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AIRLINE COMPETITION

DOT's Implementation of Airline Regulatory Authority

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The Honorable Frank Lautenberg
Chairman, Subcommittee on Transportation
and Related Agencies
Committee on Appropriations
United States Senate

The Honorable John Dingell
Chairman, Subcommittee on Oversight
and Investigations
Committee on Energy and Commerce
House of Representatives

This report, prepared at your request, provides information on the Department of Transportation's (DOT) oversight of airline industry mergers and trade practices. The Congress, states, industry experts, and consumer advocates have expressed concern about DOT's actions in these areas.

As arranged with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after the date of this letter. We will then send copies to the Chairman, House Committee on Public Works and Transportation; the Chairman, Senate Committee on Commerce, Science, and Transportation; the Secretary of Transportation; the Administrator, Federal Aviation Administration; the Attorney General; the Chairman, Federal Trade Commission; the Director, Office of Management and Budget; and other interested parties.

This work was performed under the direction of Kenneth M. Mead, Director, Transportation Issues. Other major contributors are listed in appendix IV.

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Executive Summary

Purpose

Fewer major airlines, lengthy delays, flight cancellations, and unmet schedules led to congressional concern about the effectiveness of the Department of Transportation's (DOT) oversight of the airline industry. As a result, the Chairmen of the Senate Committee on Appropriations' Subcommittee on Transportation and Related Agencies and the House Committee on Energy and Commerce's Subcommittee on Oversight and Investigation asked GAO to examine DOT's implementation of the airline oversight functions it received in 1985, when the Civil Aeronautics Board (CAB) was abolished. In particular, they asked GAO to review

- how DOT developed and implemented its airline merger policy and
- how DOT protects airline passengers from unfair and deceptive trade practices.

GAO was not asked to evaluate the correctness of individual merger decisions.

Background

The Congress passed the Airline Deregulation Act of 1978 to phase out domestic airline rate and route regulation. As a result of this legislation, on January 1, 1985, CAB—the agency that had regulated such activity—ceased to exist. To ensure a smooth transition of government authority after CAB's demise, the Congress passed the CAB Sunset Act of 1984. This act required DOT to reject or approve airline acquisitions, consolidations, and mergers (referred to in this report as "mergers"); receive and resolve airline consumer complaints; and investigate and prosecute unfair and deceptive airline practices, such as overbooking or false advertising. DOT's merger approval functions expired at the end of 1988 as provided by the act. The Department of Justice now has authority over airline mergers.

Results in Brief

DOT adopted the merger policy CAB had developed and implemented in 1979. To analyze airline mergers, DOT, like CAB, assumed that airline markets were contestable, i.e., airlines not currently in a market could readily enter and provide competition if fares were raised to excessive levels. Between 1978 and 1985, fundamental changes occurred in airline marketing and operating strategies that often lowered costs and fares but also made it difficult for potential competitors to enter and compete in an incumbent airline's market. Although the opportunity existed to examine the effects of these changes either through a broad study of the airline industry or during individual merger cases, DOT did not do so.

GAO's review of DOT's consumer protection activities produced a mixed picture. On the one hand, DOT has bettered the operation of its consumer protection functions, including improving the speed with which consumer complaints are handled and increasing its enforcement activities. On the other hand, DOT has missed important opportunities to protect consumers because of inadequate coordination with the states.

Principal Findings

DOT's Merger Policy

Fundamental marketing and operating changes occurred in the airline industry between 1979, when CAB first formulated its assumptions about the contestability of the airline industry, and 1985, when DOT used these assumptions to approve mergers. To compete for business, airlines developed new strategies such as frequent flyer programs, travel agent commission overrides, and computerized reservations systems, each of which can make it more difficult for entrants to successfully challenge an incumbent.

DOT did not study the combined effects of these new strategies on competition in the airline industry. DOT believed that airline merger analysis should measure the likelihood that merging firms would not charge airline consumers excessive fares by examining the role of potential competitors. Yet these new strategies, if successful, reduce the importance of potential competition because they make it more difficult for new entrants to compete directly with incumbents. DOT considered physical barriers, such as whether airports had the capacity to handle take-offs and landings as the only meaningful measures of whether a merger would foreclose the market to competition.

The CAB Sunset Act's legislative history indicates that the Congress believed that DOT's merger authority would expire automatically at the end of 1988. GAO found that, owing to an anomaly in the act, DOT still has authority to bring administrative proceedings against airline mergers that violate the antitrust laws. The result is different from other industries, where the Federal Trade Commission and the Department of Justice review premerger notifications and, on the basis of that review, can bring actions to stop mergers. In the airline industry, the Federal Trade Commission and the Department of Justice will continue to receive premerger notification; however, DOT and the Department of Justice will be the only two agencies that can take action to halt a merger. DOT officials have said that they believe the authority properly belongs with the Department of Justice and the Federal Trade Commission.

DOT's Consumer Protection Functions

DOT has improved some aspects of its consumer protection functions since it inherited that authority from CAB in 1985. For example, CAB forwarded all consumer complaints about unfair and deceptive airline trade practices to the airlines and gave them 30 days to respond. It usually took longer. Today, DOT's Consumer Affairs Division resolves many complaints over the telephone. In 1987, DOT received and resolved almost 41,000 consumer complaints—a record number.

During 1988, DOT conducted 378 investigations and obtained $174,500 ir fines for violations of DOT rules, involving—among other practices—deceptive advertising and denied boarding compensation. These statistics represent a significant increase over 1985 levels.

On the other hand, DOT has missed opportunities to protect consumers from patterns of unfair or deceptive trade violations and to work with other regulatory agencies in addressing consumer concerns. For example, although DOT officials have stated that a major priority of their investigative effort is to look for patterns of violations, they did not follow up when complaints about one company's refund practices constituted about 90 percent of the refund cases received by DOT's investigative unit. These practices violated DOT's consumer credit regulations. Independently, the Federal Trade Commission, not DOT, obtained a court order halting the company's deceptive trade practices.

In another case, DOT had information, in 1987, indicating that a charter company committed numerous violations of Department rules, including failure to seek permission to sell seats. However, inadequate coordination within DOT prevented follow-up action to close down the company after it stranded approximately 300 passengers in the Caribbean.

Finally, DOT's policy on deceptive advertising has caused confusion and prompted state action. The National Association of Attorneys General promulgated national airline advertising guidelines because it believed that DOT was not protecting consumers adequately. DOT opposed some of the guidelines, claiming that federal law preempts them, and later issued two orders to clarify the types of advertisements it would permit. DOT's orders were overturned by a Federal Court of Appeals in February 1989 on procedural grounds.

Matters for Congressional Consideration

To treat airline mergers like mergers in most other industries, the Congress may wish to consider amending the antitrust laws and the Federal Aviation Act to ensure that the Department of Justice and the Federal Trade Commission, rather than the Department of Transportation, have jurisdiction over airline mergers.

Recommendations

If the Congress does not remove DOT's continuing merger authority, we recommend that the Secretary of Transportation work with the Federal Trade Commission and Department of Justice to develop rules for reviewing premerger notifications as well as procedures for taking administrative actions against anticompetitive mergers. Recommendations for improving DOT's unfair and deceptive airline trade practices oversight are also contained in this report. (See chap. 3.)

Agency Comments

GAO obtained oral comments on a draft of this report from responsible DOT officials. In general, the officials agreed with GAO's position on merger authority and said that DOT's long-standing position has been to defer to the Department of Justice on enforcement of the antitrust laws. On the other hand, the officials said that the merger section of the report was misleading because it did not accurately portray the legal time limitations DOT faced. GAO recognizes that DOT's formal hearing process limited the amount of time available to analyze individual merger applications. However, GAO believes that in order to effectively analyze these applications, DOT needed a complete understanding of the industry that only an in-depth analysis could provide. If time did not permit this analysis, then DOT should have studied the industry outside of the formal hearing process. (Agency comments are discussed in greater detail in chaps. 2 and 3.)

