high fares and Southwest has a major presence in nearby cities like St. Louis. Although Southwest has extensive operations at Detroit, Southwest's unwillingness thus far to enter the other two Northwest hubs indicates that Northwest's aggressive responses to entry may make Southwest consider other markets more attractive than Minneapolis-St. Paul and Memphis markets.

Northwest provides statistics allegedly showing that the likelihood that a new entrant will remain in a Northwest hub market is unrelated to the type of competitive response made by Northwest, since exit was less likely to occur in markets where Northwest added flights or matched fares than it was in markets where it did not. Northwest Comments at 30-32. Northwest does not say, however, whether it accompanied its matching of fare levels with a sharp increase in the availability of low discount-fare seats. Even if Northwest's

statistics reflect the airline's general experience, they do not show that Northwest never used sharp fare cuts and capacity increases in any individual market to eliminate a new competitor. The circumstances of Northwest's response to Spirit's Detroit-Philadelphia service, for example, suggest that Northwest's response forced Spirit's exit and was designed to do so.

The Competitive Enterprise Institute ("CEI") has submitted theoretical arguments that predation is not a rational strategy in the airline industry. In essence CEI argues that predation is foolish because any competitor has effective counterstrategies that will thwart the predator's ambitions. CEI Comments at 5. We think CEI's arguments do not take into account the nature of the airline industry. Professor Levine and others have shown that predation is a rational strategy. The Justice Department's complaint against American alleges, moreover, that American's internal documents reflect that airline's management's belief that predation was a rational and effective strategy for maintaining American's market power in DFW markets. CEI's assertions are also contrary to recent economics thinking. See, e.g., Patrick Bolton, Joseph F. Brodley, & Michael H. Riordan, "Predatory Pricing: Strategic Theory and Legal Policy," 88 Georgetown Law Journal.

CEI believes that the prey can force the incumbent airline to sell more seats at a loss by limiting its own output. CEI Comments at 6. As explained by Professor Levine, such a response by the entrant will only worsen its own position in the market. Levine, "Airline Competition in Deregulated Markets," at 476. And, as noted above, an incumbent hubbing airline's flights in a spoke market are also supported by flow traffic, a source of revenue unavailable to an entrant.

CEI also assumes that an entrant airline will be able to finance any losses as easily as the incumbent. CEI Comments at 5-6. We doubt that a new entrant airline could obtain the financing necessary to withstand low load factors, particularly if it operates in a handful of markets while the incumbent operates in many. See Levine, "Airline Competition in Deregulated Markets," at 472; Oster & Strong, "Predatory Practices," at 36. In many cases the predator firm will have greater access than the prey to the funds needed to finance losses. Patrick Bolton, Joseph F. Brodley, & Michael H. Riordan, "Predatory Pricing: Strategic Theory and Legal Policy," 88 Georgetown Law Journal at 2285-2296.

CEI additionally predicts that any firm buying a bankrupt entrant's assets would use them in the same market, since the incumbent would be charging high fares. CEI Comments at 10. It is more likely that a buyer would shift the assets to other markets where aggressive competitive responses are less likely. And CEI errs in believing that recoupment would be impossible, a belief based on the assumption that other airlines will enter a route if one entrant is forced to exit.

CEI Comments at 23-24. As discussed above, future entry is not that likely. In sum, the counterstrategies proposed by CEI are unlikely to succeed, and the prey's assets are unlikely to be used by another entrant in the same market. See Patrick Bolton, Joseph F. Brodley, & Michael H. Riordan, "Predatory Pricing: Strategic Theory and Legal Policy," 88 Georgetown Law Journal at 2222-2228.

Frequency of Apparent Unfair Exclusionary Conduct

We have seen a number of cases where an incumbent airline crafted its response to entry with the apparent goal of eliminating competition, since the response appears to be economically irrational unless it forces the entrant to end or reduce its service. On the basis that such conduct assertedly rarely occurs, the network airlines contend that there is no systemic problem in the airline industry and so no need for us to adopt enforcement standards on airline competition under section 411. See, e.g., United Reply at 11-13.

Unfair exclusionary conduct seems to be more common than claimed by network airlines. The Department, however, would be justified in taking action against competitive responses designed to eliminate competition and create market power, even if incumbent airlines rarely engaged in such conduct. Professor Alfred Kahn accordingly endorses our approach even if the kind of competitive response of concern to us is not typical. Alfred Kahn Comments at 2-3. But, if the network airlines are correct in claiming that the type of conduct of concern to us hardly ever occurs, enforcement action like that we had proposed would have little impact on the industry – and thus would affect the network airlines' scheduling and fare decisions only in rare cases.

United, moreover, has misstated the basis for our proposal by claiming that we proposed the policy because we found that network airlines "systematically" engage in predatory-type conduct. United Reply Comments, Dennis Carlton and Gustavo Bamberger Statement at 3. On that ground United suggests that we cannot rationally adopt a final policy without conducting a systemwide review of the industry. United Reply at 15-16. To the contrary – we proposed a policy to address specific cases of potential unfair competitive conduct, not to reshape the industry. We never intended to generally regulate responses to entry.

The network airlines, however, have understated the seriousness of unreasonably aggressive competitive responses. First, driving a new entrant from one market deters entry in other markets (or causes entry to occur on a smaller scale). The statistical studies submitted by the network airlines would not pick up these effects. Their studies, moreover, erroneously conclude that potentially exclusionary competitive responses hardly ever occur. We have identified several such instances as discussed below. Frontier has provided

potential additional examples. Frontier Comments at 28-34. The Justice Department's complaint against American alleges on the basis of internal American documents that American had adopted a strategy of using responses to low-fare airline entry at DFW that would eliminate such competition and that American carried out that strategy against several such airlines. The low-fare airlines have repeatedly maintained that unfair competitive responses by major airlines are a substantial barrier to their growth and success. See, e.g., Air Carrier Ass'n Comments at 26.

Michael Levine, a former Government and airline official as well as an academic, stated a dozen years ago that "apparent predation attempts have been plentiful." Levine, "Airline Competition in Deregulated Markets," at 417. Our analysis is consistent with his. He similarly described an incumbent's possible predation strategy as follows, Levine, "Airline Competition in Deregulated Markets," at 476:

The essence of the strategy is simple. Match, or better yet beat, the new entrant's lowest fare with a low fare restricted to confine its attractiveness to the leisure-oriented, price-sensitive sector of the market. Match business-oriented fares and offer extra benefits to retain the loyalties of travel agents and frequent flyers. Add frequency where possible, to "sandwich" the new entrant's departures between one's own departures. Make sure enough seats are available on your flights in the market to accommodate increases in traffic caused by the fare war. In short, leave no traveler with either a price or a schedule incentive to fly the new entrant.

If the new entrant attempts to lower prices . . . , the incumbent matches, no matter how low the fare. The object is to reduce trial and to subject the new entrant to a prolonged period of operation at low load factors. This strategy saps the entrant's working capital while inhibiting trials that would disseminate favorable information about the new entrant.

This Administration's conclusion that predatory-type behavior occurs often enough in the airline industry to justify Department action on the issue is consistent with the most recent studies and analyses conducted by economists. As discussed above, economists now believe that predatory pricing is a successful and rational business strategy that is more common than believed in earlier years. Patrick Bolton, Joseph F. Brodley, & Michael H. Riordan, "Predatory Pricing: Strategic Theory and Legal Policy," 88 Georgetown Law Journal at 2241, 2249.

The evidence allegedly showing that unfair exclusionary conduct rarely if ever occurs is unpersuasive. United's reply comments include statements by Professor Dennis Carlton and Doctor Gustavo Bamberger that the type of competitive response deemed exclusionary by our proposed policy has rarely occurred. Their study, however, omits any case of successful predatory-type behavior if the new entrant exited before obtaining a five-percent market share in the third quarter of any year. September 7, 1998, United Meeting Notes at 3; United Reply Comments, Dennis Carlton and Gustavo Bamberger Statement at 4, n. 3. This limitation excluded Vanguard's failed effort to provide nonstop service between Kansas City and Minneapolis-St. Paul from their study. *Id.* at Table 1.

After assessing entry and exit in domestic markets Professors Martin Dresner and Robert Windle similarly concluded that our tentative findings on the frequency of predatory-type behavior were incorrect. Dresner and Windle Comments at 1. However, their study did not analyze individual cases. Instead, they compared how fares and output changed on average when major airlines responded to entry by another major airline, to entry by Southwest, or to entry by a "small carrier." *Id.* at 5. A study based on average responses would not pick up the extreme types of behavior of concern to us. In addition, as Professors Oster and Strong point out, Professors Windle and Dresner limited their survey to the 500 largest markets, a limitation which further prevents their results from indicating whether or not predatory-type behavior exists in the domestic airline industry. Oster & Strong, "Predatory Practices," at 10, n. 9. Their class of small airlines, the "other carriers," also included airlines like Midwest Express, Alaska, America West, and several commuter airlines affiliated with a major airline. *Id.* at 15. Their study accordingly does not focus on the category of airlines most likely to be the target of predatory-type behavior. For these reasons, their study does not undermine our findings. Furthermore, they assume that a major airline's fare reductions will almost always lead to increased revenues. *Id.* at 4. As discussed above, that assumption is contrary to what has happened in several cases examined by us.

The Decline in Low-Fare Airline Competition

An additional basis for our concern about potential unfair competitive conduct is the apparent overall decline in airline competition and the lack of new entry into the industry in the years preceding our proposal of the policy, as described earlier. While the network airlines have challenged the validity of this view, they have failed to show that the recent level of competition is not problematic or that our initial findings on the state of airline competition were incorrect.

A study submitted by ATA, for example, does not undermine our finding that the apparent anti-competitive practices followed by some network airlines have unduly limited the growth of low-fare airlines. ATA's study shows, among other things, that low-fare airlines have obtained a growing share of the traffic at hub cities. ATA Comments (September 25, 1998), Statement of the Campbell-Hill Aviation Group, at 7. The hub cities cited by the study where low-fare airlines have a substantial share of the total market – Chicago, Dallas, Houston, Salt Lake City, and St. Louis – are cities where Southwest has a large presence. The public's ability to obtain low-fare service should not depend on the success of a single airline. Southwest's growth cannot excuse exclusionary conduct by other airlines designed to keep low-fare airlines (and other entrants) out of hub markets.

Some commenters claim that the low-fare airlines' share of the industry is not growing because relatively few markets have enough traffic to support their type of service. Cf. Northwest Reply Comments, Statement of Dr. Michael Carnall, at 3-6. We disagree. There are still untapped markets with enough traffic to support competition from a low-fare airline. Experience has repeatedly demonstrated that the low fares offered by Southwest and other low-fare airlines lead to a huge growth in demand – markets that had relatively little traffic have become large markets. See, e.g., September 17, 1998, Southwest Meeting Notes at 2; U.S. Department of Transportation, "The Low Cost Airline Service Revolution" (April 1996) at 16. We see no reason to assume that all markets capable of such growth already have low-fare airline service.

We cannot accept the network airlines' contentions that low-fare airline service is unimportant, since the lower fares charged in markets served by low-fare airlines assertedly reflect only the greater density of those markets. See, e.g., Northwest Reply, Statement of Michael Carnall at 3-6. These claims ignore the sharp fall in fares that normally results when a low-fare airline enters a route, which indicates that the type of competition, not the density in the absence of competition, determines fare levels. In addition, Dr. Carnall himself admits that less dense markets with low-fare airline service have significantly lower fares than comparable markets without low-fare airline service. Statement of Michael Carnall at 6.

The network airlines further contend that other causes, not their conduct, explain any inability of the low-fare airlines to operate successfully, either in specific markets or overall. They cite the inadequate capital and poor management decisions made by low-fare airlines. These contentions are unconvincing. Several of the low-fare airlines have been well-managed and properly financed. See, e.g., Spirit Reply Comments at 8.

The network airlines' position, moreover, is inconsistent – if low-fare airlines were as badly run as they suggest, network airlines should not need to respond to entry by slashing fares and offering many more seats at discount fares. Presumably the poorer service offered by mismanaged airlines would deter travellers from flying on them and would cause them to fail without a vigorous competitive response by a network airline.

We additionally disagree with the major airlines' contention that the low-fare airlines' difficulties largely stemmed from the May 1996 ValuJet crash, which deterred consumers from flying on low-fare airlines and thereby made their operations unprofitable. *See, e.g.,* Northwest Comments, Laura Tyson Statement at 13. While the ValuJet crash temporarily reduced the low-fare airlines' traffic, that effect was short-lived for at least several of them. *See, e.g.,* Frontier Comments at 4. Spirit points out that its withdrawal from the Detroit-Boston/Philadelphia markets resulted from Northwest's fare cuts and capacity increases, not the public's reaction to the ValuJet crash, Spirit Reply Comments at 7:

. . . Spirit's very modest load factors in the Detroit-Boston market actually increased following May 1996, which cuts against the claim that the ValuJet crash was the force which drove loads downward. In the Detroit-Philadelphia market, post-crash load factors remained strong in late May and throughout much of June until Northwest 'declared war' against Spirit on June 28, 1996. . . . It was primarily competitive factors, not the ValuJet crash, which decreased Spirit's overall load factors during this time period.

Furthermore, the major airlines' contention that the ValuJet crash deterred travellers from flying on low-fare airlines is belied by their actual behavior. Northwest, for example, added flights and slashed fares in the Detroit-Boston/Philadelphia markets several weeks after the crash, at a time when no competitive response should have been necessary if consumers were already avoiding low-fare airlines because of the crash. Spirit Reply Comments at 7.

While we and the FAA began reviewing new entrants' applications for operating authority more rigorously after the ValuJet crash, that heightened scrutiny of new entrants did not end new entry. The longer time needed to obtain authority from us and the FAA would not have discouraged all potential entrants. Indeed, after we published our proposed policy, several firms decided to enter the industry and have done so, such as JetBlue.

Finally, we cannot accept the network airlines' contention that the lack of start-up low-fare airlines several years ago reflected industry economic conditions, in

particular the lack of aircraft available at low prices and the shortage of experienced airline workers. The network airlines contend that little entry normally occurs during years when the industry prospers, as in recent years. Northwest Comments, Tyson Statement at 11-12; ATA Comments, Daniel Kasper Statement at 10-14. While the factors cited by Dr. Tyson and Dr. Kasper affect entry, they cannot explain the complete absence of new entry during the 1996-1998 period. The earlier periods of economic prosperity cited by them did not have so few firms entering the industry. And while the scarcity and high cost of aircraft and labor characteristic of the industry's prosperous years would make it more difficult for firms to begin operating airline service, the profits obtained by airlines in those years together with the increased demand for air travel and the high fares charged in hub markets should encourage firms to enter the industry. The TRB panel reviewed the network airlines' contention and concluded that they had failed to prove it. TRB Report at 45-49.

Past Examples of Potentially Questionable Conduct

The DOT White Paper, "Competition in the U.S. Domestic Airline Industry: The Need for a Policy to Prevent Unfair Practices," discussed four cases where an incumbent airline's response to a low-fare airline's entry may have been designed to force the entrant to leave the market. The paper did not identify the airlines and markets involved in the examples, since we did not wish to allege that specific airlines had engaged in unlawful conduct and only cited the examples as cases where an incumbent airline's response appeared to be intended to eliminate the new competition. The comments submitted by the network airlines, however, named the airlines involved in each of the four examples. See, e.g., ATA Reply Comments, Statement of Janusz Ordover and Robert Willig at 6-17.