Contents

Abbreviations

AEP	Office of Aviation Enforcement and Proceedings
ALJ	Administrative Law Judge
CAB	Civil Aeronautics Board
CRS	Computerized Reservation System
DOT	Department of Transportation

Introduction

For over 40 years, the Civil Aeronautics Board (CAB) regulated the rates and routes of interstate airlines. Many economists and industry analysts criticized this economic regulation as unnecessary and costly.[1] These critics argued that greater freedom to set fares and service levels could lead to lower fares and increased service.

The Congress passed the Airline Deregulation Act of 1978, which phased out domestic airline rate and route regulation. On January 1, 1985, CAB ceased to exist, and the Department of Transportation (DOT) received CAB's authority to

- review and reject or approve airline acquisitions, consolidations, and mergers (referred to in this report as "mergers");
- receive and resolve airline consumer complaints; and
- investigate and prosecute patterns of unfair and deceptive airline practices, such as overbooking or false advertising.

DOT Absorbs CAB Functions and Staff

During 1984 congressional hearings on how to complete CAB's phase-out, DOT's Deputy Secretary and Assistant Secretary for Policy and International Affairs testified that DOT did not want CAB's merger or unfair and deceptive trade practices authority. DOT was afraid that if former CAB personnel (and their functions) simply transferred to DOT, intact, then that group might form the nucleus of an organization that could reregulate the airlines.

Since the airlines were being deregulated, DOT officials dispersed CAB's activities throughout DOT to prevent this from happening. Merger approval responsibilities were placed in DOT's Office of the Assistant Secretary for Policy and International Affairs. Consumer complaint handling and investigations of unfair and deceptive trade practice functions were lodged in the Office of the Assistant Secretary for Governmental Affairs, while the power to prosecute unfair and deceptive trade practice violations was placed in a newly created Office of Aviation Enforcement and Proceedings in the Office of the General Counsel. DOT's Office of Litigation was directed to provide legal advice and counsel to the

[1]See Theodore Keeler, "Airline Regulation and Market Performance," The Bell Journal of Economics and Management Science 2 (Autumn, 1972) pp. 399-424; William Jordan, Airline Regulation in America: Effects and Imperfections, The Johns Hopkins Press; George Douglas and James C. Miller, Economic Regulation of Domestic Air Transport: Theory and Policy, The Brookings Institution; and U.S. General Accounting Office, Lower Airline Costs per Passenger Are Possible in the United States and Could Result in Lower Fares (CED-77-34, Feb. 18, 1977).

Office of the Assistant Secretary for Policy and International Affairs on merger decisions.

Merger Approval Process

Between 1985 and 1988, the CAB Sunset Act of 1984 required the Department of Transportation to review and approve or reject airline merger applications. In accordance with provisions of the CAB Sunset Act, DOT's special merger authority terminated at the end of 1988.

DOT's merger authority differed markedly from government involvement in merger decisions in other industries. First, DOT approval was required for a merger to be completed. In other industries, mergers involving companies of substantial size are reviewed, but not approved or denied, by the Department of Justice or Federal Trade Commission. If, after a review of the transaction, either agency believes the merger would be anticompetitive,[2] the government can try to convince the parties to change or abandon their merger plans. If the parties refuse, then the government will generally seek a preliminary injunction to prohibit the merger, pending completion of the antitrust proceedings, in order to stop it.[3]

The Congress transferred from CAB to DOT authority over airline mergers when it passed the CAB Sunset Act of 1984. This act continued the requirement that airlines obtain prior government approval before merging. An airline was required to file an application with DOT outlining the terms of the merger proposal. DOT reviewed the application and sought public comment. Interested parties could submit comments regarding the merger as well as request formal hearings. On the basis of the record created by the comments of interested parties, the Assistant Secretary for Policy and International Affairs decided whether to proceed by a show cause order or an oral evidentiary hearing. In either case, the Airline Deregulation Act required DOT to issue its final decision within 6 months after the merger application was made.

In a show cause proceeding, DOT published its proposed decision in a case and asked the public for written comments. All but 4 of the 24 merger

[2]Both the Federal Trade Commission and the Department of Justice receive premerger filings in these cases, and they use an informal process to determine which agency will handle the investigation.

[3]15 U.S.C. 18a.

cases[4] DOT decided between 1985 and 1988 were handled by means of a show cause order (9) or an exemption (11) from the merger process.[5] According to DOT's Assistant Secretary for Policy and International Affairs, show cause proceedings were held when factual disagreements on issues were lacking. If the decision was made to proceed by a show cause order, the order was drafted in DOT's Office of Litigation; comments on the proposed decision were received; and DOT's Assistant Secretary finalized or altered the decision proposed in the show cause order on the basis of his/her review of the comments received.

DOT ordered an oral evidentiary hearing only if there were material questions of fact that it believed could best be resolved through testimony or there was substantial opposition to the proposed merger.[6] If an oral evidentiary hearing was held, an Administrative Law Judge (ALJ) was appointed, and public counsel was set up to represent the public interest. Public counsel was composed of attorneys from the General Counsel's Office of Aviation Enforcement and Proceedings and analysts from DOT's Assistant Secretary for Policy and International Affairs' Office of Aviation Analysis. During the hearing, members of public counsel were not permitted to talk about the case with anyone else in DOT. This rule was intended to ensure the independence of their public interest advocacy. After the hearing, the ALJ issued a proposed decision which the Assistant Secretary could accept, reject, or modify.[7] The final order issued by DOT was drafted by its Office of Litigation.

[4]We were able to verify that 2 of 27 merger applications approved by DOT did not result in a transaction. Thus, our merger figure does not include two merger applications, which—though approved by DOT—did not result in a transaction. These are Delta Airlines—Jet America (DOT Order 86-9-18) and Horizon Air—Cascade (DOT Order 86-1-67). Further, we have excluded one of two transactions between Presidential Airways and Key Airlines in order to reflect that one order permitting common control was an interim step before Presidential's outright acquisition of Key.

[5]Like CAB, DOT rules specifically exempted air taxi operators, cargo air carriers, and charter operators from seeking prior merger approval. In addition, DOT regulations permitted any other air carriers to apply for an exemption.

[6]Evidentiary hearings were used to decide: Pacific Division Transfer Case, DOT Order 85-11-67; NWA-Republic Acquisition Case, DOT Order 86-7-81; TWA-Ozark Acquisition Case, DOT Order 86-9-29; and USAir-Piedmont Acquisition Case, DOT Order 87-10-58.

[7]The ALJ's decisions were modified in both the NWA-Republic Acquisition and in the TWA-Ozark Acquisition. The Department rejected the ALJ's decision in the USAir-Piedmont acquisition.

Unfair and Deceptive Trade Practice Functions

DOT also inherited, pursuant to the CAB Sunset Act, the authority to enforce regulations against unfair and deceptive airline trade practices. The act permits DOT to regulate a number of activities from ticket oversales to Computerized Reservation Systems (CRSs). Ticket oversales regulations protect consumers in the case of overbooking, while CRS regulations protect airline competition. In other industries, this authority resides with the Federal Trade Commission.