The White Paper cited Northwest's response to Spirit's entry into the Detroit-Philadelphia nonstop market as one example of a competitive response that may have been designed to eliminate new competition (as stated earlier, we are not determining here that Northwest's conduct or any other airline's conduct was unlawful). Northwest responded in a similar fashion to Spirit's entry into the Detroit-Boston market and forced Spirit to end its service. Spirit Reply Comments, Statement of John Haring and Jeffrey Rohlfs at 21-23. The DOT White Paper gave three other examples of an apparent exclusionary response: Northwest's response to Vanguard's entry into the Kansas City-Minneapolis-St. Paul market, American's response to Vanguard's reentry into the Dallas-Fort Worth-Kansas City market, and Delta's response to ValuJet's entry into the Atlanta-Charlotte market. DOT White Paper, Attachment, Examples 1, 2, and 4.

In each of these four cases the incumbent hub airline slashed its fares, made discount-fare seats widely available, and incurred a sharp drop in its total revenues. Northwest's response to Vanguard's resumption of flights between Kansas City and Minneapolis-St. Paul in the first quarter of 1997, for example, caused Northwest's revenues in the first quarter of 1997 to be almost fifty percent lower than its revenues in each of the two previous quarters, while Northwest's traffic in the first quarter of 1997 grew by over a third from its traffic in the fourth quarter of 1996. After selling only 850 tickets for less than \$75 in the third quarter of 1996 and 11,160 such tickets in the fourth quarter of 1996, Northwest sold 46,000 tickets for less than \$75 in the first quarter of 1997. Vanguard, in contrast, sold only 7,290 such tickets (and only 9,120 total tickets) in the first quarter of 1997. DOT White Paper at Example 1.

In the two cases where the new entrant exited the market – the Detroit-Philadelphia and Atlanta-Charlotte examples – the incumbent airlines sharply increased their fares after exit.

Another example given by the DOT White Paper involved American's response to Vanguard's entry in the third quarter of 1996 into the nonstop DFW-Kansas City market (Vanguard had been operating one-stop service between the two cities). American increased the number of roundtrip flights from ten to thirteen and cut its fares. As a result, American's revenues for the market fell by 22 percent from the first quarter of 1996 to the first quarter of 1997, and it sold more seats for less than \$75 than Vanguard operated in the market (and sold six times as many seats at that level as Vanguard did). DOT White Paper at Example 2. Vanguard cut back the number of nonstop flights in 1996 but increased its service and managed to remain in the market after the Justice Department began investigating American's conduct. However, American's response to Vanguard's entry into this market provides one basis for the Justice Department's antitrust suit against American.

The White Paper's fourth example concerned the responses by US Airways and Delta to ValuJet's entry into the Atlanta-Charlotte market. Both incumbent airlines sharply cut fares when ValuJet began service and sharply raised them after ValuJet's exit due to regulatory action taken by the FAA. The number of passengers carried by the incumbent airlines increased by fifty percent, but their total revenues fell by about fifteen percent, from the fourth quarter of 1995 to the second quarter of 1996. DOT White Paper at Example 4.

The network airlines have challenged the validity of these examples. We are unpersuaded by their arguments that the competitive responses described in these examples were legitimate and that there is no basis for concern about potential unfair competitive responses to entry.

While we are not finding here that any incumbent airline responded to entry with the intent of eliminating the new competition rather than maximizing its revenues, the network airlines' arguments do not show that our concerns about the legitimacy of the competitive responses in these examples have no basis. For example, the Air Transport Association ("ATA") suggests that Spirit withdrew from the Detroit-Philadelphia route because it decided to shift aircraft to its charter business from its scheduled business. ATA Comments (September 25, 1998), Statement of the Campbell-Hill Aviation Group at 25. No evidence is cited to support this claim. Spirit has repeatedly alleged Northwest's responses to Spirit's service forced Spirit to withdraw from the Detroit markets. See, e.g., Spirit Comments, Appendix B at 6-9.

As stated by the network airlines, the aggressive responses by Delta and US Airways to ValuJet's entry on the Atlanta-Charlotte route, one of the examples given in our paper, did not force ValuJet to leave the market. ValuJet instead left because of FAA actions taken on safety grounds. Nevertheless, the competitive responses by Delta and US Airways appeared to be designed to eliminate their competitor, not to maximize their profits. Moreover, when ValuJet reentered the market in 1997, the two hubbing airlines responded with massive fare reductions that forced ValuJet to leave within two quarters. The two incumbent airlines' substantial increases in traffic were accompanied by significant revenue losses during the period of ValuJet's reentry into the market.

The network airlines also point out that Vanguard has remained in the two Kansas City markets. However, the responses by American and Northwest still seem suspect to us. As noted, American's response to Vanguard's entry into the DFW-Kansas City market is one basis for the Justice Department's antitrust suit. The Justice Department alleges that American added flights and cut fares with the intent of forcing Vanguard to withdraw from its DFW routes (or keeping Vanguard from adding routes at DFW) and that American succeeded in compelling Vanguard to end all DFW service except its Kansas City-DFW flights. Furthermore, an aggressive response by a network airline that focuses on eliminating competition may achieve part of its goal even if it does not force the target to withdraw from the market – the entrant airline may well postpone or abandon plans to expand service on that route, and other airlines may be deterred from entering other spoke routes at that hub.

Some commenters defend American's response to Vanguard's resumption of flights between Dallas-Fort Worth and Kansas City on the ground that American's added capacity merely replaced the capacity previously operated by Delta before Delta's withdrawal from the market. Thus, these commenters contend, there was no net increase in the number of seats operated by network

airlines. See, e.g., American Reply Comments at 15, 16. However, when Delta withdrew from other Dallas-Fort Worth markets, American usually did not replace Delta's capacity. Since Delta's withdrawal from a nonstop DFW market would usually give American a monopoly in that market, American would presumably maximize its profits by restricting its capacity and focusing on selling its seats to travellers willing to pay unrestricted fares.

To some extent, moreover, the attacks on our examples wrongly assume that we viewed the entire revenue loss incurred by the network airline after the low-fare airline's entry as self-diverted revenues and that the new competition was not responsible for any of the reduction in revenues. See, e.g., ATA Reply Comments, Reply Statement of Janusz Ordover and Robert Willig at 8-9. To the contrary: we have always recognized that the incumbent airline will often find it necessary to cut its fares in response to new entry.

The network airlines additionally err in assuming that the network airline's competitive response in each case was legitimate, since its reduced fares allegedly still exceeded its costs. See, e.g., Northwest Comments at 26, 29. The Justice Department asserts, however, that American's competitive responses to entry by Vanguard, Western Pacific, and Sun Jet in several DFW markets were not profitable. We are not at all certain that the fares exceeded the incumbent's costs. Finally, as discussed later in this paper, a determination that an airline's competitive response is or is not an unfair method of competition should not necessarily depend on a cost standard.

OUR CONCLUSIONS

Our investigations indicate that airlines at times have apparently responded to new competition in ways designed to drive the entrant out of markets that the incumbent airline can otherwise dominate. When such practices succeed, they cause travellers to pay higher fares and deny them the benefits of competition in the long term. Such conduct could well be unlawful as an unfair method of competition. This Administration believes that the Department should carry out its obligation under section 411 to prevent unfair methods of competition in the airline industry by taking action to stop unfair competitive practices of the kind discussed in this paper. Among the tools that may be used by the Department would be enforcement action. Rather than adopt guidelines committing the Department to consider enforcement action in certain types of cases, this Administration is publishing the findings and analysis in this paper, which will enable the Department to decide whether enforcement action could be justified in future cases.

If future Secretaries of Transportation decide that enforcement action is the best way to address unfair competitive practices, they should focus on cases where an incumbent airline responds to entry (or anticipated entry) with fare cuts, capacity increases, or other tactics that appear to be economically rational only if they force the new entrant to exit the market or reduce its service (or if they deter entry). This Administration thinks that conduct of this kind – unfair exclusionary conduct -- would likely constitute an unfair method of competition.

The findings set forth in this analysis and the accompanying report by Professors Oster and Strong support our conclusion that the Department should consider taking steps to prevent dominant airlines from unfairly eliminating or reducing competition. Our findings will provide a solid foundation for further efforts by way of enforcement action or otherwise to address these issues. The Department should be prepared to consider taking action against such responses to entry in all markets where an airline has the potential to obtain market power, not just major airline hub markets, without regard for the kind of airline that is the target or the perpetrator of the exclusionary conduct.

Addressing unfair competitive practices through the enforcement process would have advantages over other approaches. The enforcement process would give the Department an opportunity to investigate the evidence in specific cases and develop standards on the types of conduct that would be unlawful as unfair methods of competition. Developing standards through the enforcement process would be consistent with the recommendation of several of the TRB panel members that we continue our efforts to define the kind of anticompetitive conduct that would be an unfair method of competition.

The Types of Conduct That May Warrant Department Action

If the Department decides to pursue enforcement action, our findings would support doing so when an incumbent airline responds to entry with fare cuts, capacity increases, or other tactics that appear to be economically rational only if they force the new entrant to exit the market or reduce service or if they deter entry. Enforcement action may be appropriate in any market where an incumbent airline may gain or maintain the ability to charge supracompetitive fares (and operate service at levels below those that would exist if the market were competitive) if it can eliminate a competitor, not just in hub markets. For example, some small and medium-sized communities may receive service from only one airline, which connects the community with one or more of that airline's hubs; if the airline responds to entry by a competing airline offering service between such a community and a different hub city with fare cuts and capacity increases seemingly designed only to eliminate the new entrant, enforcement action may be warranted if the community's geographical location and other

factors indicated that the incumbent's success in forcing the entrant's exit would likely enable the incumbent for a significant period of time to charge supracompetitive fares.

Similarly, enforcement action may be justified when an airline begins service from a second airport in a metropolitan area when that airline has a hub at a different airport in the metropolitan area, if the airline begins serving the second airport in an apparent effort to protect its dominance at its hub airport. See TRB Report at 92-93.

Another possible unfair competitive practice would be an airline's entry into one or more markets served by a second airline in order to force the latter to exit a market served by the first airline. As an example, after Reno Air entered the Reno-Minneapolis market, a market not served by Northwest, Northwest entered that market and other markets served by Reno Air from Reno. Northwest may have acted because Reno's entry into Minneapolis enabled Reno to compete with Northwest for Minneapolis-West Coast traffic.

In addition, enforcement action may be warranted when an incumbent airline takes steps to deter entry into one of its markets that appear to be rational only if the competitor is deterred.

This Administration's findings indicate that the Department should also address situations where the incumbent airline seeks to substantially reduce competition by using deep fare cuts, capacity increases, and similar tactics with the goal of disciplining a competitor. This kind of conduct is exclusionary, since it seeks to prevent the prey from growing or entering new markets by offering services attractive to the public that would likely reduce the incumbent airlines' market share or force them to offer services that would be less profitable than their existing services. See Patrick Bolton, Joseph F. Brodley, & Michael H. Riordan, "Predatory Pricing: Strategic Theory and Legal Policy," 88 Georgetown Law Journal at 2268-2269.

An incumbent's delay in aggressively responding to entry should not preclude enforcement action, if the response still appears to be designed to eliminate or substantially reduce competition.

We originally focused on the use of fare reductions and greater availability of low-fare seats to eliminate competition from low-fare airlines because our investigations involved such conduct. The comments and the TRB Report, however, have persuaded us that the Department should protect consumers in all markets where exclusionary conduct may eliminate or substantially reduce competition, not just markets served by low-fare airlines. The TRB panel and a

number of parties argued that the Department's enforcement actions should not protect only one type of airline. TRB Report at 9, 97; see, e.g., Midwest Express Comments at 9. We note, moreover, that one network airline – US Airways – complained that United greatly increased its capacity at Washington Dulles Airport in order to force US Airways' Metrojet operations out of Dulles markets. This suggests as well that the Department should broaden its enforcement efforts rather than confine its actions to the protection of one type of airline – new entrant airlines – in one type of market – network airline hub markets.

Focusing on markets where the elimination of an entrant may well enable the incumbent airline to preserve or obtain market power would be consistent with the recommendation of Professors Oster and Strong that we consider taking enforcement action only in markets where predatory-type behavior is likely to occur and succeed. Oster & Strong, "Predatory Practices," at 19. See also Janusz Ordover and Robert Willig, "An Economic Definition of Predation: Pricing and Product Innovation," 91 Yale L. J. at 11-12.

We are not, however, adopting guidelines on the use of our enforcement discretion. Specifying in detail the kind of behavior that could become the subject of enforcement action seems impracticable at this time given the variety of potential unfair competitive practices. As noted, the formal hearing process would enable the Department (and the parties) to further investigate these issues and provide an opportunity to develop more definitive standards in this area. This manner of developing standards would be consistent with the recommendation of many of the TRB panel members that the Department should continue our efforts to define the kind of conduct that should be considered predatory and therefore an unfair method of competition.

While this Administration believes that the Department should not limit its discretion to look at any type of unfair competitive conduct, given the agency's interest in pursuing cases likely to benefit consumers the most and the Department's resource limitations, the Department should focus on the more egregious cases likely to cause the most harm to consumers and to airline competition.

In addition, of course, the Department may choose to use other avenues than enforcement action for addressing unfair competitive practices. The analysis in this paper suggests when action should or not be taken with respect to competitive responses to new entry.

Examples of Fair and Potentially Unfair Competitive Conduct

The following discussion gives examples of competitive practices that this Administration thinks may and may not warrant Department action.

While it is this Administration's position that the Department should be prepared to address all types of competitive responses that are economically rational only if they eliminate or reduce competition, the responses most likely to require review are those involving sharp fare reductions and increases in capacity made by an incumbent airline in response to entry. As noted, the legitimacy of such responses has been the main concern raised by the low-fare airlines and the main subject of our informal investigations into potential unfair competitive conduct.

Our investigations indicate that incumbent airline responses to new competition from a low-fare airline range between two extremes.

At one extreme the incumbent airline greatly increases its sales of low-fare seats and reduces its total revenue. To accommodate the increased number of local passengers using low fares, it has to "spill" flow passengers.

As an example of this behavior, we observed a market where Airline X, the incumbent airline, operated six roundtrips. Only about 5% of its local passengers paid less than \$100, and about 25% of its local passengers paid \$450 or more. The latter accounted for more than 50% of its local revenue. When Airline Y, a low-fare airline, entered with three roundtrips, Airline X responded by reversing its traditional pricing strategy -- it began carrying very few passengers at more than \$200 and carried a majority of its local passengers at fares of less than \$100. It sold five times more seats at less than \$100 than did Airline Y; indeed, the number of seats sold by Airline X for less than \$100 almost equalled the new entrant's total seat capacity. In addition, Airline X's flow traffic significantly declined. Since Airline X's average load factors were relatively high before Airline Y's entry, its pricing changes appears to have "spilled" flow passengers in order to accommodate low-fare passengers in the local market -- in other words, Airline X had no seats for the flow passengers, who then had to fly on other airlines or not fly at all. While local passengers usually contribute higher yields than flow passengers when an airline has no competition in the local market, sharp cuts in local fares would make flow passenger revenues relatively more attractive and should cause the airline to allocate more seats to satisfy flow traffic demand. Airline X thus engaged in a pricing strategy in the local market that resulted in a 20% decline in its revenues while increasing its passengers by more than 50%, and it reduced its network feed by displacing flow passengers. In this case Airline Y exited the market.

This kind of response troubles us, because the incumbent airline likely intended to compel the entrant to exit the market by capturing almost all of the low-fare traffic. If Airline X had chosen a more moderate response to entry, it presumably would have obtained higher revenues in the market – and thus higher profits – without having to abandon the market. The entrant’s exit will enable the incumbent to charge high fares undisciplined by competition.

In cases where the incumbent chooses to offer a smaller portion of its seats at lower discount fares, the incumbent is probably not engaging in unfair exclusionary conduct. In one case, for example, the incumbent airline responded by selling more seats at lower fares subject to restrictions while continuing to sell other seats at significantly higher fares. To the extent that its local passenger traffic declined as a result of the low-fare airline’s entry, the network airline filled seats with additional flow passengers. In this scenario, the airline’s local passengers and revenue may decline, but its flow passengers and revenue increase.

In one case, for example, Airline A, the one incumbent carrier, operated nine roundtrips in the market. The mix between local and flow traffic was roughly equal. In the local market, about 15% to 20% of its passengers paid fares under \$125, and 60% paid at least \$250; the latter group accounted for about 80% of the airline’s local revenue. Airline B, a low-fare airline, entered with three roundtrips. After initially responding quite aggressively, Airline A quickly refocused its pricing strategy in the local market, apparently by restricting the availability of low-fare seats. The net result was a slight reduction in local passengers but a large increase in local revenue. Airline A’s local revenue then equalled the local revenues it obtained before the low-fare airline’s entry. Less than twenty percent of its passengers paid fares below \$125, as had been true before entry occurred. In addition, Airline A filled its seats with flow passengers that fed its network and obtained far more flow passengers than it had before entry occurred. Airline A eventually increased its seat capacity following a capacity increase by Airline B, but Airline A continued to carry many of its local passengers at higher fares, and it filled an even larger proportion of its seats with flow passengers. Consumers continued to benefit because Airline B remained in the market for a substantial period, and both airlines offered competitive fares and services.

American, misconstruing our proposal as covering any case where fare cuts by a major airline on a route force another airline to exit the route, has cited a case which instead demonstrates the type of competitive response that appears to be legitimate competition: Southwest’s capture of the Los Angeles-Kansas City nonstop market. According to American, only Vanguard and US Airways served that market before mid-1997. Southwest, then the largest airline at Kansas City,

entered the route in mid-1997 with more flights than the total number of flights operated by Vanguard and US Airways. Southwest offered low fares on all its flights. Within a few months both Vanguard and US Airways withdrew from the nonstop market. Southwest's average fares on the route thereafter increased by 21 percent, a result of a change in Southwest's fare mix, since the airline did not change its fares. American Reply Comments at 18-20.

Southwest's conduct is not suspect because its entry into the Kansas City-Los Angeles market and its continuing presence in the market seem to be consistent with its normal operating practices. Southwest did not slash fares or flood the market with low-fare seats only until it forced out its competitors, and it had no hub at Kansas City or Los Angeles. Southwest's capture of the market resulted from its ability to offer attractive service and operate efficiently, since it had not dominated the market. Thus, this case represents an example of vigorous competition where the airline with the most efficient operations and best ability to satisfy consumer needs ended up dominating the market.

Delta has cited markets where it responded to entry by ValuJet with fare cuts and capacity increases that caused Delta to obtain higher revenues and greater profits than it would have obtained without lowering fares and offering more seats. Delta Comments at 13-14. In general, a competitive response is probably not unfair competition if the incumbent's response significantly increases its revenues, unless the incumbent has also substantially increased its capacity, in which case its increased costs may significantly reduce its profits.

In this Administration's view, the Department, as discussed, should not limit its review of potentially unfair competitive practices to pricing and capacity conduct. It should, for example, consider investigating cases where an incumbent airline, to counter new entry, greatly increases the commissions payable travel agencies under its override commission program only in the markets where entry has occurred. In such cases the cost of the increased commissions may well exceed their revenue benefits, unless the action causes the entrant airline to withdraw from the market.

The Department should not consider taking action when an airline exits a market because it cannot operate efficiently, nor should it protect an airline whose inability to obtain passengers stems from its failure to offer attractive service. Consistently with antitrust law principles, the Department should protect competition, not individual airline competitors.

In addition, when an airline's fare reductions and increases in the availability of discount seats are not targeted to the airline entering the incumbent's market, the airline's conduct represents legitimate competition. Broad-based fare cuts that

are offered in a number of markets, not just those served by the new entrant, should not lead to enforcement action. Discount fares offered to particular categories of travellers in a number of markets, such as Internet and senior citizen fares, that are commonly offered by airlines should not be unfair competitive practices. Nothing in our enforcement policy as proposed placed in question a hubbing airline's ability to offer such fares at a hub. See, e.g., September 7, 1998, United Meeting Notes at 5. Similarly, the Department should not interfere with normal seasonal adjustments in capacity and pricing.

The Implications of Our Findings

In our view, the Department should continue to work with the Justice Department to prevent any unnecessary duplication of work and to minimize the burdens on the parties in any investigation. If the Justice Department determines that enforcing the antitrust laws will provide the most appropriate method for preventing anticompetitive conduct at issue in a case, this Department should defer to its judgment.

If the Department is considering enforcement action, it should always give the airline being investigated the opportunity to show that its competitive response was legitimate, even if aggressive. While the Department should consider the airline's defense, it should not accept unsubstantiated claims that its competitive response served a legitimate purpose. An incumbent airline's claim that it has some legitimate purpose for its conduct should not keep the Department from pursuing enforcement action if the airline's action would be economically rational only if it eliminates or reduces competition. The Department should remember, however, that an incumbent airline faced with new competition must respond, that its response may involve fare reductions (and an increase in the number of seats made available at discount fares), and that its revenues may decline. If the airline can show that it responded to entry in ways that were economically rational whether or not the entrant ended or reduced its service, the Department should not take action. It should not chill legitimate competition.

A determination of whether the incumbent's response was designed to eliminate competition should be based on the information reasonably available to the incumbent airline at the time and its reasonable expectations on the impact of its response. The Department should not second-guess an airline's reasonable expectations on the effects of entry and the airline's response. Of course, on this issue, as on other issues, the Department's enforcement office will have the burden of proof in any enforcement proceeding.

If the Department investigates whether an incumbent airline's response represents legitimate competition, we recommend that it consider how the airline has responded to entry in similar markets, how comparable airlines have responded to similar types of entry, and how different responses have affected the airline's revenue and traffic. In an investigation involving entry by a low-fare airline, the Department could, for example, examine the incumbent airline's responses to Southwest's entry in comparable markets and the airline's revenue and traffic in markets where it competes with Southwest.

The Department should consider how the incumbent airline's response affected both local and flow traffic. We recognize that hubbing airlines depend on both types of traffic to support flights in hub markets. Indeed, the dumping of low-fare seats in local markets strikes us as questionable because of the importance of saving seats for flow traffic. Network airlines normally prefer to carry flow passengers paying fares at least comparable to those paid by local passengers. But an incumbent airline's defense that its response is necessary to preserve its network operations should not be accepted unless supported by substantial evidence.

The Department should be reluctant to pursue cases where the incumbent has only matched low fares offered by a new entrant, even if those fares are well below the incumbent airline's original fares. The Department should also look at whether the incumbent airline has greatly increased the availability of low-fare seats. However, we recognize that an incumbent firm's matching of a low price offered by an entrant raises troubling questions if the entrant, but not the incumbent, can offer the product or service at a profit. Phillip Areeda & Donald Turner, III Antitrust Law (1978) at 178. Given the other service features offered by network airlines, in particular, a more attractive frequent flyer program, matching the fares offered by a low-fare airline may amount to undercutting the fare. Cf. Oster & Strong, "Predatory Practices," at 25. Nonetheless, the Department should not consider investigating the incumbent airline's matching of an entrant's fares unless the incumbent airline greatly increases the availability of low-fare seats or adds capacity.

We know as well that airlines, like other firms, sometimes offer services at below-cost promotional fares and that airlines sometimes continue serving unprofitable routes due to the requirements of the network or for other legitimate reasons. See, e.g., July 29, 1998, American Meeting Notes at 2. In reviewing an airline's response to entry, the Department should bear in mind such business practices.

Finally, the Department should consider taking action only where the incumbent airline's conduct will probably cause substantial harm. Northwest has cited a

hypothetical example where the entrant offers fares twenty-five percent below the incumbent's fares, the incumbent reduces its fares by fifteen percent, and we determine that the profit-maximizing response would have been a fare reduction of ten percent. Northwest Comments, Statement of Laura Tyson at 41. The Department should rarely pursue cases involving modest differences, unless the incumbent airline has also engaged in other actions (added flights and increased travel agency override commissions, for example) that suggest an intent to eliminate the new competition.

We appreciate the concerns expressed by several parties that an incumbent airline's response may force an entrant to exit the market before the final decision in an enforcement proceeding if we do not adopt procedures allowing for interim relief and a quick decision. See, e.g., Air Carrier Ass'n Comments at 28. Section 411, however, will require the Department to hold a hearing before determining that a party has engaged in an unfair method of competition, and the statute does not authorize the agency to issue preliminary relief. The Department should move as quickly as possible in cases where enforcement action is appropriate.

Low-Cost Subsidiaries

Three of the major airlines – United, Delta, and US Airways -- have created low-cost subsidiaries – respectively Shuttle by United, Delta Express, and MetroJet -- to compete with Southwest and other low-fare airlines. Oster & Strong, "Predatory Practices," at 14-15. US Airways and United contend that our proposal failed to take account of the different operating strategy used by these subsidiaries. US Airways Comments; United Comments at 9, n. 5. According to US Airways, it created MetroJet because it "recognized the marketplace challenge presented by low-cost carriers and resolved to meet it head on, not by trying to drive the competition out of the market through unfair competitive practices, but by creating its own low-cost airline." US Airways Comments at 3-4. US Airways and United claim that the proposed guidelines could prevent such a subsidiary from offering low fares in hub markets and competing on even terms with independent low-fare airlines. US Airways Comments at 5-8; United Comments at 9.

We recognize that low-fare subsidiaries offer consumers low fares and additional service options in a growing number of markets. The network airlines' creation of low-cost subsidiaries is a legitimate response to consumer demands and competition from airlines like Southwest. If a network airline responds to entry by a low-fare airline by substituting service operated by its low-cost subsidiary, and the latter airline operates in that market as it does in other markets, there would be little justification for Department action.

Similarly, since low-cost subsidiaries have lower operating costs than their parent airlines and model their operations on Southwest's operations, a low-cost subsidiary's choice of fare cuts and increased availability of discount seats in response to entry should cause the Department less concern than a similar response by a network airline that typically does not focus on travellers demanding low fares.

However, low-cost subsidiaries do not deserve a blanket exemption from Department action, since such an airline could react to new competition in ways designed to eliminate competition, either independently or in coordination with its affiliated network airline. If a low-fare subsidiary slashes fares and widens the availability of discount seats in a way that is not profit-maximizing in a hub market for itself (or the parent airline), enforcement action may be appropriate.

Routes Served by Two Hubbing Airlines

This Administration believes that the Department should be ready to investigate unfair competitive practices on routes already served by two airlines if the elimination of an entrant would give the incumbent airlines the ability to charge supracompetitive fares. While neither airline would likely obtain a monopoly by forcing the exit of an entrant into the market, the elimination of competition from a third airline could harm consumers as much as the elimination of an entrant from a hub market served by a single hubbing airline. There have been cases where the exit of a low-fare airline from a route served by two hubbing airlines allowed the latter to impose large fare increases on consumers. The Philadelphia-Detroit market is one such case (as discussed above, we are not concluding here that the incumbent airlines' responses were unfair methods of competition). Consumers can be harmed by predation occurring in an oligopolistic industry, since it could cause consumers to pay supracompetitive prices. See Jonathan B. Baker, "Predatory Pricing after Brooke Group: An Economic Perspective," 62 Antitrust Law Journal (Spring 1994) 585, 594-595. The Department can and should address unfair competitive practices in markets having two incumbent airlines if the elimination of an entrant would cause significant harm to consumers.

POSSIBLE ALTERNATIVES TO OUR FINAL FINDINGS

We considered several alternatives to our proposed policy, including those suggested by the TRB and the commenters, for addressing complaints about apparent unfair methods of competition in the airline industry.

The Adoption of the Proposed Guidelines or Revised Guidelines

Our proposed guidelines would have protected only one class of airlines against only one type of unfair competitive response, the use of fare reductions and capacity increases to eliminate competition. As noted above, the TRB panel and others asserted that the proposed policy should not protect only one class of airlines. TRB Report at 9, 97. In addition, the TRB recommended, TRB Report at 9, that we further investigate competitive issues before establishing a definition of unfair methods of competition with respect to pricing and capacity actions in response to new entry.

On the basis of the TRB recommendations, the comments, and our own further investigations, this Administration has concluded that our proposal was too narrow and that standards for judging which competitive responses will be deemed an unfair method of competition should be developed through the enforcement process.

We could adopt revised guidelines reflecting the suggestions of the parties and the TRB. We have determined, however, that doing so at this point would not be wise. We think that standards for determining what kinds of competitive responses should be considered an unfair method of competition can be developed more rationally on a case-by-case basis through the enforcement process. There are too many potential types of unfair competitive practices to make practicable a policy statement listing those that will be considered an unfair method of competition or even those for which enforcement action should be considered. In addition, further analysis of the issues through individual enforcement cases would give the Department an even better understanding of the issues. For these reasons, while enforcement action is not the only avenue that could be pursued by the Department, a decision to take enforcement action would be consistent with the TRB panel's recommendations.

Reliance on the Justice Department's Antitrust Enforcement

One option would be for the Department to take no action and to rely on suits filed by Justice Department (and private parties) under the antitrust laws for the prevention of anticompetitive practices that harm consumers by eliminating competition. We have considered this option and rejected it. The Department should exercise its authority under section 411 to complement the Justice Department's enforcement of the antitrust laws. Taking no action would conflict with the Department's responsibility to prevent unfair methods of competition in the airline industry and would unreasonably limit the Government's ability to stop such practices, resulting in substantial harm to consumers.

We recognize, of course, that the antitrust laws provide the principal safeguard against anticompetitive conduct in the domestic airline industry, just as they do in other unregulated industries, and that the Justice Department has the responsibility for enforcing the antitrust laws in the airline industry. Congress, however, has given us the responsibility to prohibit unfair methods of competition in the airline industry, just as the FTC has similar authority in other industries. That authority, as discussed later in this paper, enables us to prohibit unfair competitive conduct that may not violate the antitrust laws.

While the kinds of competitive responses potentially subject to enforcement action by the Department may well violate the antitrust laws, the Department can stop some types of unfair competitive practices that could not be stopped under the antitrust laws. As stated, the Department should work closely with the Justice Department in investigating predatory-type behavior.

We have considered the views of those members of the TRB panel who believe that the Justice Department should take the lead in seeking to prevent predatory-type behavior in the airline industry. In addition to their specific criticisms of our proposal, these members generally considered that anticompetitive behavior is better addressed by the Justice Department than an industry-specific regulatory agency. TRB Report at 8-9. Of course, this Department should defer to the Justice Department if its enforcement of the antitrust laws is the best means for addressing an airline's apparent anticompetitive conduct. In other cases, however, this Department's exercise of its authority to prevent unfair methods of competition in the airline industry may be the best way to protect competition.

We have concluded that the Department should continue developing its own standards for determining when some types of competitive responses constitute unfair methods of competition for the reasons discussed above. Several members of the panel share our view that we should continue developing our own standards due to the seriousness of the problem. TRB Report at 9. And the entire panel stated that this Department has an important role to play in ensuring competition continues and should act on other types of competitive problems. Ibid.

In our view, moreover, the TRB panel has overstated the risks created by this Department's pursuit of the issue. Panel members are concerned that the Department may become increasingly regulatory and seek to protect its "constituencies" from excess competition. TRB Report at 8. We are sure, however, that the new Administration, like us, will be committed to deregulation and not seek to reregulate the airline industry.