DOT also receives and resolves airline consumer complaints. On the basis of complaints from consumers or competitors, DOT investigates and prosecutes patterns of unfair or deceptive airline practices, such as overbooking or false advertising. Usually, consumer complaints are handled by the Consumer Affairs Division of the Office of Intergovernmental and Consumer Affairs. Analysts in the Consumer Affairs Division try to remedy consumer problems by phone, mediating between the airline and the consumer. Complaints that appear to constitute violations of DOT regulations, and that cannot be remedied by the Consumer Affairs Division, are forwarded to the Investigations Division. If, after investigation, it is determined that some enforcement action may be appropriate, the matter is sent to the Office of Aviation Enforcement and Proceedings. In general, enforcement actions based on consumer complaints will only be taken when there is a pattern of wrongdoing. In other words, a case might be brought for a pattern of refund regulations violations, but not for one refund problem.

Government Actions

Over the last several years, DOT's most visible airline oversight responsibilities were its review of airline merger applications and the investigation of unfair and deceptive trade practice violations. Between 1985 and 1988, DOT approved 24 mergers. Some of the mergers have been alleged to have resulted in less competition and higher fares. Reflecting congressional concern about continuing industry consolidation under DOT's aegis, two bills were introduced during the 100th Congress that would have transferred merger approval authority from DOT to the Department of Justice earlier than the end of 1988, as provided in the CAB Sunset Act. However, none were passed.

Members of Congress have also expressed concern about DOT's enforcement of its unfair and deceptive trade practices authority with respect to airlines' unrealistic schedules, advertising, and CRSs. Several bills introduced during the 100th Congress would have transferred unfair and deceptive trade practice authority from DOT to the Federal Trade Commission, or required more extensive reporting of information on such things as flight delays, lost baggage, cancelled flights, and fare availability.

State governments have also been active in dealing with the airline industry. In December 1987, the National Association of Attorneys General, concerned about what it believed was a lack of action by the federal government, adopted airline advertising guidelines that address consumer complaints about deceptive advertising, frequent flyer plans, and overbooking compensation.

DOT has taken several steps in an attempt to meet rising congressional and consumer concerns. For example, in 1987, after initiating an investigation at four airports with substantial flight delays, DOT entered into settlement agreements with seven airlines, requiring them to meet specific on-time standards. However, by the time of the settlement, the airlines were generally meeting these standards. Also, in September 1987, DOT promulgated regulations requiring airlines to report on-time performance data. DOT publishes these statistics every month along with denied boarding and mishandled baggage statistics.

Objectives, Scope, and Methodology

This review of DOT's airline oversight activities was conducted at the request of the Chairmen of the Subcommittee on Transportation and Related Agencies, Senate Appropriations Committee, and the Subcommittee on Oversight and Investigation, House Energy and Commerce Committee. They asked us to examine

- how DOT developed and implemented its policy for approving airline mergers and
- how DOT protects airline passengers from unfair and deceptive trade practices.

To review DOT's development and implementation of its merger policy, we examined DOT's statutory mandate, as well as court and agency case law. We also reviewed the antitrust statutory authority of the Department of Justice and the Federal Trade Commission. We examined how DOT analyzed airline mergers and we interviewed DOT, Justice Department, former CAB and airline officials, and industry experts. Appendix I lists the individuals and organizations we interviewed during our study. We focused on the process and criteria DOT used to arrive at its merger decisions. We were not asked to evaluate the correctness of individual merger decisions.

To review DOT's protection of airline passengers from unfair and deceptive trade practices, we examined how DOT

- resolves individual consumer complaints;
- investigates and takes enforcement action on the most pressing consumer concerns as measured by federal and state complaint statistics; and
- develops regulations to protect consumers, not only in major complaint areas, but also in areas where consumers might not be aware of abuses.

In the course of our review, we were concerned not only with how well DOT met its own informal goals and priorities in complaint handling, investigation, and enforcement functions, but also to what extent DOT coordinated its activities internally and externally with other consumer protection agencies to maximize the use of its limited resources. To accomplish these tasks, we examined DOT's complaint and enforcement records and discussed them with officials in DOT's Consumer Affairs Office and Office of General Counsel. Further, we discussed with the Federal Trade Commission and New York state officials their enforcement of similar statutes. We also discussed DOT's enforcement record with industry officials and experts.

Our review was conducted during the period October 1987 to January 1989, in accordance with generally accepted government auditing standards. During that period, we testified on DOT's airline industry oversight before the Congress on two occasions.[8]

[8] DOT Airline Industry Oversight (GAO/T-RCED-88-36, Apr. 21, 1988) and Factors Affecting Concentration in the Airline Industry (GAO/T-RCED-88-65, Sept. 22, 1988).

DOT's Policy and Procedures for Reviewing Airline Mergers

From 1985 to 1988, DOT approved 24 airline mergers, assuming—as had CAB before it—that, even where there were few actual competitors in a market, the threat of entry alone would be enough to prevent merged airlines from exploiting their market power. (For a list of mergers, see app. II.) Some of these mergers led to greater airport concentration. For example, of the 100 largest airports, the number where 1 airline had captured 60 percent or more of passenger enplanements increased from 11 to 18.[1] Most of the increase took place at airports where larger airlines had merged. Although comparison of the most heavily traveled routes shows more carriers competing in 1988 than in 1978, the largest airlines control a larger share of the national traffic than they did in 1978.

Between 1978, when the airlines were deregulated, and 1985, when DOT took over merger authority, fundamental changes occurred in the airline industry that can make it more difficult for new airlines to compete with established airlines or for existing airlines to expand their operations. Further, several studies of the airline industry showed that the number of airlines actually competing in a market was positively correlated with fares, indicating that potential competition alone was not sufficient to discipline fares.[2] These studies and observations made by industry experts about the differences between airline competition immediately after deregulation and airline competition in 1985 called into question DOT's assumptions that the threat of new entry would prevent merged airlines from exploiting their market power. DOT neither tested its assumptions to see if they were valid, nor looked at the effects its merger decisions were having on the industry.

Fundamental Changes in the Airline Industry Can Hinder Market Entry

Significant changes occurred in the domestic airline industry after deregulation. Initially, deregulation allowed airlines to compete on the basis of fares, opened up the airline industry to new entrants, and allowed existing carriers to expand their operations. In the early years of deregulation, a number of low-cost carriers entered the industry and competition intensified.

[1] Enplanement data overstate concentration at an airport because they include through passengers as well as passengers beginning or ending their trips at that airport.

[2] David Graham, Daniel Kaplan, and David S. Sibley, "Efficiency and Competition in the Airline Industry," 14 The Bell Journal of Economics, p. 118 (1983); Elizabeth Bailey, David Graham, and Daniel Kaplan, Deregulating the Airlines, MIT Press, 1985, pp. 153-172; and David Graham and Daniel Kaplan, Competition and the Airlines: An Evaluation of Deregulation, Civil Aeronautics Board Staff Report, 1982. (This report was not adopted by CAB.)

Established carriers responded to the new competition by adopting a number of new marketing and operating strategies, including frequent flyer programs, travel agent commission override payments, yield management, and hub-and-spoke systems. While some of these new strategies improved airline operating efficiencies, and benefited travelers, they also could make it more difficult for new entrants to compete with the established airlines or for existing carriers to expand their operations to compete on routes out of a dominant carrier's hub airport. In addition, physical barriers, such as gate availability and landing restrictions also limited entry.

Frequent Flyer Programs

American Airlines adopted the first frequent flyer program in the early 1980s, and now virtually every major carrier has one. The program rewards travelers by giving them bonuses in the form of travel or service upgrades on the basis of the distance they have flown with the carrier. Frequent flyer programs were designed to create brand loyalty. Since awards are only paid out after reaching a mileage threshold, the traveler who has collected some, but not all, of the mileage necessary to reach a desired bonus is less likely to switch to another airline than a traveler without such ties. This can make it hard for a new entrant to attract passengers away from an incumbent.