Reliance on Antitrust Standards

As a related matter, some commenters argue that any action by us involving pricing and capacity conduct should use the standards applicable in predation cases decided under the antitrust laws. These parties contend that the Sherman Act prohibits price cuts by a dominant firm only when the resulting prices are below an appropriate measure of cost. See, e.g., ATA Comments at 23-27. Our proposed policy did not use a cost standard for determining when we would consider taking enforcement action. We instead proposed to look at whether the incumbent airline's response to new competition reasonably appeared to be the profit-maximizing response. Under our proposal we therefore could begin an enforcement proceeding against a hubbing airline whose fares exceed its costs, at least when measured on the basis of accounting costs. We tentatively concluded that a profit-maximization standard would give us better guidance than a cost standard in determining when a hubbing airline's response to new competition appears to be an unfair method of competition.

We continue to believe that enforcement action may be appropriate if an incumbent airline cuts its fares and sells many more discount-fare seats in a situation where that response appears to be economically irrational unless the response successfully forces the entrant airline to exit the market.

Adopting a cost standard limiting the Department's discretion would be unwise. The characteristics of the airline industry may well justify the use of a test for unlawfulness other than a cost standard in individual enforcement cases, despite the arguments in favor of using cost standards in predation cases involving other industries. Patrick Bolton, Joseph F. Brodley, & Michael H. Riordan, "Predatory Pricing: Strategic Theory and Legal Policy," 88 Georgetown Law Journal at 2261-2262.

In addition, a number of economists think that a dominant firm's charging of prices above cost is potentially predatory, if the firm dominates the market and entry by other firms will be unlikely if the firm can force out a competitor. See, e.g., Janusz Ordover and Robert Willig, "An Economic Definition of Predation: Pricing and Product Innovation," 91 Yale L. J. 8 (1981). As we noted in proposing the policy, "Economists have recognized that consumers are harmed if a dominant firm eliminates competition from firms of equal or greater efficiency by cutting its prices and increasing its capacity, even if its prices are not below its costs," 63 Fed. Reg. at 17921, n. 5, citing Janusz Ordover and Robert Willig, "An Economic Definition of Predation."

We therefore disagree with the network airlines' contention that cases decided under section 411 must use the cost standard employed in antitrust law cases.

To a large extent, these airlines base this contention on arguments that we have no statutory authority to adopt a standard for predatory-type behavior that is different from the Sherman Act standard. As shown by our legal analysis in this paper, section 411 gives us the authority to adopt a policy that differs from Sherman Act standards. Congress specifically gave us the authority to prohibit conduct that violates antitrust principles, even if it does not violate the antitrust laws.

The network airlines contend that using a cost standard, preferably one based on average variable costs, will ensure that we do not use our enforcement powers to protect less efficient airlines. The use of an average variable cost standard will assertedly protect any entrant airline that is at least as efficient as the incumbent. See, e.g., ATA Comments at 23. Several of the network airlines additionally allege that a hubbing airline is necessarily the most efficient airline in any hub market. See, e.g., Northwest Reply Comments at 22-23; Northwest Comments, Statement of George Eads at 6.

We cannot agree that not using a cost standard will favor less efficient airlines. Indeed, to meet the demand for low-fare service (and to compete effectively with Southwest and other low-fare airlines) network airlines like US Airways have had to create low-cost subsidiaries. See, e.g., US Airways Comments at 2-4. See also Levine, "Airline Competition in Deregulated Markets," at 407-408.

In addition, consumer welfare will benefit from increased competition. Our statute specifically cites as public interest goals the prevention of anti-competitive practices and market domination. 49 U.S.C. 40101(a)(9), (10). Protecting a low-fare airline from unfair competitive responses by an incumbent airline in hub markets would maintain competition and enable travellers to obtain low fares on a continuing basis. Spirit Reply Comments, Statement of John Haring and Jeffrey Rohlfs at 9. Professor Kahn thus states, "[T]he benefits of competition are not limited to ensuring productive efficiency," for they "embrace also the elimination of monopoly profits and the allocational efficiencies that getting prices closer to incremental costs serves." Alfred Kahn Comments at 28.

Moreover, any relative efficiency of the network airlines is the result of the larger scale of their operations, particularly at their hubs. The newer low-fare airlines would be able to obtain such efficiencies if they could grow, as Southwest has done. The network airlines' unreasonable responses to entry by the low-fare airlines in their hub markets would block those airlines from reaching a scale that would enable them to operate with great efficiency. Spirit Reply Comments, Statement of John Haring and Jeffrey Rohlfs at 9.

Furthermore, some of the parties urging us to adopt an antitrust law cost standard assume that any such standard would effectively exempt hubbing airlines from any sanctions under section 411, no matter how much they cut fares and increased the availability of discount seats. Although the Supreme Court has never decided what cost standard should be used in antitrust cases, some network airlines believe that the proper standard is a narrow average variable cost standard based on accounting costs. See, e.g., Northwest Reply at 3-5. However, one network airline essentially conceded that our adoption of such a cost standard would likely mean no enforcement action at all. July 29, 1998, American Meeting Notes at 3. See also Northwest Comments, Laura Tyson Statement at 39. The use of such a standard in Sherman Act cases has been called “a defendant’s paradise,” since plaintiffs almost never succeeded under that standard. Patrick Bolton, Joseph F. Brodley, & Michael H. Riordan, “Predatory Pricing: Strategic Theory and Legal Policy,” 88 Georgetown Law Journal at 2252-2253. The Department need not use an enforcement standard that would allow hubbing airlines to use practices that are seemingly designed to eliminate competition and that in the long run would deny consumers the benefits of competition and lower fares.

If the Department investigates an incumbent airline’s response under a profit-maximizing analysis, it would essentially be using a test reflecting opportunity costs. The incumbent airline’s response would likely involve substantial self-diversion -- such a large increase in the number of seats offered by the incumbent at low discount fares that the incumbent unnecessarily reduces its sales of higher-priced tickets. The difference between the revenues that the airline could have realized and those that it actually realizes is a sacrifice that would constitute an opportunity cost – the incumbent chose to reduce its own revenues by an amount much greater than that necessary to adjust to the new competition. If the incumbent adds flights, as has happened in several cases we have observed, the incumbent incurs the additional opportunity cost of the revenues lost by not using the aircraft in more profitable markets.

As recognized by Alfred Kahn, opportunity costs are properly considered in determining whether a dominant incumbent has engaged in behavior designed only to eliminate competition, Alfred Kahn Comments at 15 (emphasis in original):

The DOT rules go beyond Areeda-Turner in identifying as also objectionable pricing and capacity additions by incumbent airlines that have the result of producing “lower local revenue than would a reasonable alternative response.” In other words, they would require not necessarily the acceptance of actual, out-of-pocket losses but a sacrifice of profits that could have been achieved by

some alternative policy – presumably one involving lesser price reductions or the offer of fewer additional discount fares or a refraining from adding capacity. . . . This is merely another recognition of the fact that opportunity costs are true economic costs (and vice versa): the profits sacrificed by a particular course of action are undeniably a cost to the seller of undertaking that course of action.

The TRB agreed that opportunity costs should be considered in determining whether an incumbent airline's response was intended to exclude competition, although the TRB panel had concerns about the feasibility and predictive accuracy of a test based on profit-maximization. TRB Report at 86-87.

The TRB's Comments on the Proposed Policy

The TRB questioned our proposed guidelines in two respects: whether implementing the proposed profit-maximization standard would be practicable and whether the proposal would adequately differentiate between cases where the incumbent airline's predatory-type behavior would eliminate competition and cases where it would not. TRB Report at 87, 92.

This Administration has carefully considered the TRB's recommendations and criticisms. First, instead of adopting specific standards that would define the kind of conduct that would trigger an enforcement investigation, we are giving examples of the kinds of conduct that should concern the Department. The Department may develop on a case-by-case basis standards for defining when responses to new competition constitute unfair methods of competition if it chooses to act on our findings by bringing enforcement cases. Secondly, we agree that the Department should investigate unfair responses to entry by any kind of airline, not just a new entrant airline.

In other respects, however, we disagree with the TRB's comments. We believe that the Department in appropriate cases should investigate whether an incumbent airline could have chosen an alternative response to new competition that would have generated significantly higher revenues and profits. The TRB predicted that the difficulties involved in such an analysis make would the test impracticable. TRB Report at 87.

We think enforcement action may still be appropriate in such circumstances. Some guideposts exist for making such a determination that should reduce the difficulties. In particular, the Department could assess the response of the respondent airline to new competition in other markets and the responses of comparable airlines to new entry in their markets. An airline's internal documents may well disclose the routes that were the source of any aircraft used for additional flights. The Department also should not pursue cases where determining that an airline engaged in unfair exclusionary conduct would be a close call.

In addition, consumers and competition may well suffer when an incumbent airline responds to entry with fare cuts and capacity increases that cannot reasonably be expected to maximize its profits. Rather than take no enforcement action in response to predatory-type behavior by hub airlines, the Department in our view should accept the difficulties of determining what alternative competitive responses were available.

The TRB panel also doubted the value of our proposal due to the difficulty of determining when an incumbent airline's use of fare cuts and capacity increases will eliminate new competition. If the entrant does not exit the market, the public would obtain the benefit of low fares and greater frequencies from both airlines, not just the entrant. TRB Report at 92.

We recognize that consumers benefit when an incumbent airline lowers its fares and increases the number of flights in response to entry. If the incumbent airline responds with the intent of eliminating the competition, as has seemingly happened in a number of cases, the public will benefit from the increased availability of low fares for only a short period if the incumbent's strategy succeeds. Even if an incumbent airline's response intended to eliminate the new competition fails to do so, the response will still harm travellers. The entrant will obtain fewer passengers than expected, which could keep it from adding as many flights as it otherwise might have done and may keep it from entering other markets dominated by that incumbent airline. In the hope of avoiding an aggressive response from the incumbent airline, moreover, an entrant may deliberately enter the market with relatively few flights. For these reasons even a response that does not eliminate the entrant may still reduce competition and thereby harm consumers.

Like the TRB panel, we recognize the overriding value of maintaining competition. The Department should not use its authority under section 411 to protect individual airlines or classes of airlines from competition.

Instituting Enforcement Cases Without Adopting a Policy

We could have terminated this proceeding and instead taken enforcement action against one or more airlines that have responded to new competition in a manner suggesting an intent to eliminate competition and restore the incumbent airline's market power. Some commenters urged us to do that. ASTA Comments; Midwest Express Comments at 12-13.

We think that the publication of our analysis and findings is the best means for carrying out our obligation to prevent unfair methods of competition. We published our proposal to carry out the Secretary's wish to hold a national dialogue on the issues, and the resulting debate has refined our understanding of the issues. Our analysis will provide a framework for future enforcement proceedings if the Department decides that enforcement action is the best avenue for addressing unfair competitive practices.

Beginning a formal enforcement case against one airline would have achieved some of these goals, but it would not have given us an opportunity to consider

the issues on an industry-wide basis in a proceeding where, as here, we have the opportunity to obtain the views of all interested parties. As explained, however, the Department may use the enforcement process to develop more definitive standards on the kind of competitive responses that constitute unfair methods of competition.

The Safe Harbor Proposals

Some parties proposed that we establish “safe harbor” standards so that airlines would know that no enforcement action would be taken if their competitive responses satisfied certain conditions.

Some of the safe harbor proposals involve commitments to maintain fare reductions and capacity increases if the incumbent airline’s response is followed by the entrant’s exit from the market. The American Antitrust Institute, for example, has suggested that no enforcement action should be taken against an incumbent airline due to its response to entry in a hub market if that airline makes a commitment to maintain its fare reductions for a specified number of seats for a period of two years, without regard to whether the entrant remains in the market. The airline would be entitled to seek an increase in the fares if necessary to pass through increased costs of doing business on the route. The Institute notes that it has based this suggestion on proposals originally suggested by Dr. William Baumol. American Antitrust Institute Comments at 9-12, citing William J. Baumol, “Quasi-Permanence of Price Reductions: A Policy for Prevention of Predatory Pricing,” 89 Yale L. J. 1 (November 1979).

We recognize the benefits of creating a workable safe harbor standard, but we are uncertain whether such a standard involving commitments to maintain fare levels after any exit by the entrant would be practicable. The incumbent airline might well argue that changed economic conditions or market conditions on the route at issue made fare increases or capacity reductions necessary, notwithstanding its commitment to maintain fares and flight frequencies. Determining the validity of such arguments could be difficult. See also ATA Reply Comments, Reply Statement of Janusz Ordover and Robert Willig at 18-19.

A safe harbor test requiring the incumbent airline to make commitments if its competitive response were followed by the entrant’s exit would discourage the incumbent airline from responding to entry in an exclusionary manner. It also assumes, however, that we would take no enforcement action unless the incumbent airline at some future time failed to comply with its commitment. In other words, we would take no action against the incumbent airline while the

new entrant was still in the market. Such a test could unreasonably tie our hands in the enforcement of section 411.

The Department can always consider similar proposals in individual cases, however, when appropriate. In determining whether to take enforcement action, a respondent airline's willingness to make the kind of commitment proposed by the American Antitrust Institute might weigh against enforcement action, even if the airline's conduct otherwise appears to warrant such action.

Professors Haring and Rohlfs suggested an alternative safe harbor test: no enforcement action would be taken if, among other things, the incumbent airline did not carry more local passengers than it did before entry occurred. Spirit Reply Comments, Statement of John Haring and Jeffrey Rohlfs at 31-32. They contend that we should be skeptical about the legitimacy of an incumbent airline's response to entry involving an increase in output "precisely when demand facing the firm declines and the market becomes less profitable." *Id.* at 31.

While this proposal would provide benefits, adopting a safe harbor test of this kind would be more rational if done after the Department has developed standards for determining the kinds of competitive responses that will be deemed unfair methods of competition.

THE IMPACT OF PREVENTING UNFAIR EXCLUSIONARY CONDUCT ON AIRLINE OPERATIONS AND CONSUMERS

Preventing unfair competitive responses that are designed to eliminate or reduce competition would benefit consumers -- it would protect competition and thereby enable travellers to obtain lower fares and better service over the long term. We explain next the basis for this finding and our related findings on how travellers, airline operations, smaller and medium-sized communities, and labor would be affected by the prevention of unfair competitive responses.

Increased Access to Low Airfares

Preventing unfair competitive responses of the kind analyzed in this paper would give consumers better access to low fares by promoting competition in airline markets. Encouraging competition involving all types of airlines should cause travellers in more markets to benefit from lower fares and additional service options. The Department's action would not prevent any network airline or any other airline from offering low fares and large numbers of discount seats.

This proceeding and the investigations that led up to it have focused on the impact of increased entry by low-fare airlines, which provides the most compelling example of the benefits created by competition. When a network airline's unfair exclusionary conduct forces a low-fare airline to exit the market, the public no longer has the benefit of competition (and is unlikely to regain that benefit) and must pay fares at least as high as the fares charged by the incumbent airline before entry occurred. While the incumbent airline's response initially gives the public the benefit of its low fares and ample availability of discount-fare seats, those benefits last only during the usually brief period when the incumbent seeks to force the entrant's exit. See Alfred Kahn Comments at 10-12.

The exercise of the Department's authority to prohibit unfair methods of competition would discourage hubbing airlines from slashing fares and adding capacity in response to entry with the goal of eliminating the new competition. That may deny the public the short-term benefit of obtaining very low fares subject to few, if any, restrictions from the incumbent airline. On the other hand, it would not keep incumbents from reducing fares in response to entry – indeed, we would expect them to cut their fares. More importantly, by facilitating entry into hub markets and enhancing the entrant's ability to gain a foothold in the market for the long term, stopping unfair competitive responses would give consumers better access to low fares over the long term. Competition provides the best assurance that consumers can obtain low fares.

While actual competition, not potential competition, is the primary determinant of a market's fares and service levels, the prospect of enforcement action under section 411 could also encourage incumbent airlines to charge lower fares than they otherwise would in order to discourage entry. Spirit Reply Comments, Statement of John Haring and Jeffrey Rohlfs at 11; Alfred Kahn Comments at 12.

Preventing unfair competitive responses would not significantly limit the amount of legitimate fare reductions made by incumbent airlines in response to entry. We assume that incumbent airlines will cut fares when entry occurs. The commenters opposing our proposed policy typically focus only on the alleged possibility that a policy would harm travellers by discouraging incumbent airlines from cutting fares as much as they otherwise might. See, e.g., American Comments at 25-26; Northwest Comments at 58-59. These commenters, however, totally ignore the other danger – that the lack of any action by the Department will encourage hubbing airlines to respond to entry in ways intended to eliminate competition. That danger cannot be ignored. Spirit Reply Comments, Statement of John Haring and Jeffrey Rohlfs at 3-4, 11-12; Alfred Kahn Comments at 13, 32. See also Jonathan B. Baker, "Predatory Pricing after Brooke Group: An Economic Perspective," 62 Antitrust Law Journal (Spring 1994) 585, 591, 593. Such anti-competitive responses to entry would reduce competition and cause

consumers to pay higher fares over the long term. Furthermore, in the cases of concern to us, the incumbent airline's low fares and greater availability of discount-fare seats are economically rational only if they force the entrant to end or reduce service. After the incumbent airline achieves that goal, it will substantially increase its fares. Thus such unfair exclusionary conduct harms rather than helps consumers over the long term. See also Patrick Bolton, Joseph F. Brodley, & Michael H. Riordan, "Predatory Pricing: Strategic Theory and Legal Policy," 88 Georgetown Law Journal at 2267, n. 161:

Predatory pricing might appear socially beneficial in all cases through the lower prices it immediately brings to consumers, but that would neglect the vital need to protect the competitive process and thereby the long-run welfare of consumers and society. Predation harms competition and consumers over the longer period because it permits the exclusion of equally or more efficient firms, which is to undermine competition on the merits. . . . Thus, predatory pricing presumptively harms consumers by harming competition itself.

Furthermore, the network airlines' contention that our proposed enforcement of section 411 would frustrate their wish to make low discount fares widely available is contrary to their practices in markets without low-fare airline service, where they do not now choose to make low discount fares widely available. As shown, network airlines focus on travellers willing to pay higher fares. This focus undermines their claims that limiting an incumbent airline's ability to greatly expand the availability of low-fare seats may force the incumbent to "leav[e] passengers standing at the gate." Northwest Comments, Laura Tyson Statement at 25. The network airlines regularly leave passengers "standing at the gate" – they ration the number of low-fare seats and consequently keep many consumers from obtaining low fares in most markets. Alfred Kahn Comments at 19-20. As the state attorneys general point out, "[C]oncern for the fate of the public's access to low fares rings hollow in light of the fact that all airlines are entirely free to offer low fares right now on any route they serve and to commence low fare service today whenever they like." State Attorneys General Reply Comments at 5.

The network airlines claimed that our proposed policy would promote higher fares by encouraging the entrant airline to charge higher fares than it otherwise would, since it would know that the incumbent has a limited ability to cut its fares. See, e.g., American Comments at 26-31. We think this claim is invalid. A hubbing airline remains free to cut fares when doing so is economically rational. A network airline, moreover, has formidable competitive advantages in its hub markets, such as more frequent flights and an attractive frequent flyer program.

A low-fare airline can only hope to attract passengers by relying on its own competitive strength, its ability to offer low fares. Sun Pacific Comments at 16; Spirit Reply Comments at 9. Even those entrants that do not follow a low-fare strategy will likely charge fares lower than the incumbent in order to offset its service advantages. In any event, even if the entrant airline charges somewhat higher fares than it otherwise would, the public still gains from its longterm presence in the market, since otherwise the market would likely have no competitive service. Alfred Kahn Comments at 13, n. 12.

In sum, the prevention of unfair competitive responses would give travellers greater access to low fares over the long term by promoting competition. By deterring some types of unfair competitive conduct, that would encourage more entry into airline markets (and entry on a larger scale) than would otherwise occur.

Since the Department should address competitive responses targeted at a new competitor, this Administration believes that the Department should not seek to block systemwide fare changes or discounts, such as senior citizen, Internet, and standby discount fares. Similarly, the Department should not undermine the ability of airlines to offer inclusive leisure travel for which airfares are not separately advertised (that is, package tours including land accommodations), except in rare situations where such fares were used to eliminate competition in a hub market. In our experience the incumbent airline has entirely or primarily relied on cuts in its fares for scheduled service in responding to entry.

Service Benefits for Small Communities

Any Department action that would foster the growth of competitive airline service would improve service to many small and medium-sized communities. As one group of commenters pointed out, "Competitive air service is vital" to "most small towns and cities in America." July 16, 1998, letter signed by Mike Boggs, the manager of the Eugene Airport, and the managers of sixteen other airports in six Western states. Similarly, Charles Everett, Jr., the Commissioner of Aviation for the City of Syracuse, stated, "The lack of competition in upstate New York markets has caused passenger enplanements to decrease, economic development opportunities to be constrained, and has challenged our ability to secure conventions and other regional and national events, which rely heavily on our ability to provide adequate air service and competitive fares."

Preventing unfair competitive responses would particularly benefit those communities that attract low-fare airline service. As shown, the fares charged in markets without such service are substantially higher than the fares charged in markets with low-fare airline service. Many communities recognize the benefits

of low-fare airline service. Southwest, for example, received delegations seeking Southwest service from 76 communities in 1995, 86 communities in 1996, and 122 communities in 1997. Business Travel Coalition Comments at 3.

Communities such as Rochester, New York, and Des Moines that have had little low-fare airline service strongly supported our proposed guidelines. William Flannery, the Aviation Director of the City of Des Moines, stated, “[W]e enthusiastically encourage the Department of Transportation [to] continue its efforts to preserve competition and to stop anticompetitive behavior”

The comments filed by Rochester parties and other upstate New York parties demonstrate how the lack of low-fare airline competition causes substantial harm to a community’s economy. Thomas Mooney, the President of the Greater Rochester Chamber of Commerce, stated,

There is a correlation between the high cost of air travel and the slow rate of growth for the upstate economy. Ultimately, these firms must pass on these costs on to customers when pricing their goods and services.

The disparity in airfares has also caused a growing number of Rochester area businesses to hold their sales meetings in other cities

Worse still, some Rochester companies have even relocated certain operations to other cities.

Congresswoman Louise Slaughter has similarly stressed the need of communities for lower airfares and more competition,

To compete effectively, our region must have access to frequent and affordable air service.

. . . . A relatively young and growing Rochester-based firm recently wrote me that due to the high cost of air travel, they made a decision four months ago not to add any high travel positions out of their Rochester based headquarters. Since that time, they have added several positions in their mid Atlantic based locales, where the airfares are much more reasonable.

We cannot agree with the claims by network airlines and other commenters that our proposed policy would harm service to small and medium-sized communities. These claims assume that a hubbing airline’s loss of any

significant amount of traffic on a hub route will force the airline to reduce the number of flights on that spoke and that that reduction in flights will in turn force the hubbing airline to reduce the number of flights offered on other spoke routes. See, e.g., ATA Comments at 59-60.

This scenario is contrary to experience. We have conducted studies of the effect of increased low-fare airline service at four network airline hubs – Atlanta, Chicago, Denver, and Salt Lake City – and found that the low-fare airlines' increased market share did not unravel the network airline's service to small and medium-sized communities (the study categorized cities as large hubs, medium hubs, small hubs, and non-hubs; a small hub is defined as an airport that has from 0.05 and 0.2499 percent of total U.S. enplanements, a non-hub is defined as an airport that has less than 0.05 percent of total U.S. enplanements).

The growth of low-fare airline competition at Salt Lake City, for example, has not led to a shrinking of Delta's hub there. Morris began operating at Salt Lake City during the second quarter of 1993; by March 1997, Southwest, which had acquired Morris, served fourteen nonstop markets from Salt Lake City and had an eighteen percent share of local Salt Lake City traffic. The local market share of the hub airline, Delta, dropped from 60 to 52 percent during the period. Nonetheless, the number of small and medium-sized communities served by Delta from Salt Lake City did not change significantly, while the number of both flights and seats operated by Delta to non-hub communities and to small hub communities from Salt Lake City increased.

Similarly, between March 1993, before ValuJet began operating at Atlanta, and March 1996, when ValuJet had a twelve percent share of local Atlanta traffic, Delta added service to three small hub and non-hub communities and increased (slightly in some cases, significantly in other cases) the number of both flights and seats operated to non-hub communities and to small hub communities from Atlanta.

United increased the number of small hubs with nonstop service from Denver from September 1994 to September 1997, a period in which low-fare airlines centered in Colorado began business; United continued to operate about the same number of flights from Denver to small hubs and to non-hubs, although it decreased the number of seats on those routes.

The network airlines have provided no evidence showing that increased competition at hubs has caused a hubbing airline to reduce service on the smaller spoke routes. Furthermore, a network airline's loss of some revenue on its larger spoke routes at a hub should encourage it to take steps to promote traffic growth on the smaller spokes.

We recognize that a number of medium-sized and smaller communities fear service losses if major airlines are limited at all in their ability to respond aggressively to new entry. The Chattanooga Metropolitan Airport Authority, for example, is concerned that our proposed policy could deter network airlines from adding flights to smaller or medium-sized communities in competition with a low-fare airline and would lead to reductions in the sizes of hubs due to the hubbing airline's loss of traffic. We understand the concerns of such communities, whose airline services often already fall short of their needs. However, as shown, preventing unfair competitive responses would not cause hubs to shrink and so would not cause significant service reductions. In addition, it should cause a number of smaller and medium-sized communities to gain the benefit of competitive service.

Impact on Hub Operations

Investigating competitive responses seemingly designed only to eliminate or reduce competition would not undermine the network airlines' hub-and-spoke operations. We have long recognized that hub-and-spoke operations enable airlines to operate more efficiently, create more competition for longhaul travellers using alternative airline hubs as a connecting point between their origin and destination points, and enable local hub markets to receive more flights than the local traffic alone would justify. U.S. Department of Transportation, The Low-Cost Airline Service Revolution (April 1996) at 26; U.S. Department of Transportation, Secretary's Task Force on Competition in the U.S. Domestic Airline Industry (February 1990), Executive Summary to Industry and Route Structure at 14-16. See also TRB Report at 65-67; Levine, "Airline Competition in Deregulated Markets," at 441-442.

Enforcement action against unfair exclusionary practices would promote competition in the local hub markets by helping to prevent anti-competitive practices that appear to be designed only to eliminate competition. If competing airlines establish themselves in hub markets, they will carry a portion of the traffic and reduce the hub airline's share of the market. Competition, especially when due to a low-fare airline's entry, will lead to lower fares, which will increase the size of the market. The hubbing airline may well carry more traffic than it did before. And the new entrant may itself develop a hub, as AirTran and Frontier have done at Atlanta and Denver, respectively.

Experience has shown that entry into hub markets by low-fare airlines, even on a large scale, does not interfere with a network airline's ability to maintain its hub. Network airlines have maintained hubs after entry by low-fare airlines. Some network airline hubs have a significant amount of low-fare airline service, such

as Atlanta, Denver, Salt Lake City, and St. Louis. In addition, the airlines operating hubs at Chicago's O'Hare International Airport, the Dallas-Fort Worth International Airport, and Houston's George Bush International Airport face competition from the low-fare services offered at, respectively, Midway, Love Field, and Hobby.

Thus neither the prevention of unfair competitive responses nor the growth of low-fare airline operations would undermine the network airlines' hub-and-spoke systems. Moreover, even if a hubbing airline operates somewhat fewer flights in some spoke routes as a result of any enforcement efforts by the Department (and the encouragement given competitors to enter hub markets), travellers on those routes would gain the benefits of lower fares, a choice of airlines, and often more flights and seats.

Several of the commenters nonetheless charge that our proposed policy would interfere with the operation of hubs and cause hubbing airlines to reduce service in many spokes and perhaps end service on some spokes. *See, e.g.,* ATA Comments at 59-60. They have not shown, however, that a hub's survival requires the hubbing airline to maintain its control of all or most of the traffic in spoke markets at a hub, nor have they alleged that hub operations at cities like Salt Lake City and Denver have suffered from the growth of low-fare airline service.

And even if it were true that competitive low-fare airline service in hub markets would undermine the incumbent airline's hub operations, that would not justify allowing the incumbent airline to deliberately take steps to exclude competition. The commenters essentially contend that we should not block anti-competitive practices that reduce competition in hub markets because that would interfere with the hubbing airline's ability to continue providing the hub services valued by many consumers. This type of claim is contrary to the purpose of the nation's competition laws.

The Supreme Court has held that conduct violating the Sherman Act should not be excused on the claims that the conduct, unlike competition, will achieve a socially desirable result. In NCAA v. Board of Regents, 468 U.S. 85, 116-117 (1984), for example, the NCAA had argued that its restraints on televising college football games were necessary since its preferred product -- tickets for attending the games -- would not attract enough consumers without limits on televised games. The Court rejected this justification: "By seeking to insulate live ticket sales from the full spectrum of competition because of its assumption that the product itself is insufficiently attractive to consumers, [the NCAA] forwards a justification that is inconsistent with the basic policy of the Sherman Act," 468 U.S. at 117.

This principle applies here – the marketplace, not government regulators, should determine what types of service are offered the public. The Department should use its section 411 authority to protect competition, not to promote one type of service over another by giving the former unfair advantages in the marketplace. See also Love Field Service Interpretation Proceeding, Order 99-4-13 at 14 (April 13, 1999), affirmed, American Airlines v. Department of Transportation, 202 F.3d 788 (5th Cir. 2000).

Furthermore, even if the prevention of unfair competitive responses undermined an airline’s hub-and-spoke system, that could benefit travellers in the markets served by that airline in some ways. Many travellers and airports have come to believe that the airline services at non-hub cities may be better in several respects than the service at hub cities. “Taking Off: Kansas City Thrives Despite Not Boasting an Airline Hub,” Wall Street Journal (July 2, 1999). As discussed above, travellers in hub markets usually pay significantly higher fares than travellers in comparable non-hub markets, unless the hub market has low-fare airline service.

Protecting Competition Is Not Reregulation

Preventing unfair competitive practices is consistent with Congress’ decision to deregulate the airline industry. Indeed it would help assure the continuing success of deregulation, since deregulation cannot succeed without competition. We are firmly convinced of the great value of airline deregulation and that the type of economic regulation imposed on the airline industry until 1978 should not be restored in whole or in part. Our DOT White Paper thus stated, id. at 1:

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 airfares.

At the May 19, 1998 hearing of the House Judiciary Committee, Nancy McFadden, then the Department’s General Counsel, similarly testified,

Let no one mistake our view – deregulation of domestic air travel in 1978 was one of Congress’ earliest and best efforts to bring powerful economic forces to bear on behalf of the traveler, the shipper, and the airline industry itself. This view is widely shared, and is confirmed by all of our studies at the Department.

Our conviction that deregulation works – and works well – by no means excuses us from addressing practices that are anticompetitive. The success of deregulation depends on competition and thus on the prevention of unfair practices that may reduce or eliminate competition. As Congress stated when it deregulated the airline industry, S. Rep. No. 95-631, 95th Cong., 2d Sess. (1978) at 52:

Vigorous enforcement of antitrust policy is the discipline by which competition can remain free and markets can operate in a healthy fashion. Predatory behavior, market concentration, and other economic evils should be avoided and remedied by the Board when they exist.