Because many businesses permit their employees to keep frequent flyer bonuses accumulated on business trips, business travelers will prefer flights on carriers where they can increase their frequent flyer mileage, and they may be less concerned about fares or other service arrangements. In choosing between different frequent flyer programs, travelers are likely to prefer carriers which fly to the widest range of destinations from their community. This maximizes the traveler's ability to accrue mileage on business trips and use the bonuses to travel to desirable vacation spots. Carriers that hub at an airport are more likely to offer the largest number of destinations from that location.

Travel Agent Commission Overrides

Since deregulation, the types of fares airlines offer have proliferated. The increased complexity in the number of fares has caused consumers to rely more on travel agents who, as a result, now book most airline flights. The airlines provide travel agents with a number of incentives to increase sales. One such incentive, the commission override, is based on the ticket volume the travel agent sells. This practice may provide travel agents with an incentive to steer passengers to a particular airline.

One common form of travel agent commission override increases the agent's commission on all business done with an airline if the agent's volume of business on that airline increases a certain amount. For example, the agent might receive a 10-percent commission on $100,000 worth of business. However, if the agent did an extra $20,000 worth of business, the airline would pay the agent a 13-percent commission on the $120,000 of business booked on that airline.

Any air carrier can offer an override commission, but because they are based on the volume of bookings, the carrier offering most of the flights out of a city or an area will be more attractive because it offers more booking opportunities. In other words, the additional revenue that can be generated by increasing sales on a high-volume account is usually worth more to the travel agent than the same volume increase on a low-volume account. These commissions provide an incentive to steer passengers to those airlines where the agent will earn the most money. Thus, at a hub dominated by one airline, a new airline with a relatively small number of flights might have trouble obtaining bookings through travel agents. To overcome this disadvantage, the new airline could offer a higher commission per ticket sold to offset its dominant rival's higher total commission payments, then the new airline would have higher commission costs than its rival, which could make it more difficult to compete successfully.

Computerized Reservation Systems

Most travel agents use one of five computerized reservation systems (CRSs) to sell tickets. Airlines own the five existing CRSs and market their systems to travel agents.[3]

Initially, CRS-owning airlines used their systems to gain an advantage over their competitors by ensuring that the owner's flights were displayed first. CAB found this practice to be anticompetitive and prohibited it in 1984. Two years ago, we reported on possible continuing anticompetitive impacts of CRSs.[4] We focused on two issues: (1) incremental revenues, the extent to which the airlines that own these systems are able to capture a disproportionate share of the air travel market because agents using CRSs tend to favor the flights of the CRS provider, and (2) booking

[3]SABRE is owned by American Airlines; COVIA is owned by United Airlines, KLM, USAir, British Airways, Alitalia, and Swissair; PARS is owned by Northwest Airlines and Trans World Airlines; System One is owned by the Texas Air Corporation; and DATAS II is owned by Delta Air Lines. Delta and American have proposed combining their systems.

[4]Airline Competition: Impact of Computerized Reservation Systems (GAO/RCED-86-74, May 9, 1986).

fees, the charges that airlines must pay to the CRS owner every time a flight is booked on the owner's system. We recommended that DOT determine the size and persistence of incremental revenues and examine the potential anticompetitive effects of booking fees.

DOT issued its report in May 1988. Although it made no recommendations, DOT found that CRS-owning airlines continued to earn substantial incremental revenues from their systems. In addition, according to the report, booking fees for the two major CRSs were about double the cost of providing the service, including the cost of capital and a 15-percent return on investment. Revenue transfers from non-CRS vendor airlines to CRS-vendor airlines have been substantial, resulting in lost income for the non-CRS-owning airlines. Moreover, if an airline refused to pay the fee of one of the vendors, it would essentially forfeit any business from travel agents using that CRS.

Airline-owned CRSs also make it more difficult for a new carrier to enter the industry or for an existing carrier to expand into the hub of an airline that owns the CRS used by most travel agents in that market. New carriers often try to enter the industry by offering fares below those of the incumbent airlines. However, the booking fee charges they incur raise the new carrier's costs relative to those of CRS-owning, established carriers and reduce the opportunities for profitable entry. Further, if the dominant airline owns the CRS used by most agents in the region served by the hub, any airline attempting to compete at that hub will find itself at a competitive disadvantage. Local travel agents will tend to favor the flights of the airline providing the CRS because of the airline's maintenance of supportive business relationships with its network of subscribers—the so-called "halo effect." The potential competitor will also have higher costs because of the booking fees.[5]

Yield Management

Airlines, through the use of their computers, can change prices on a seat-by-seat basis as often as every 15 minutes. As a result, airlines make thousands of fare changes every day. This flexibility permits incumbents to make rapid price adjustments in response to potential entry. If an incumbent, earning monopolistic profits[6] on a particular

[5]For additional analysis of DOT's report and our conclusions, see our September 1988 testimony, Competition in the Airline Computerized Reservation System Industry (GAO/T-RCED-88-62, Sept. 14, 1988).

[6]Monopolistic profits are profits over and above the return necessary to maintain a given level of production and earn a fair return.

route faces new entry, the incumbent can lower prices quickly, thus frustrating a new entrant's ability to attract traffic by undercutting the incumbent's high fares.

Hub and Spokes

The airlines have relied increasingly upon hubbing operations in which they combine passengers from spoke cities at a hub. This allows more frequent and attractive service to more destinations. Because some cities may have only a few travelers each day for each of many destinations, nonstop service to all those destinations may be unprofitable. However, by combining passengers from a number of cities and transferring them to connecting flights at a hub, the airlines can better fill their planes and improve profitability.

The new marketing techniques available to the airlines reinforce the effects of a hub. The hub-and-spoke system consolidates traffic volume to increase load factors. Frequent flyer plans, commission overrides, and CRSs assist an incumbent in maintaining its traffic volume by inducing brand loyalty and by providing additional incentives for booking flights on the dominant carrier. These factors make it harder for a new airline to profitably compete in another carrier's hub market. Representatives of several major airlines said that they believed an airline could only enter and compete at another airline's hub with service from its own hub.

Physical Constraints

A number of physical barriers have arisen primarily as a result of congestion. They involve restrictions on airport use and, except for gate availability, are government imposed.

Gate availability is tied to an airport's physical plant and its ability to accommodate new entrants or increased competition either through new construction or better use of existing gates. Airlines have differing degrees of control over the airport facilities they rent, including the ability at some airports to veto airport expansion projects.

The federal government imposes landing and take-off restrictions at four airports to limit the amount of traffic. Known as "slot controls,"[7] these rules allotted landing and take-off space because of existing service. If a new carrier wants to enter one of the slot-controlled airports,

[7] The four slot-controlled airports are: O'Hare, in Chicago; LaGuardia and Kennedy, in New York; and National, in Washington, D.C.

or, if an existing carrier wants to expand operations, it must buy slots from another carrier already serving the airport.

Finally, environmental noise controls are imposed on flights at a number of airports. The federal government has restricted the types of airplanes that can be flown on the basis of noise considerations. For the purposes of reducing the noise in communities surrounding airports, state and local governments have restricted the number, types, and timing of flights. These actions have reduced new carriers' ability to enter airports or already existing carriers to expand their services at airports.

DOT Oversight of Mergers

DOT's airline merger policy relied on assumptions about the ease of entry into airline markets, assumptions that underlie CAB's merger analysis. DOT did not thoroughly examine the continuing applicability of these assumptions to the airline industry in light of the evolving nature of airline competition.

Background

The Airline Deregulation Act of 1978, in addition to phasing-out government controls over domestic market entry, exit, and fares, also changed the statutory criteria CAB applied to reviewing and approving airline mergers. In the past, CAB had viewed mergers as a method of ensuring the financial well-being of economically ailing air carriers. The Congress saw this use of merger authority as inappropriate in a deregulated environment and sought to ensure that airline mergers were initially examined using the same criteria as mergers in other industries. However, anticompetitive mergers could still be approved if they met certain public interest criteria.

The new merger provisions instructed CAB to conduct two types of analyses. The first, an antitrust analysis, was intended to ensure that the merger would not substantially lessen competition. The second, a public interest review, required CAB to examine wage provisions and working conditions to determine if provisions were needed to protect labor as a result of the merger. Even though CAB might find a merger to be anticompetitive, the Congress allowed the Board to approve the application if the Board found

> "that significant transportation conveniences and needs may not be satisfied by a reasonably available alternative having materially less anti-competitive effects."

CAB's Merger Policy Based on Theory of Contestability

CAB's framework for determining a merger's competitive impact was based largely on the economic theory of contestability. Contestability theory focuses on the role of potential competitors in restraining an incumbent firm's ability to exercise market power and charge monopolistic prices. According to the contestability theory, even in a concentrated market where there are few or no other carriers serving the same two cities (city-pair market), incumbent carriers cannot take advantage of their dominant position if it is not costly for other carriers to enter and exit the market. If the incumbent airline raised its prices above competitive levels, other carriers could rapidly enter the market, undercut the incumbent's price and capture some of the traffic on the route, earn some profits, and quickly exit the market before the incumbent responded to the entrant's actions. Therefore, according to the contestability theory, the incumbent is constrained from charging prices above competitive levels because of the potential for "hit-and-run" entry.

This theory suggested that merger analysis should focus on how costly it is for firms to enter and exit the market. However, if an incumbent can change its prices quickly in response to new entry, the theory of contestability is less applicable because the threat of entry is less strong when incumbents as well as entrants realize that actual entry is unlikely to be profitable.

CAB looked at the way the airline industry was organized in 1979 and found that

- the airline industry had always been concentrated, partly owing to regulation;
- capital was especially mobile, i.e., airplanes could be moved easily from one market to another; and
- entry into new markets was not expensive, in part, because the major barrier to entry, government regulation, had been eliminated.

Taken together, CAB said that concentration generally would not lead to high fares in the airline industry because of easy entry and exit conditions. In CAB's view, the major barrier to entry, government regulation, had been removed and in the absence of government regulation, airline markets would prove to be highly competitive.

CAB Applied Its Policy in the Texas International-National Case

In the 1979 Texas International-National Acquisition Case,[8] CAB set the framework for all subsequent airline merger decisions. The Administrative Law Judge (ALJ) hearing the case rejected Texas International's merger application because he found that it would result in a substantial lessening of actual competition in one city-pair market and a substantial lessening of potential competition in 16 other city-pair markets.

The ALJ applied the same criteria as the Supreme Court had in United States v. Philadelphia National Bank, 374 U.S. 321, 363 (1963). In that case, the Supreme Court prevented the merger of two banks where the surviving company would have controlled 30 percent of the market and the two largest competitors 59 percent of the market. As part of its decision in United States v. Philadelphia National Bank, the Supreme Court developed a presumption for allocating the burden of proof between merger opponents and proponents. The Court said that mergers producing firms controlling an undue percentage of market share and resulting in significant increases in concentration[9] would be presumed to be anticompetitive unless there was evidence showing that the merger was not likely to have an anticompetitive effect.

In interpreting United States v. Philadelphia National Bank, the ALJ looked at the market concentration data for each of the routes where Texas International and National actually competed or were potential rivals. He found that on the Houston-New Orleans route, the merged firm would have more than 50 percent of the traffic and the two largest airlines would control about 75 percent of the market. The ALJ also found that either Texas International or National was the most likely potential competitor in 16 other highly concentrated routes.

CAB overturned the ALJ's decision, noting that simply showing high market shares was not a sufficient basis for rejecting the merger. CAB added that, as a specialized agency with extensive experience in airline economics, it need not use the Supreme Court's presumption from United States v. Philadelphia National Bank that high market share was related to market power. CAB said that although most airline markets were concentrated, it was relatively easy for a new firm to enter any given market. CAB noted that the costs of entering a route were low once the planes and facilities were available, and that previous entry in the Houston-

[8]Texas International-National Acquisition Case, CAB Order 79-12-163.

[9]The most commonly used concentration measurements are based on market shares. The Justice Department uses the Herfindahl-Hirschman Index to determine which mergers it will investigate. This index is based on the sum of the squares of market shares for all firms in the relevant market.

New Orleans markets demonstrated its point. For example, Texas International, a relatively new entrant, began offering service between Houston and New Orleans in 1978 and quickly established itself as the major carrier by the end of 1978. Southwest Airlines entered the market in February 1979 and by October 1979, when CAB made its decision, already flew about 25 percent of the capacity on the route. Since there was actual, and apparently effective, entry on the only route where existing competition was threatened, CAB concluded that entry barriers were low.

For the 16 markets where the loss of potential competition was an issue, CAB emphasized again that the most important barrier to entry—government regulation—no longer existed. Moreover, CAB pointed to extensive entry in many markets around the nation since deregulation. Finally, carriers other than Texas International or National served both end points, and in CAB's view, were credible potential entrants into these markets. CAB believed that the threat of potential competition would be sufficient to prevent Texas International from taking advantage of a strong market position, should it merge with National.

CAB's perception of the ease of entry into airline markets may have been accurate for conditions at the time the industry was being deregulated and when CAB established its merger analysis. But by 1985, when DOT assumed airline merger responsibility, changes in the operating environment made the presumption of easy market entry less persuasive. Further, a number of empirical studies had been done affirming a relationship between concentration and fares[10] and indicating that the contestability model CAB used did not adequately reflect airline industry behavior. These studies and the airlines' marketing and operational responses to competition led former CAB officials, DOT economists, Justice Department officials, and airline industry analysts to challenge the assumption that airline markets were contestable.

DOT Merger Policy

Initially, the Department of Justice, pursuant to the Airline Deregulation Act of 1978, was to assume merger approval authority in 1985, when CAB went out of existence. However, in 1984, over the objections of both the Justice Department and DOT, the Congress gave airline merger approval authority to DOT. The House Report accompanying the Sunset Act said that DOT was given merger authority because, as the lead transportation agency, it was familiar with the issues involved in providing

[10] See footnote 2, p. 16.

transportation services. DOT's merger approval authority expired in January 1989, when the Department of Justice assumed responsibility for airline mergers. However, DOT continues to have the authority to bring actions against mergers that it feels violate the antitrust laws.

Like CAB, DOT's merger policy was predicated on the assumption that airline markets, while usually concentrated, behave competitively. DOT believed that potential entry would be sufficient to ensure that fares and revenues stayed at competitive levels, because most markets were easy to enter. In reviewing our report, DOT officials said that they thought any increase in concentration would be offset by entry from another carrier. DOT did not examine how the changing airline industry might have affected its assumptions about airline competition either by undertaking a broad study of the industry or by a thorough analysis in individual cases.

Industrywide Studies Not Conducted

DOT did not study the combined effects of hubs, frequent flyer plans, travel agent commission overrides, or CRSs on entry or pricing.[11] The former Deputy Assistant Secretary for Policy and International Affairs told us that, despite DOT analysts' concerns about continuing to apply the contestability theory to the airline industry, an analysis of the applicability of the theory was not undertaken because there were too many merger cases and they did not have the time. Instead, DOT depended upon public counsel and the Department of Justice to explore these issues in evidentiary hearings.