Firms in every unregulated industry are subject to laws designed to ensure the maintenance of competition – both the antitrust laws and, in most other industries, the Federal Trade Commission Act, which authorizes the FTC to prohibit unfair methods of competition. The Department’s statute gives it similar authority.

As a result, there is no basis for the claims of some parties that preventing unfair competitive responses would amount to reregulation. The Department should consider enforcement action only in cases where an incumbent airline has taken action which appears to be designed only to eliminate competition in markets where that airline has an ability to obtain market power.

Moreover, the claim by some commenters that the prevention of unfair competitive responses, despite our best intentions, would create a slippery slope toward reregulation, ATA Surreply Comments, Statement of Janusz Ordover and Robert Willig at 7, ignores both our express intent and the other commitments on our resources. Enforcement action would not entail a general regulation of airline fares and services. The Department would just be carrying out its responsibility to prevent unfair competitive practices that will deny consumers the benefits of competition and thus the benefits of deregulation. Even if the Department wanted to reregulate (and it would not), it could not do so without a radical expansion of its statutory authority over domestic airline operations and very large increases in its staffing and budget.

These commenters, moreover, overlook the real threat to deregulation – the use by dominant airlines of their market power to end competition. If hubbing airlines can exercise the power to charge supracompetitive fares without restraint, community groups and consumers will demand that the Government regulate fares and service so that travellers can obtain reasonable fares. Professors Haring and Rohlfs accurately characterize the need to ensure a

competitive airline industry when they say, Spirit Comments, Statement of John Haring and Jeffrey Rohlfs at 12:

[G]overnment failure to take effective steps to ensure maintenance of effective competition could well lead to calls for and reimposition of genuine regulation. . . . Taking prudent steps to insure against the evolution of market structures that invite re-regulation would thus likely enhance economic welfare.

See also Alfred Kahn Comments at 10.

Impact on Legitimate Competition

If the Department takes action against unfair competitive practices in order to promote competition, it would not chill legitimate competition or lead to any reregulation of domestic fares and service. The Department would be creating a level playing field, not protecting individual competitors or classes of competitors. The Department would consider acting only when an airline is responding to new competition in ways seemingly designed only to eliminate competition. Any major airline that wants to adopt a strategy of making low fares widely available should remain free to do so. And network airlines should be able to create and develop low-cost subsidiaries, as three have done.

We fully understand that a competitor's entry, especially entry by a low-fare airline, into a market will usually force the incumbent to respond by cutting its fares and by making more discount seats available. In fact we are recommending that the Department take steps to promote entry because competition causes airlines to reduce their fares. We want incumbent airlines to compete vigorously.

Adequate Guidance

The Department through the enforcement process can develop standards on the kinds of competitive responses that are unfair methods of competition. We have decided against adopting such standards now, since relying on the enforcement process would result in standards that best account for industry practices. As a result, we are not defining the specific types of conduct that would cause us to take enforcement action or the types of conduct that should be deemed an unfair method of competition.

In general, this Administration has concluded that the Department should consider taking action when an airline responds to entry in a manner that seems intended to eliminate or reduce competition, since the response otherwise would not make economic sense. We assume that airlines ordinarily seek to maximize their profits when they develop a response to entry (or increased competition from airlines already in the market). Delta, for example, claims that airlines always choose a response that will be profit-maximizing. Delta Comments at 9-10; July 28, 1998, Continental Meeting Notes at 2.

Airlines in fact normally respond to entry (or to other fare and schedule changes made by competitors) in ways designed to maximize profits. They are used to deciding quickly how to respond to competitive developments. See, e.g., July 28, 1998, Continental Meeting Notes at 1, 2. Continental, for example, states that

it developed a mathematical model to forecast demand based on varying fare levels. Continental Comments at 10.

Thus, as the state Attorneys General point out, Department action that discourages competitive responses that are economically rational only if they exclude or reduce competition would not require airlines to depart from normal business practices, State Attorneys General Reply Comments at 6-7:

Every business has as one of its purposes the maximization of profits. Maximizing profits usually, although not always, accompanies maximization of revenue. Thus, every business makes a reasonable effort to price its products and offer services that will have that end result. In doing so, those businesses make many judgments comparable to the judgment required by the guidelines. Many legal standards, whether in the business world or elsewhere, require people to make decisions with less than perfect information. There is no reason to suppose the judgments required by the proffered standards are any more taxing than many others in the business world. In fact, the primary duty required of airlines by the guidelines is to follow ordinary business conduct in setting business strategy and revenue targets and avoid the short term anticompetitive strategy the guidelines are designed to prevent.

Impact on Frequent Flyer Program Members

Preventing unfair competitive responses would benefit travellers who belong to frequent flyer programs. Frequent flyer program members usually fly more often than other travellers so they would benefit more from Department actions which will promote competition and thus lower fares and additional service. In addition, airlines use frequent flyer programs as a competitive tool, so increased competition would encourage airlines to increase the attractiveness of their programs. We fully recognize the value to consumers of their ability to obtain frequent flyer program benefits.

In some cases incumbent airlines faced with new competition have responded by offering bonus frequent flyer mile awards – triple miles, for example -- to passengers in the markets where entry has occurred, but not in other markets. Such bonus awards of frequent flyer miles may be intended to eliminate the new competition. If so, the incumbent airline will likely terminate the bonus awards after the entrant has left the market. Bonus frequent flyer mile awards targeted to routes where entry has occurred may warrant enforcement action, but only if the incumbent airline has taken other steps that appear to be economically

irrational unless they succeed in forcing the entrant to exit the market. Few of the complaints submitted to us thus far, however, have cited bonus frequent flyer mile awards as one of the competitive tactics used by an incumbent airline to eliminate competition. In extreme cases an incumbent airline may use large bonus frequent flyer program awards, however, as a means of eliminating or reducing competition. We encourage airlines to compete by offering more attractive programs.

Impact on Flow Traffic

Taking enforcement action against unfair exclusionary conduct would not affect the ability of airlines to carry non-origination and destination traffic on the portion of routes served by new entrant airlines. It would not affect a network airline's ability to carry flow passengers on spoke routes where it competes with a new entrant airline. As shown, preventing unfair competitive responses would not undermine hub-and-spoke operations or preclude an incumbent airline from changing its capacity on a spoke route to meet the needs of flow passengers.

Some of the unreasonably aggressive competitive responses observed by us, moreover, have caused the incumbent airline to sell so many seats to travellers in the local market where entry occurred that the airline has too few seats available to meet the demands of flow traffic. Taking enforcement action against unfair competitive responses would benefit travellers in the connecting markets. It should deter incumbent airlines from limiting the seats available to flow traffic in an effort to soak up all of the increased demand generated by the low fares originally offered by the entrant in the local market.

Impact on Industry Profit Levels

Preventing unfair competitive practices would strengthen airline competition. Increased competition would give consumers lower fares and better service and encourage airlines to operate more efficiently. It would also reduce the ability of incumbent airlines to maintain market power, which could reduce their overall profitability. On the other hand, increased competition would likely encourage incumbent airlines to operate more efficiently in order to maximize their profits. Given the public policy favoring competition and the substantial benefits obtainable by consumers, the possible reduction of airline profits would not be a ground for staying the Department's hand under section 411. Indeed, even before deregulation the courts held that the Civil Aeronautics Board's goal of improving the airline industry's overall financial condition could not justify a Board decision blocking new competitive service. Continental Air Lines v. CAB, 519 F.2d 944, 957-958 (D.C. Cir. 1975).

We recognize that the public's ability to obtain adequate service in the long run depends on the industry's financial stability and ability to earn sufficient profits. However, we do not think that anticompetitive conduct should be excused on the ground that industry profits will otherwise be too low. Moreover, the airline industry has earned record profits in the late 1990's, although in 2000 increased fuel prices significantly increased airline costs and some airlines earned lower profits (or incurred losses) due to operational problems and labor disputes.

On the other hand, we are not concluding that the industry's profits are too high. We instead have found only that fares in many hub markets are much higher than the fares in comparable non-hub markets, that entry by low-fare airlines and other airlines into hub markets would reduce hub fare premiums, and that incumbent airlines have responded to entry in ways that appear to be motivated to eliminate competition and that achieve that goal. We have never stated that the total profits earned by individual airlines and by the industry are too high, and we are not seeking to reduce overall profits. As a result, Northwest wrongly asserts that we unreasonably assumed that the airline industry is making large profits.

The Department should not end its efforts to promote additional competition in hub markets because the industry incurred record losses in the early 1990's. The industry in recent years has not suffered large losses. Instead most airlines have been earning large profits. In addition, no one claims that the earlier losses have severely damaged the airlines' current financial position and thereby prevented them from investing in aircraft and facilities.

Impact on Labor

Preventing unfair competitive responses should not harm airline employees. It would give airlines, including low-fare airlines, a better chance to succeed in penetrating markets now dominated by one or two airlines. Increased competition in those markets would lead to lower fares and more traffic, thereby increasing the industry's demand for employees. Encouraging low-fare airlines to enter more markets would not harm employment at the network airlines -- those airlines have been able to share markets with low-fare airlines, so any growth of low-fare airlines would not significantly reduce the network airlines' traffic.

The labor union commenters' claim that subjecting unfair competitive responses to potential enforcement action would be unfair to labor is based on inaccurate assumptions. Labor parties assume that the only substantial cost advantage of a low-fare airline is its alleged failure to pay wages and provide benefits comparable to those offered by network airlines. ALPA Comments at 2; Allied

Pilots Ass'n Comments at 2. Southwest's experience demonstrates the contrary – despite its low costs, Southwest provides good wages and working conditions, as recognized by some labor parties. See, e.g., Allied Pilots Ass'n Comments at 3. The network airlines' low-cost subsidiaries, moreover, are similarly achieving lower costs largely by operating more efficiently. They do not pay substandard wages.

Even if low-fare airlines typically pay lower wages and operate without unionized employees, as they grow they are likely to become unionized. That has happened with Southwest, as ALPA recognizes. ALPA Comments at 4. The Transportation Trades Department, AFL-CIO, submitted a resolution opposing our proposed guidelines that also states, "The reality is that most new entrants will eventually become unionized and in fact at a number of smaller carriers employees have already chosen to enjoy the benefits that union representation and collective bargaining can bring." Transportation Trades Department, AFL-CIO, Comments. New firms in any industry typically begin operating with a non-union workforce; after the firms become established, their employees are likely to seek union representation. We assume the same pattern will occur with the newer low-fare airlines and other entrants into the industry.

In addition to increasing overall employment levels in the airline, moreover, any expansion of low-fare airline service – and the resulting increases in traffic – would increase employment in related travel industries and in the aircraft manufacturing industry. For these reasons as well workers would benefit from the Department's enforcement of section 411 in cases where incumbent airlines are implementing a goal of excluding competition.

Finally, airline employees and their families as consumers would benefit. Discouraging unfair competitive conduct intended to eliminate competition would lead to lower fares in a number of markets. That would benefit labor union members. The UAW thus signed a stock investment agreement with ProAir, the low-fare airline based at Detroit, that enabled UAW members to travel on ProAir at reduced fares. The February 4, 2000, UAW press release describing the agreement quotes the UAW's President as saying, "We view this partnership with ProAir as good for our members in the many communities served by ProAir, good for Detroit City Airport, good for the general public in terms of keeping airfares lower and good for ProAir's effort to build an efficient, safe, and consumer friendly airline." Although ProAir's suspension of service has temporarily ended these benefits for UAW members, the union's willingness to enter into the agreement with ProAir indicates the value placed by unionized workers on access to low fares.

Consistency with the United States' International Aviation Policy

Several network airlines contend that our adoption of the proposed guidelines would damage the United States' international aviation policy by encouraging foreign governments to restrict schedule and fare changes made by U.S. airlines in order to protect the foreign governments' homeland airlines. That would frustrate the United States' policy of promoting competition in international airline markets and ending government regulation that denies airlines the ability to respond to consumer demands. See, e.g., ATA Comments at 61-63; United Comments at 4-5.

We recognize that some foreign governments have tried to restrict the service offerings of U.S. airlines on the basis of claims that the U.S. airlines' schedule and fare proposals would unfairly undermine the ability of a foreign airline to compete and survive in a market. We fully agree with the commenters' statements that the kind of restrictions sought by these foreign governments are often unwarranted and harm travellers. See also Alfred Kahn Comments at 31, n. 28. However, the possible misuse of our findings by some foreign governments provides no basis for suspending this proceeding, as urged by the network airlines.

We held this proceeding to examine when the Department should consider taking enforcement action under its authority to prohibit unfair methods of competition. Given the benefits that section 411 enforcement should provide domestic travellers, we would be very reluctant to abandon this proceeding on the basis of foreign policy concerns without a strong showing that it could cause substantial harm. We think that taking enforcement action against unfair exclusionary practices would not undermine the United States' procompetitive international aviation policy. The United States has always had the right to enforce its competition laws in domestic and international markets. As noted above, the Justice Department has filed a Sherman Act suit against American that alleges that the airline used price cuts and capacity increases to monopolize DFW markets. The Department would be considering enforcement action against similar conduct that is seemingly designed only to restore or obtain market power.

In addition, the Department should not seek to protect airlines whose competitive difficulties flow from inefficient operations or an inability to provide services that consumers find attractive. The Department's implementation of this Administration's findings accordingly cannot justify foreign government restrictions on U.S. airline services designed only to protect an inefficient homeland airline against aggressive competition. The United States, moreover, retains the right to stop foreign governments from unfairly and

unlawfully limiting the schedule and fare changes made by U.S. airlines. We intend to take action when a foreign government unlawfully restricts the rights of U.S. airlines in order to protect a competing foreign airline.

LEGAL ISSUES

Introduction

The Department's proposal to adopt an enforcement policy on unfair exclusionary conduct raised a number of legal issues. The major issue is whether our authority under 49 U.S.C. 41712, formerly section 411 of the Federal Aviation Act, to prohibit unfair methods of competition authorizes us to consider taking enforcement action against unfair competitive conduct, such as fare cuts and capacity increases by dominant airlines in response to new competition, that may not violate the antitrust laws. After considering the parties' arguments, we conclude that the Department has the statutory authority to take such action. Doing so would be consistent with Congress' intent to deregulate the domestic airline industry and would carry out the Department's responsibility to prevent unfair competitive practices.

We had proposed guidelines for our use of our discretionary enforcement authority. We have determined not to adopt such guidelines. We are instead setting forth our findings that airlines have at times apparently engaged in unfair competitive practices designed to eliminate or reduce competition in markets where market power can be obtained and that the Department should address such conduct. The Department can develop standards on what constitutes an unfair method of competition in violation of section 411 in individual enforcement cases.

Section 411 authorizes the Department to prohibit unfair methods of competition, which can include practices that violate antitrust principles even if they do not violate the antitrust laws. Congress created and then maintained our authority to prohibit unfair methods of competition in the airline industry to supplement the antitrust laws. Section 411 therefore gives the Department the power to prohibit conduct that violates antitrust principles, even if the conduct does not violate the antitrust laws. The type of competitive response discussed in this paper – responses intended to restore and preserve an incumbent airline's market power in individual airline markets – is analogous to conduct prohibited by the antitrust laws. The Department's exercise of its authority under section 411 would strengthen the government's efforts to prevent unfair competitive conduct, as Congress intended, since the Department has the power to stop unfair competitive practices that may not violate the antitrust laws.

The Department's governing statute, moreover, directs it to stop unfair competitive conduct that harms consumers. As Congress explained when it enacted the Airline Deregulation Act of 1978, P.L. 95-504, 92 Stat. 1705 (1978)

("the Deregulation Act"), maintaining competition requires the prevention of unfair competitive conduct, S. Rep. No. 95-631, 95th Cong., 2d Sess. (1978) at 52:

Vigorous enforcement of antitrust policy is the discipline by which competition can remain free and markets can operate in a healthy fashion. Predatory behavior, market concentration, and other economic evils should be avoided and remedied by the Board when they exist.

Six years later Congress enacted the Civil Aeronautics Board Sunset Act of 1984, P.L. 98-443, 98 Stat. 1703 ("the Sunset Act"), in part to preserve our authority to prohibit unfair methods of competition in the airline industry. In doing so Congress reaffirmed its position that deregulation requires the prevention of unfair competitive conduct. Congress reasoned that maintaining the Department's authority to prohibit unfair methods of competition was necessary to make deregulation work, H.R. Rep. No. 98-793, 98th Cong., 2d Sess. (1984) at 4-5:

There is also a strong need to preserve the Board's authority under Section 411 to ensure fair competition in air transportation Although the airline industry has been deregulated, this does not mean that there are no limits to competitive practices. As is the case with all industry, carriers must not engage in practices which would destroy the framework under which fair competition operates.

Thus, as explained in more detail below, the prevention of unfair competitive practices, including the use of fare cuts and capacity increases designed only to eliminate competition, would be consistent with Congress' goals for a deregulated industry.

A number of the comments, primarily those submitted by the network airlines, challenged the Department's authority to adopt our proposed policy, since it did not purport to follow the antitrust cases applying the Sherman Act. Since we are not adopting guidelines as we had proposed, we do not need to respond to all their arguments. We will, however, explain why the Department's authority to prohibit unfair methods of competition authorizes it to prohibit practices that violate either the letter or the spirit of the antitrust laws; why we may lawfully prohibit conduct that may not constitute predation prohibited by the antitrust laws; why doing so would be consistent with Congress' deregulation of the airline industry; why our findings and recommendations, insofar as they involve predatory-type conduct, are consistent with the statute's use of a limited

definition of predation for other purposes; and why the Department may take action against unfair exclusionary conduct notwithstanding earlier statements by this Department and the Civil Aeronautics Board ("the Board") that suggested that predation should not be a concern in the airline industry.

THE DEPARTMENT'S AUTHORITY TO PREVENT UNFAIR COMPETITIVE PRACTICES

The Department's Authority to Prohibit Unfair Methods of Competition

Section 411 of the Federal Aviation Act, recodified as 49 U.S.C. 41712, empowers us to prohibit business practices as unfair methods of competition. It states,

[T]he Secretary may investigate and decide whether an air carrier . . . has been or is engaged in an unfair or deceptive practice or an unfair method of competition in air transportation If the Secretary, after notice and an opportunity for hearing, finds that an air carrier . . . is engaged in an unfair or deceptive practice or unfair method of competition, the Secretary shall order the air carrier . . . to stop the practice or method.

The Department's authority to prohibit unfair methods of competition gives it the power to prohibit conduct on competitive grounds even if that conduct does not violate the Sherman Act. See, e.g., Pan American World Airways v. United States, 371 U.S. 296, 306-308 (1963).

In United Air Lines v. CAB, 766 F.2d 1107 (7th Cir. 1985), the Seventh Circuit, in an opinion written by Judge Posner, affirmed the Board's airline computer reservations system rules on that basis. The Board had adopted most of those rules under its section 411 authority to prohibit unfair methods of competition. The Court affirmed the rules even though it believed that no system had monopoly power. The Court held that the Board's finding that some of the systems had substantial market power was sufficient to authorize the Board to regulate CRS practices: this finding "would bring their competitive practices within the broad reach of section 411," for the Board "can forbid anticompetitive practices before they become serious enough to violate the Sherman Act." The Court reasoned that the types of conduct prohibited by the Board on antitrust grounds -- price discrimination and denying a competitor access to an essential facility on equal terms -- were "traditional methods of illegal monopolization" that the

Board could prohibit, even though no system had a monopoly under Sherman Act standards. United Air Lines, 766 F.2d at 1114.

Congress modelled the Department's authority under section 411 to prohibit unfair methods of competition on section 5 of the Federal Trade Commission Act, 15 U.S.C. 45. See American Airlines v. North American Airlines, 351 U.S. 79, 82 (1956); United Air Lines, *supra*, 766 F.2d at 1111-1112. The judicial decisions on the scope of the Federal Trade Commission's comparable authority to prohibit unfair methods of competition therefore provide guidance on the extent of the Department's authority under section 411.

The courts have held that the FTC's authority to prohibit unfair methods of competition allows that agency to prohibit practices that do not violate the Sherman or Clayton Acts. For example, in FTC v. Brown Shoe Co., 384 U.S. 316, 320-321 (1966), the Court stated, "[I]t is now recognized . . . that the Commission has broad powers to declare trade practices unfair. This broad power of the Commission is particularly well established with regard to trade practices which conflict with the basic policies of the Sherman and Clayton Acts even though such practices may not actually violate those laws." See also Atlantic Refining Co. v. FTC, 381 U.S. 357, 368 (1965) (" . . . [T]here are many unfair methods of competition that do not assume the proportions of an antitrust violation"). Similarly, the Second Circuit has held that the FTC may bar conduct "which, although not a violation of the letter of the antitrust laws, is close to a violation or contrary to their spirit." E.I. Du Pont de Nemours & Co. v. FTC, 729 F.2d 128, 136-137 (2nd Cir. 1984). These decisions thus show that section 411 similarly authorizes the Department to prohibit practices that violate antitrust principles, even if they do not violate the antitrust laws.

Congress created the FTC after determining that the Sherman and Clayton Acts did not address all potential unfair methods of competition. See FTC v. Gratz, 253 U.S. 412, 432-435 (1920) (Brandeis, J., dissenting). Congress gave the FTC broad authority to prohibit unfair methods of competition, since defining all potential unfair competitive practices by statute would be impracticable. See FTC v. Sperry & Hutchinson Co., 405 U.S. 233, 239-240 (1972); E.I. Du Pont de Nemours & Co. v. FTC, 729 F.2d 128, 136 (2nd Cir. 1984). In addition, as Justice Brandeis explained, individual industries could require different competition standards due to differences in their business and competitive conditions. FTC v. Gratz, 253 U.S. at 436 (Brandeis, J., dissenting). Justice Brandeis, one of the drafters of the Federal Trade Commission Act, stated,

Experience with existing laws had taught that definition, being necessarily rigid, would prove embarrassing and, if rigorously applied, might involve great hardship. Methods of competition which would be unfair in one industry, under certain circumstances, might, when adopted in another industry, or even in the same industry under different circumstances, be entirely unobjectionable.

The Department would base its decisions on its examination of how competition operates in the airline industry. That approach would be consistent with Congress' expectation on the Department's use of its expertise to define unfair methods of competition in the airline industry.

Consistency with Antitrust Principles

We have construed section 411 as allowing the Department to prohibit a practice as an unfair method of competition if the practice violates antitrust principles. See, e.g., 57 Fed. Reg. 43780, 43789 (September 22, 1992). Taking enforcement action against unfair competitive practices such as fare reductions and capacity increases intended only to eliminate or reduce competition policy would meet this standard. This Administration has concluded that the Department should examine whether certain types of competitive responses in the airline industry appear to be economically rational only if they eliminate, reduce, or prevent competition and thereby deny travellers its benefits over the long term.

Section 2 of the Sherman Act prohibits monopolization and attempted monopolization. As stated by the Supreme Court, "The offense of monopoly under section 2 of the Sherman Act has two elements: (1) the possession of monopoly power in the relevant market and (2) the willful acquisition or maintenance of that power as distinguished from growth or development as a result of a superior product, business acumen, or historic accident." United States v. Grinnell Corp., 384 U.S. 563, 570-571 (1966). The Sherman Act allows a dominant firm to increase its market share by being more efficient or offering better products or services. See, e.g., Foremost Pro Color v. Eastman Kodak Co., 703 F.2d 534, 544-546 (9th Cir. 1983). A monopolist may not, however, engage in conduct that is economically rational only if it eliminates competition. See, e.g., Aspen Skiing Co. v. Aspen Highlands Skiing Corp., 472 U.S. 585 (1985).

One practice that constitutes unlawful monopolization is predatory price cuts. See, e.g., Kelco Disposal v. Browning-Ferris Industries, 845 F. 2d 404 (2nd Cir. 1988), aff'd on other grounds, 492 U.S. 257 (1989). Other practices may also constitute illegal monopolization, such as refusals to deal when effective competition and consumer demands require some cooperation between

competitors, Aspen Skiing Co. v. Aspen Highlands Skiing Corp., 472 U.S. 585, 604-605 (1985), and denials of access to an essential facility controlled by the dominant firm, MCI Communications Corp. v. American Telephone & Telegraph Co., 708 F.2d 1081, 1132-1133 (7th Cir. 1983).

Our proposed guidelines, which focused on fare reductions and capacity additions, were limited to those extreme fare cuts and capacity increases that would be rational for the incumbent airline only when they eliminate competition in its hub markets, where that airline is likely to possess market power.

After considering the comments, the TRB report, and our own further investigations, we have concluded that the Department should take action against any kind of conduct that is seemingly designed to restore or create market power for a dominant airline. The Department should not limit its action to cases where one airline may obtain the power to dominate a market. We have seen several examples of potential anticompetitive conduct involving markets served by two hub airlines offering nonstop service, where one or both of the hubbing airlines had apparently taken steps to eliminate the new competition. A hub airline that eliminates competition from a low-fare airline in such a market will often be able to recoup its lost revenues by charging much higher fares after the low-fare airline exits.

Department action in cases involving nonstop markets served by two incumbent airlines would be consistent with the Supreme Court's decision in Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 228-230 (1993). The Court there held that consumers can be harmed by predation in an oligopolistic industry: "A predatory pricing scheme designed to preserve or create a stable oligopoly, if successful, can injure consumers in the same way, and to the same extent, as one designed to bring about a monopoly." 509 U.S. at 229. See also Jonathan B. Baker, "Predatory Pricing after Brooke Group: An Economic Perspective," 62 Antitrust Law Journal (Spring 1994) 585, 594-595. The Court's reasoning would apply to hub markets served by two network airlines.

Department action may also be appropriate in some cases where the incumbent airline's response to entry has reduced but not eliminated competition. Brooke Group itself involved an alleged plan to use predation as a means of disciplining one firm without forcing its exit from the market. The firms allegedly engaging in predatory pricing intended to compel that firm to stop selling cigarettes at low prices. The Court described predation under the Sherman and Robinson-Patman Acts as a firm's pricing of products "with an object to eliminate or retard competition and thereby gain and exercise control over prices in the relevant market." Brooke Group, 509 U.S. at 222. See also

Patrick Bolton, Joseph F. Brodley, & Michael H. Riordan, "Predatory Pricing: Strategic Theory and Legal Policy," 88 Georgetown Law Journal (August 2000), 2239, 2268-2269.

Although the courts have held that the Department's authority under section 411 empowers it to prohibit conduct that does not violate the antitrust laws, the network airlines and several other commenters contended with respect to our proposed policy that statements made by the Supreme Court in several antitrust cases indicate that we may not prohibit predatory-type behavior by an airline unless the airline's reduced fares are below its costs under an appropriate measure. The network airlines additionally cited the Supreme Court's statements in Brooke Group that predation is unlikely and that price cuts almost always benefit consumers. The Court suggested in that case that a plaintiff in a Robinson-Patman or Sherman Act predation case must show that the price is below an appropriate measure of cost and that the defendant firm could probably charge supracompetitive prices after eliminating competition and thereby recoup the losses incurred by pricing below its costs. Brooke Group, 509 U.S. at 222-225.

This Administration has concluded that the Department should not dismiss the possibility of action in cases where the incumbent airline's fares appear to be above cost. The Court's observations in Brooke Group would not prevent the Department from beginning an enforcement proceeding where the incumbent airline's behavior may be lawful under Sherman Act cost standards. Among other things, as explained earlier in this paper, the fare reductions of concern to us do not ultimately benefit consumers – those kinds of short-term fare reductions in the long term may well deny travellers the benefits of lower fares and competitive service. Congress has given us the authority to prevent unfair competitive practices of this kind in the airline industry.

Moreover, section 411 creates no private right of action. Polansky v. Trans World Airlines, 523 F.2d 332 (3rd Cir. 1975). The Department cannot award treble damages (or any damages) in a section 411 proceeding. Pan American World Airways v. United States, 371 U.S. 296, 311 (1963); S.S.W., Inc. v. Air Transport Ass'n, 191 F.2d 658, 663 (D.C. Cir. 1951); Aloha Airlines v. Hawaiian Airlines, 349 F. Supp. 1064, 1067 (D. Hawaii 1972), aff'd, 489 F.2d 203 (9th Cir. 1973). The Department's findings that an airline engaged in unfair methods of competition would not establish liability in a private suit under the Sherman Act, since a decision that an airline has violated section 411 does not necessarily show that it has violated the Sherman Act. See, e.g., 62 Fed. Reg. 59784, 59800 (November 5, 1997); cf. Foremost Int'l Tours v. Qantas Airways, 478 F. Supp. 589, 593 (D. Hawaii, 1979), aff'd per curiam, 649 F.2d 867 (9th Cir. 1981). For these reasons,

the Department's exercise of its section 411 authority would not chill legitimate competition.

Finally, the Department would not be bound by the FTC's policy decisions on the use of its authority under section 5 of the Federal Trade Commission Act. The FTC in recent years has followed a policy whereby prices above average total cost are conclusively presumed legitimate. International Telephone & Telegraph Corp., 104 FTC 280 (1984); In re General Foods, 103 FTC 204 (1984). ATA mischaracterizes the FTC decisions as determinations that the FTC must as a matter of law follow the antitrust law predation standard. See, e.g., ATA Comments at 35, n. 45. The FTC instead decided only as a matter of discretion that it would not apply a different standard. See, e.g., American Comments at 45.

The Consistency of Enforcement Action with Deregulation and the Terms of the Department's Statute

Congress recognized that the success of deregulation requires the prevention of unfair competitive practices. Preventing illegitimate practices that reduce or eliminate competition is consistent with Congress' decision to deregulate the airline industry.

When Congress enacted the legislation deregulating the airline industry, Congress maintained the Board's authority to prohibit unfair methods of competition and directed it to use that authority to maintain a competitive industry. The Deregulation Act cut back or eliminated much of the Board's regulatory authority, but not the Board's authority under section 411. As noted above, Congress later enacted the Sunset Act in part to preserve section 411 and transfer the responsibility for its enforcement to us. Congress acted due to its determination that "[t]here is also a strong need to preserve [this authority] to ensure fair competition in air transportation" H.R. Rep. No. 98-793 at 4-5. Deregulation by no means had made this authority unnecessary, for, "[a]s is the case with all industry, carriers must not engage in practices which would destroy the framework under which fair competition operates."

Congress was fully aware, moreover, that maintaining section 411 would enable the Department to prohibit some airline practices permitted by the antitrust laws: "Air carriers are prohibited, as are firms in other industries, from practices which are inconsistent with the antitrust laws or the somewhat broader prohibitions of Section 411 of the Federal Aviation Act (corresponding to Section 5 of the Federal Trade Commission Act) against unfair competitive practices." H.R. Rep. No. 98-793 at 4-5.

Congress had previously affirmed the importance of preventing unfair competitive conduct when it enacted the Deregulation Act. That act added policy statements to our statute directing us to consider the following matters, among others, as public interest goals: (i) the prevention of predatory or anticompetitive practices in the airline industry, (ii) the prevention of unreasonable industry concentration, excessive market domination, monopoly powers, and other conditions that would allow an airline unreasonably to increase fares, reduce service, or exclude competition, and (iii) the encouragement of entry by new and existing air carriers. 49 U.S.C. 40101(a)(9), (10), (13). Preventing unfair competitive practices would help achieve these statutory goals.