In one case, the need for an in-depth study was suggested by the Director of the Office of Aviation Analysis. In October 1986, after reviewing the merger applications of People Express and Texas Air Corporation, he wrote the Assistant Secretary for Policy and International Affairs and the Assistant General Counsel for Litigation and noted that as a result of recent mergers, industry conditions were changing rapidly. He said that DOT did not know enough about these changes to understand what effect further concentration would have. He added that if airline concentration and yield[12] were related, then the proposed merger between People Express and Texas Air Corporation might be a problem because it would dramatically increase concentration and, therefore, yield. To establish the relationship between concentration and yield

[11]See discussion later in this chapter of the public counsel's role.

[12]Yield is calculated in terms of revenue per passenger mile.

would require more analysis than could be undertaken in a show cause proceeding. Therefore, the Director recommended an oral evidentiary hearing. DOT opted for a show cause order, stating that the transaction was not likely to substantially reduce competition.

Individual Case Analysis Was Limited to Physical Barriers

Four merger applications underwent in-depth scrutiny at the evidentiary hearings that were held when DOT believed there were important factual questions to be decided.[13] In all but one of the cases, DOT focused its analysis of barriers to entry on physical barriers, such as whether airports had the capacity to handle take-offs and landings and whether gates were available to enplane and deplane passengers, as the only meaningful measures of whether a merger would foreclose the market to competition.

DOT officials who reviewed our report told us that the reason they limited their analysis to physical barriers was because these were the issues raised by merger opponents and the ALJs' decisions were limited to the facts presented on the record. The only exception was in the USAir-Piedmont Acquisition Case discussed below.[14]

The following three cases illustrate how DOT performed its analysis. In August 1986, DOT initially rejected the Texas Air Corporation's application to merge with Eastern.[15] This decision, DOT's only rejection of an attempted merger, was based on its determination that a Texas Air subsidiary competed with Eastern in the air-shuttle markets between New York and Washington and between New York and Boston and there were too few gates and slots available to permit another carrier to compete. DOT approved the merger when Eastern sold a sufficient number of gates and slots to Pan American Airlines so that it could begin a competing shuttle service.

In July 1986, DOT considered the Northwest-Republic Acquisition Case[16] and examined the effects on competition from consolidating two airlines that competed at the same hub. The Department of Justice argued in

[13]Evidentiary hearings were used to decide: Pacific Division Transfer Case, DOT Order 85-11-67; NWA-Republic Acquisition Case, DOT Order 86-7-81; TWA-Ozark Acquisition Case, DOT Order 86-9-29; USAir-Piedmont Acquisition Case, DOT Order 87-10-58.

[14]USAir-Piedmont Acquisition Case, DOT Order 87-10-58.

[15]Texas Air-Eastern Case, DOT Order 86-8-77.

[16]Northwest-Republic Acquisition Case, DOT Order 86-7-81.

this case that since the merger would eliminate competing hub service at Minneapolis, the proper analysis should focus on what would be necessary to reestablish competition such as the service offered by the smaller of the two carriers. The Justice Department felt that obtaining feed traffic at a hub was vital for a new airline seeking to replace the lost competition. According to DOT, the Justice Department's arguments were not supported by the record and approved the merger. DOT added that even if the Department of Justice's arguments were supported, another carrier could construct a competing hub at Minneapolis within a reasonable period of time.

DOT did not consider the marketing and operational changes in the industry until the USAir-Piedmont Acquisition Case[17] in October 1987. An economist for a merger opponent presented an econometric analysis of the markets affected by the proposed merger and found a statistically significant correlation between both route and endpoint enplanement share and fares, suggesting that airlines were able to exert market power on routes from the airports they dominated. DOT's public counsel attempted to rebut this study by performing its own econometric analysis. However, the public counsel's results showed an even stronger correlation between these market-share measures than the merger opponent's study. The ALJ then found that the studies indicated the existence of market power. This market power was evidence of the existence of entry barriers. The ALJ found marketing and operational tools such as frequent flyer programs, travel agent override commissions, CRSs and yield management to be the entry barriers that allow the dominant airline at an airport to exert market power. On the basis of these findings, the ALJ recommended rejecting the merger because it would be anticompetitive.

In not accepting his recommendation, DOT chose not to look at whether marketing and operating strategies allowed a dominant airline to exercise market power on routes from hubs as the ALJ maintained. Instead, DOT focused on the effect of these competitive tools in individual city-pair markets and concluded that for any individual market, these tools did not significantly harm competition. Thus, DOT never reached the question of the combined effects of all of the barriers the ALJ found to be important. On the basis of its analysis of individual markets, DOT approved the merger.

[17]USAir-Piedmont Acquisition Case, DOT Order 87-10-58.

Other Factors Contributed to DOT Merger Approvals

Two other factors contributed to DOT's approval of 24 airline mergers—the burden of proof it placed on merger opponents and the limited role DOT defined for its public counsel.

In court proceedings, mergers that would (1) produce firms controlling an undue percentage of market share and (2) result in a significant increase in concentration are presumed to be anticompetitive unless evidence shows that they are not likely to have anticompetitive effects. This test is based on two propositions: (1) competition is likely to be greatest where there are many sellers, none of which has any significant market share, and (2) congressional intent to arrest concentration in its infancy. As a result, the merger opponent's task is easier, because once a high level of concentration is shown, the burden of proof shifts and the merger proponents must demonstrate that the merger will not be anticompetitive.

DOT's belief in contestability led it to adopt its own presumptions about the effects of concentration. DOT required merger opponents to bear the burden of proof even after showing that the merger would result in highly concentrated markets, because it believed that airline concentration and market power were not related. Thus, at DOT, the merger opponent had to show not just high concentration, but also that the merger would be anticompetitive. This is a more difficult burden for merger opponents to meet than the federal court standard because the latter presumes that concentration results in market power, while at DOT, the merger opponent must show the link.

The Assistant Secretary for Policy and International Affairs, who made most of the merger decisions, told us that it was DOT's responsibility to raise issues not addressed in the submissions of the parties. Both he and DOT's General Counsel told us that they relied on public counsel, as well as the Department of Justice, to develop new information about airline industry market structure in evidentiary hearings.

While the Assistant Secretary for Policy and International Affairs viewed the public counsel's role as critical, the public counsel told us that its role was limited to making sure that the record in any merger case provided the ALJ with enough information on which to base a decision. Public counsel developed this information and performed its analysis on the basis of DOT's prior assumptions about the airline industry. The public counsel told us that, in merger cases, it did not seek changes in the interpretation of the law, which it believed to be correct, and it simply provided the ALJ with an accurate picture of where the law stood.