Many of the commenters opposing our proposed policy nonetheless argue that it would violate Congress' intent to deregulate the airline industry. *See, e.g.*, ATA Comments at 40-43. Their argument is contrary to Congress' recognition that the success of deregulation depends on the prevention of unfair competitive conduct.

Consistency with the Terms of Our Statute

Taking action against unfair competitive practices that involve fare reductions and capacity increases is within the Department's authority under section 411, since, as shown, the unfair conduct described in this paper seems to violate antitrust principles. Section 411 by its terms does not limit the Department's authority to define what constitutes an unfair method of competition with respect to predatory-type conduct. The Department could take enforcement action based on fare reductions by a dominant airline that are economically irrational unless they eliminate or reduce competition, even though the reduced fares seem to exceed the airline's costs.

The major airlines and Congressman Norman Mineta allege that Congress wished to confine section 411 to conduct that violates the antitrust laws insofar as pricing practices are concerned. *See, e.g.*, ATA Comments at 34-35, 39-43; Congressman Mineta Comments (Congressman Mineta submitted his comments after he had left the House of Representatives and before he became Secretary of Commerce). Neither the language of section 411 nor the legislative history of the Deregulation and Sunset Acts, however, indicate that Congress intended to limit the Department's authority over unfair methods of competition (instead, as explained below, they rely on a statutory provision limiting the Board's tariff authority over fares). Congress actually did nothing to narrow the reach of section 411 (or change it in any way) when it enacted the Deregulation Act in 1978 or the Sunset Act in 1984. In these circumstances, the statements by Congressman Norman Mineta, who had been the Chairman of the House

Aviation Subcommittee and the Sunset Act's principal sponsor, about Congress' intent are insufficient to override the terms of section 411 and the Congressional committee reports on the Deregulation and Sunset Acts. Congressmen Oberstar and Lipinski Comments.

The network airlines and Congressman Mineta assert that our proposed policy would be contrary to another section of the statute, 49 U.S.C. 40102(a)(34), which defines "predatory" as "a practice that violates the antitrust laws as defined in the first section of the Clayton Act (15 U.S.C. 12)." If this definition were applicable to our authority under section 411, we arguably could only rule that fare reductions are unlawful where the fares are lower than an appropriate measure of their cost, no matter what impact they would have on competition and consumers.

We cannot agree that this definition of "predatory" limits our authority under section 411. Since section 411 does not use the term "predatory", the statutory definition of the term is irrelevant to that section's interpretation. As Congressmen Oberstar and Lipinski state, "We do not see how a definition can be construed to limit an agency's powers under a section of law which does not use the defined term." Congressmen Oberstar and Lipinski Comments at 6.

Furthermore, the network airlines' argument ignores the purpose of the definition of "predatory". Congress established the definition of "predatory" in the Deregulation Act in order to limit the Board's authority to disapprove tariffs that reduced fares. To keep the Board from using that authority to protect airlines against fare competition, Congress adopted an antitrust law definition of "predatory" that limited the Board's authority to disapprove tariff changes under those statutory sections which, unlike section 411, used that term. As Congressmen Oberstar and Lipinski point out, imposing strict limits on the Board's ratemaking authority over fares but not its authority under section 411 made sense. In ratemaking cases the Board "was given power to immediately suspend a fare, pending a hearing," while in section 411 cases the Board could not require an airline to end a practice without first holding a hearing before an administrative law judge. Congressmen Oberstar and Lipinski Comments at 6.

As stated above, nothing in the legislative history of the Deregulation Act (or the Sunset Act) suggests that Congress intended to change the Department's authority under section 411. In fact, when the Deregulation Act was pending in Congress, the Senate committee stated in discussing its proposed deregulation of charter fares that ending the Board's ratemaking authority over charter fares would not end the Board's section 411 authority over the fares. While the Senate committee bill would have eliminated the Board's authority to disapprove charter fares as unjust or unreasonable, the Senate committee stated that the

Board could still take action against predatory charter fares under its section 411 authority to prohibit unfair methods of competition. S. Rep. No. 95-631 at 108-109. The Senate committee's statement did not suggest that the Board should limit its use of its section 411 authority, even when reviewing pure pricing behavior.

The Senate committee's statement is consistent with a Supreme Court decision that held that an agency's lack of authority to set rates did not bar the agency from regulating rates when necessary under its authority to stop unreasonable or unfair competitive practices. In California v. United States, 320 U.S. 577 (1944), the Court upheld a regulatory agency order specifying certain waterfront terminal rates even though the agency had no conventional ratemaking authority over waterfront terminal charges. The Court held that the agency's authority to prescribe just and reasonable practices allowed it to set rates when necessary to end the preferential and unreasonable treatment caused by the terminals' use of non-compensatory charges.

We agree, of course, with the position taken by Congressman Mineta and other commenters that any action taken by the Department in this area must be consistent with Congress' decision to deregulate the airline industry. We believe that the prevention of unfair competitive practices would benefit consumers and be a proper exercise of the Department's authority to prohibit unfair methods of competition.

Finally, Continental and Delta wrongly contend that section 411 would not allow us to take into consideration an airline's capacity decisions, for that would allegedly violate 49 U.S.C. 41109(a)(2). Continental Comments at 14; Delta Comments at 26-27. That provision bars the Department from prescribing in a certificate a restriction that would prevent an airline from adding or changing schedules or equipment "to satisfy business development and public demand." The provision is part of the statutory scheme for defining our power to grant and condition certificates authorizing U.S. airlines to operate passenger airline service. 49 U.S.C. 41101. This provision, however, governs only our authority to issue certificates and does not affect our authority under section 411. Just as we may address pricing behavior under section 411 notwithstanding the limits on our tariff authority, we may address capacity decisions when necessary to prevent unfair methods of competition.

Consistency with Board and Department Precedent

We have based our findings on our investigations of several complaints against major airlines, on discussions with network airlines, low-fare airlines, travel agency groups, community groups, and others with a stake in airline

competition issues, and on our review of the comments filed in this proceeding. What we have learned has convinced us that the Department should take action, for example, by considering enforcement cases when dominant airlines engage in fare reductions, capacity increases, and other conduct designed to maintain or restore market power. Neither the Department nor the Board had previously conducted such extensive investigations of the competitive responses of dominant airlines to new entry. However, in earlier years, the Department and the Board had made statements suggesting that predatory-type behavior was unlikely in airline markets and that fare reductions by incumbent airlines should not threaten airline competition unless they violated antitrust law standards. The network airlines now claim that our proposed policy is allegedly contrary to these earlier statements. See, e.g., ATA Comments at 54-55; American Comments at 51.

Any inconsistency between our past statements and our findings in this proceeding cannot invalidate those findings when, as is the case, we explain their basis. Like any administrative agency, the Department may change its rulings and practices in response to changing circumstances or on reconsideration of the relevant facts and our mandate. See, e.g., American Trucking Ass'ns v. Atchison, Topeka, & Santa Fe Ry., 387 U.S. 397, 415-416 (1967). Thus in City of New York v. Slater, 145 F.3d 568, 570 (2nd Cir. 1998), the Second Circuit affirmed our reevaluation of our policies for granting slot exemptions under 49 U.S.C. 41714(c)(1), a reevaluation based on our decision that the benefits of low-fare airline service mandated a broader use of our authority to award slot exemptions, Order 97-10-17 (October 24, 1997) at 3-5.

Our conclusions in this proceeding reflect our additional experience with the workings of airline competition under deregulation. As Nancy McFadden, then the Department's General Counsel, told the Senate Commerce Committee at a hearing on June 23, 2000, "[W]e have learned a lot about the airline industry over the past 15 years [and] simply have a greater understanding of how airlines act and react in a deregulated environment."

The earlier agency decisions cited by the network airlines reflected assumptions about the operations of a deregulated airline industry that have proved to be partially invalid. When deregulation began in the late 1970's, most commentators believed that entry into airline markets would be easy and that incumbent airlines could not keep out competition, as explained earlier in this paper. Several of the precedents cited by the network airlines relied on these beliefs. See, e.g., Air Florida, Order 81-1-101 at 10.

Experience has demonstrated the contrary, at least as to hub markets, as explained in this paper and the accompanying report by Professors Oster and

Strong. In hub markets the hubbing airline's operational and marketing advantages generally give it market power on routes at its hub when no other airline has a hub at either endpoint. Entry by any airline into short-haul markets at another airline's hub is quite difficult, particularly for network airlines without the competitive advantage of offering low fares, unless the endpoint of the route is a hub for the entrant. As shown by Professors Oster and Strong, airlines have therefore been able to charge significantly higher fares in hub markets over a sustained period of time. Oster & Strong, "Predatory Practices," at 31. See also the Statement by John Nannes, Deputy Assistant Attorney General, Antitrust Division, before the House Judiciary Committee on June 14, 2000.

PROCEDURAL ISSUES

We are publishing our findings on the extent of apparent unfair competitive practices in the airline industry and the need to prevent such conduct. This Administration believes that using the Department's powers to enforce section 411 appears to be the soundest method for stopping unfair competitive responses by dominant airlines that are likely to deny travellers the benefits of competition.

Under the Department's usual enforcement procedures, if it has reason to believe that an airline may be engaged in unfair exclusionary conduct warranting the consideration of enforcement action, based on an informal complaint or our own observation, the Department would first informally investigate the matter and give the airline the opportunity to explain why its conduct is fair competition. If it could show that its conduct was economically rational other than as a means of reducing or eliminating competition, no further action would be taken. If the airline failed to persuade the Department that its conduct represents competition on the merits and if the matter were not settled, the Department could institute a formal enforcement proceeding to be heard by an administrative law judge. At such a hearing the parties would present factual evidence and legal and economic arguments on whether the airline's conduct should be held unlawful. Under the Administrative Procedure Act, 5 U.S.C. 556(d), the Department's Enforcement Office, not the incumbent airline, would have the burden of proof in such a proceeding. See, e.g., Air Florida, Order 81-1-101 at 2; Los Angeles International Airport Rates Proceeding, Order 96-6-36 (June 30, 1996) at 17.

If the Department determined that the airline's conduct was an unfair method of competition that violated section 411, the remedy for such conduct would be a cease-and-desist order, unless the airline had violated an existing cease-and-desist order, in which case the Department could impose civil penalties. Any

decision in an enforcement case defining conduct as an unfair method of competition would be effective only for the future – the Department has no authority to impose monetary penalties on an airline for having engaged in the conduct in the past, unless it has violated an existing order.

Our decision against adopting guidelines in this proceeding will not limit the Department's discretion to begin enforcement cases in the future. We could have begun enforcement cases under section 411 without adopting an enforcement policy. The Department may institute an enforcement proceeding if it has grounds for believing that an airline's conduct is unlawful under section 411, whether or not it has announced policy guidelines defining when such conduct may constitute an unfair method of competition. The Department has always had the authority to determine on a case-by-case basis whether an airline is engaged in unfair methods of competition. Both section 411 of the Department's statute and section 5 of the FTC Act create an adjudicatory procedure for defining and prohibiting unfair methods of competition. United Air Lines v CAB, 766 F.2d at 1111; National Petroleum Refiners Ass'n v. FTC, 482 F.2d 672, 674-675 (D.C. Cir. 1973).

As discussed above, we have in fact received quite a few allegations in recent years that major air carriers were engaged in unfair methods of competition of the kind addressed by our proposal. Instead of beginning an enforcement proceeding, however, the Secretary decided to publish a proposed policy on enforcing section 411 in the Federal Register so that all interested persons would have the opportunity to present their views on the issue. A policy statement would give airlines notice of the conduct that was likely to trigger an enforcement investigation. The public comment process would enable us to make a final decision representing the best thinking of all interested parties.

As discussed, we are not establishing guidelines on when the Department should consider taking enforcement action, presumptions on when competitive responses should be deemed unfair methods of competition, or rules making specified types of conduct unlawful as unfair methods of competition. As a result, many of the procedural objections made by the parties to our proposed guidelines are now moot and need not be discussed in this paper.

The network airlines' objections to our procedures in this proceeding largely reflect their assumption that the policy would establish a binding rule. See, e.g., ATA Comments at 47-50. Since we are not adopting a binding rule, or even enforcement guidelines, their procedural objections are irrelevant. Their objections in any event would lack merit. For example, their complaint that we gave the parties inadequate notice of our analysis overlooks the ample

opportunities we have given the network airlines and other interested persons to submit their views on the issue. After all, we began this proceeding so that all interested parties would have an opportunity to comment on our tentative findings and proposals. In any event, the Administrative Procedure Act allows agencies to adopt statements of policy without notice and comment. 5 U.S.C. 553(b). We thus could have adopted an enforcement policy without providing any notice at all. See, e.g., Bechtel v. FCC, 10 F.3d at 878.

The network airlines additionally erred in claiming that we had prejudged the issues by issuing a paper explaining in more detail the basis for our belief that the competitive responses by some major airlines appear to constitute unfair methods of competition. ATA Reply Comments at 34; Northwest Reply Comments at 44-48, citing “Competition in the U.S. Domestic Airline Industry: The Need for a Policy to Prevent Unfair Practices” (“DOT White paper”). This assertion is wrong. The cited paper simply restated the basis for our decision to propose the enforcement policy and gave four examples of competitive responses that could warrant enforcement action under the policy. That paper made no findings that an airline has violated section 411.

Our tentative view that certain types of competitive responses may be unfair methods of competition and our citation of several examples of such conduct in our proposed policy and the DOT White Paper did not amount to prejudgment. Agency officials are entitled to hold policy and economic views on the issues within their jurisdiction. See, e.g., FTC v. Cement Institute, 333 U.S. 683, 702-703 (1948); Hortonville Joint School District No. 1 v. Hortonville Education Ass’n, 426 U.S. 482, 493 (1976). See also Association of National Advertisers v. FTC, 627 F.2d 1151 (D.C. Cir. 1979), where Judge Leventhal stated in his concurring opinion, 627 F.2d at 1176:

[O]ne cannot even conceive of an agency conducting a rulemaking proceeding unless it had delved into the subject sufficiently to become concerned that there was an evil or abuse that required regulatory response. It would be the height of absurdity . . . for an agency to embroil interested parties in a rulemaking proceeding without some initial concern that there was an abuse that needed remedying

The parties also had an adequate opportunity to discuss the White Paper’s analysis. That paper did not identify the airlines and markets used as examples. The major airlines were able, however, to determine the identity of the airlines and markets from the factual information given in the paper, and they discussed the validity of the examples in their pleadings. See, e.g., ATA Reply Comments, Statement of Janusz Ordover and Robert Willig at 6-17; American Reply

Comments at 14-18 (defense of American's conduct on the route between Dallas-Fort Worth and Kansas City). Moreover, one of the paper's four examples -- Northwest's competitive response to Spirit's entry into the Philadelphia-Detroit route -- has frequently been cited by low-fare airlines and others as an example of conduct that should be unlawful. Northwest discussed at length with Department officials and staff members its position that its response to Spirit's entry in the Detroit-Philadelphia market was reasonable. July 23, 1998, Northwest Meeting Notes at 1-3. The supplemental comments filed by Northwest and ATA long after the close of the comment period gave them an additional opportunity to analyze and answer the points made by the DOT White Paper.

CONCLUSION

For the reasons explained in this paper and the accompanying paper from Professors Oster and Strong, this Administration has concluded that apparent unfair competitive practices have occurred in the airline industry. Such practices are likely to cause consumers to pay higher fares and receive poorer service than they would obtain in a competitive market. The Department, working with the Justice Department, has an obligation to prevent such practices. Our findings and analysis will support any further efforts by the Department to eliminate unfair competitive practices that are likely to deny consumers the benefit of competition.