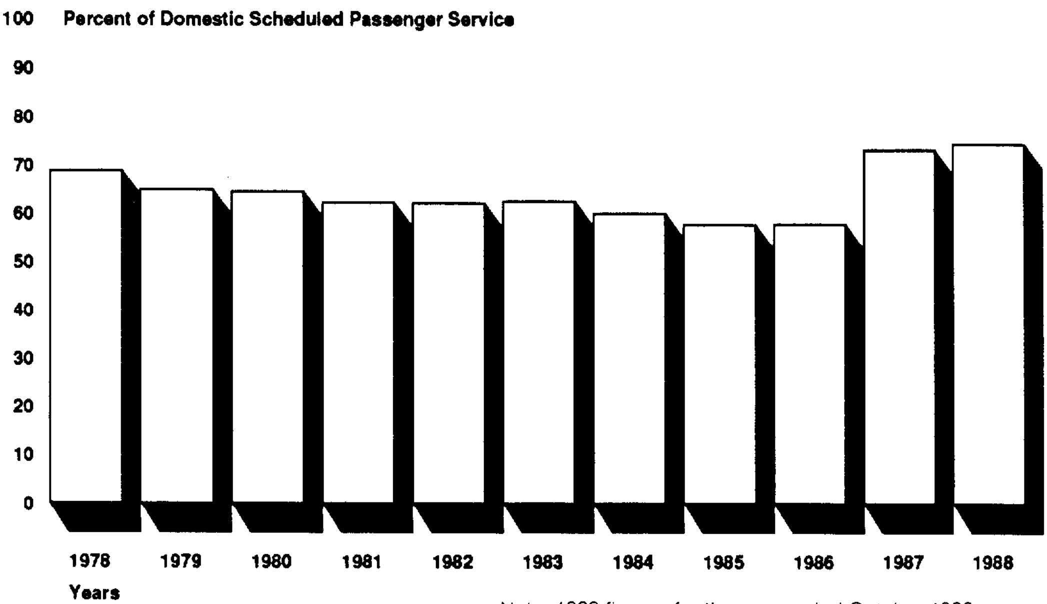
Further hampering the public counsel's ability to raise new issues was a lack of computer assistance. Specifically, the analysts noted that they received little programming support from DOT and frequently had to write their own programs. Because of the limited amount of time for merger cases, the time the public counsel spent programming limited the office's ability to explore alternative types of analyses.

Airline Industry Concentration Increased

In 1978, after 40 years of federal regulation, the five largest airlines controlled 69 percent of the national market. At first, deregulation brought new entry to the industry so that by 1985, the five largest airlines' market share had fallen to about 57 percent. New entrants' market share rose from nothing in 1978 to almost 6.5 percent in 1985. For 3 of the first 4 years after deregulation, the scheduled airlines' operating profit margin was negative and less than the operating profit margin in 1978. These lower profit margins reflected a number of factors, including not only an increased number of new entrants, but also higher aviation fuel prices, the air traffic controllers' strike, two recessions, and 2 years of declining air traffic.

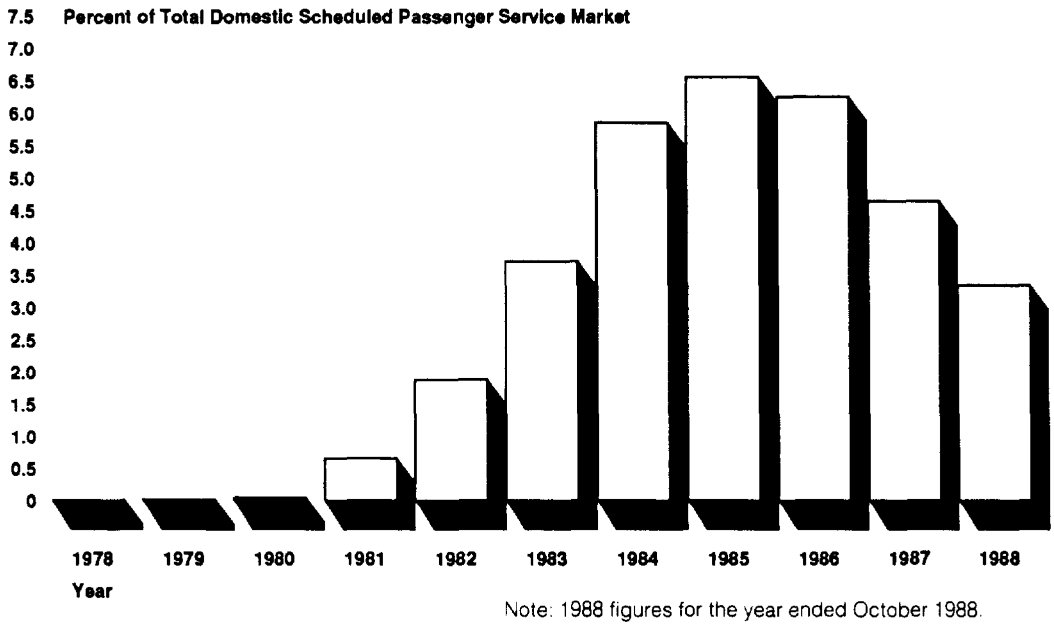
After the series of mergers that occurred between 1985 and 1988, the national industry is more concentrated than it was when the government regulated airline entry, exit, and fares. By October 1988, the five largest carriers controlled about 74 percent of the national market (see fig. 2.1.) and new entrants' market share declined to about 3 percent. (See fig. 2.2.) Although more carriers now compete on many routes than before deregulation, many new entrants either went out of business or were absorbed by larger carriers. From September 1985 to September 1988, the major airlines' net operating profits have ranged between $730 million and $2.8 billion.

Figure 2.1: Market Shares of the Largest Five Airlines, 1978-88



Note: 1988 figures for the year ended October 1988.
Source: DOT Air Carrier Traffic Statistics, 1978-88.

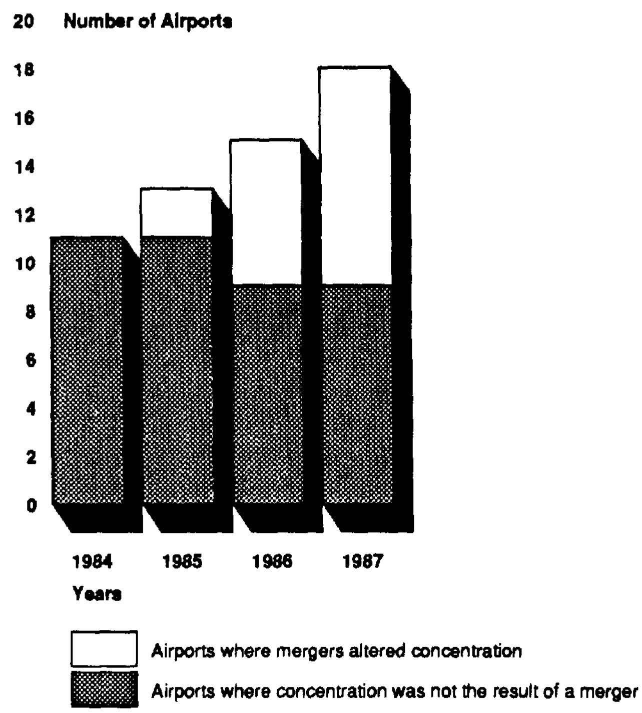
Figure 2.2: Market Shares of New Entrants, 1978-88



Note: 1988 figures for the year ended October 1988.
Source: DOT Air Carrier Statistics, 1978-88.

A similar trend toward concentration took place at the nation's 100 busiest airports between 1985 and 1987. Over this period of time, the number of airports where one airline accounted for 60 percent or more of passenger enplanements went from 11 to 18. Most of the increase took place at airports where the principal airlines serving that airport merged. (See fig. 2.3.)

Figure 2.3: Number of 100 Busiest Airports Where 1 Airline Controls 60 Percent or More of Passenger Enplanements



Note: The stack labeled "Airports where mergers altered concentration," includes only those airports where no single carrier controlled 60 percent or more of passenger enplanements before a merger.
Source: Data Base Products, Inc.

In response to a request from the ranking minority member of the Senate Committee on Commerce, Science, and Transportation, we are currently evaluating fare and service changes following mergers at a number of major airports affected by mergers. As part of that request, in September 1988, we testified before the Senate Committee on Commerce, Science, and Transportation about the changes in average fares and services at Lambert-St. Louis International Airport following the acquisition of Ozark Air Lines by TWA in late 1986.[18] While service levels were largely unchanged, travelers now have less choice between competing airlines in many markets, and TWA's fares have increased.

At the time of the merger, TWA handled almost 57 percent of the passengers enplaning at Lambert, while Ozark handled 26 percent. No other carrier had as much as 3 percent of the market. The merger left TWA

[18] Factors Affecting Concentration in the Airline Industry (GAO/ T-RCED-88-65, Sept. 22, 1988). See also, Airline Competition: Fare and Service Changes at St. Louis Since the TWA-Ozark Merger (GAO/ RCED-88-217BR, Sept. 2, 1988)

with 82 percent of the enplanements, and Lambert rose from the 10th to the 5th most concentrated of the nation's 50 busiest airports.

The level of service available to St. Louis air travelers did not change significantly after the merger. However, the number of direct routes served by only a single carrier (usually TWA) increased 42 percent, from 60 to 85. At the same time, the number of routes served by 2 or more carriers fell from 64 to 36, and those served by 4 or more airlines fell from 15 to 7.

With respect to fares, we compared TWA's and Ozark's average round-trip fares during three quarters of 1986 with TWA's fares for corresponding periods in 1987. We found that TWA's fares on 67 major St. Louis routes rose 13 to 18 percent. Fares of other carriers competing on the same routes rose a little more than half as much. By comparison, the airline fares component of the Consumer Price Index increased 5 to 6 percent during this period.

According to TWA officials, the relatively large average fare increases in 1987 reflected depressed fares in 1986. In March 1986, TWA's flight attendants went on strike, and TWA was forced to reduce service offerings, such as hot meal service. To win back passengers, TWA offered discount coupons worth 20 to 30 percent off the regular fare. TWA also fell victim to a widely publicized hijacking in 1985, and TWA officials believe that this probably affected some of its high-yield traffic. Finally, according to the officials, TWA was in the midst of a competitive struggle with Ozark in 1986. In 1987, following the merger, these factors which depressed fares abated and, in addition, TWA average fares rose as it began offering first-class service in markets where Ozark had offered coach service only.

We did not separate the various influences on TWA's fare increases to determine the proportion of TWA's fare increases at St. Louis that was due to the merger. However, TWA officials acknowledge that part of the reason why fares were low in 1986 was that TWA was competing vigorously with Ozark before the merger, and that fares had fallen to levels that were not sustainable. The merger eliminated that competition and its effect on fares.

In light of our findings, the ranking minority member of the Senate Commerce, Science, and Transportation Committee asked the Secretary of Transportation to evaluate competitive conditions at St. Louis. DOT issued its report in January 1989.[19] DOT's study largely supports our findings. For example, our study compared fares for the first three quarters of 1986 with those for the first three quarters of 1987 and found that TWA's fares rose 13 to 18 percent, while DOT reported a 20-percent increase for only the first two quarters of 1986 and 1987. Similarly, DOT found that in 1986, when TWA and Ozark were competing, fares fell an average of about 9 percent. Finally, DOT extended its analysis to include the first two quarters of 1988 and found that TWA's fares had risen an additional 11 percent over the previous year, a period during which the airline fares component of the Consumer Price Index increased less than one-half of 1 percent.

Moreover, DOT's analysis showed that TWA's fares rose 17.7 to 39 percent between 1985 and 1988 on those routes where it had been in competition with Ozark. On the routes where the two airlines did not compete, fares rose by only 1 to 1.5 percent.[20] Over the same period, the airline fares component of the Consumer Price Index rose 11.1 percent. Finally, DOT also examined fare changes between 1985 and 1988 at 8 other concentrated airports and found that fares rose 21 to 35 percent at six of them. The two exceptions were Pittsburgh, where USAir has been dominant since before 1985, and Atlanta, where two carriers operate a hub.

Future Merger Responsibilities

Statements made by Department of Justice officials suggest that their perspective on mergers is different from DOT's. Justice Department lawyers and economists have said that enough studies of the airline industry were done by 1985 to show that concentration and fares were positively correlated. Such a relationship suggests that airlines adjust fares on the basis of the actual number of competitors, not potential competitors. This led the Department of Justice to question whether airline markets were contestable as well as to challenge three of the four merger applications that received evidentiary hearings. Further, the Justice Department criticized DOT's decision not to shift the burden of

[19] U.S. Department of Transportation, A Comparison of Air Fares and Services at St. Louis Before and After Trans World Airlines Acquired Ozark Airlines (DOT-P-37-89-3), Jan. 1989.

[20] DOT claims that there is an inconsistency in the fare results. On routes where TWA and Ozark were the only competitors before their merger, and TWA had a post-merger monopoly, fares rose less than in markets where the merger eliminated Ozark as a competitor but other carriers also served the market. This discrepancy can be traced to DOT's inclusion of New York among the cities where other carriers competed. However, the other carrier serving New York nonstop from St. Louis—People Express—exited the market about the time of the merger, leaving TWA with a monopoly on that route. If the New York route is considered with the other post-merger monopoly routes, much of the inconsistency disappears.

proof from merger opponents to proponents after the former demonstrated that the merger would result in a highly concentrated market.

The merger procedures employed by the Department of Justice are different from those used by DOT. The Department of Justice believes that the procedures available to it under the antitrust statutes are more effective tools for obtaining the facts about airline mergers than those that were available to DOT.

DOT Will Still Have Authority

The Secretary of Transportation testified before the Congress that the Department would no longer have authority over mergers after December 31, 1988. However, we found that DOT will be able to bring administrative proceedings against airline mergers that DOT believes violate the antitrust laws. Specifically, 15 U.S.C. 21 gives the Secretary of Transportation authority to enforce airline compliance with the merger provisions of the antitrust laws and withholds the same authority from the Federal Trade Commission.

In addition, DOT has authority to challenge unfair methods of competition, including mergers, under 49 U.S.C. 1381. The Federal Trade Commission is specifically barred from using its unfair competition authority to contest airline mergers.

The legislative history of the CAB Sunset Act provision amending 15 U.S.C. 21 indicates that it was one of a number of miscellaneous changes made to reflect the termination of CAB and the transfer of CAB authority to DOT January 1, 1985. Unlike DOT's authority to approve mergers, this provision did not sunset at the end of 1988, thus continuing different merger treatment for the airline industry when compared with other industries. In other industries, the Federal Trade Commission and the Department of Justice review premerger notifications[21] and either can bring an action to stop a merger. In the airline industry, as the law is now written, the Department of Justice and Federal Trade Commission will continue to receive premerger notification; however, DOT and the

[21]The parties to a merger must notify the Justice Department and the Federal Trade Commission before merging, when one of the parties has $100 million or more in total assets or net sales, and the other has $10 million or more in total assets or net sales. Once the government receives the notification, the two merging parties must usually wait at least 30 days before consummating the merger. During the waiting period, either the Justice Department or the FTC reviews the merger for its competitive impact and decides whether or not to oppose the transaction. The waiting period may be extended by the Justice Department or the Federal Trade Commission for up to another 20 days when either seeks more information from the merging parties.

Justice Department are the only two agencies that can bring an action to halt a merger.

DOT's Deputy General Counsel agreed that DOT would have administrative merger authority under this provision. She said that because DOT had separate authority to approve or disapprove airline mergers, it had never implemented its 15 U.S.C. 21 authority and has no plans to do so at this time. Finally, the Deputy General Counsel said that DOT's position is that airline merger authority should belong to the Department of Justice and Federal Trade Commission.

Conclusions

Under the CAB Sunset Act, DOT was given responsibility for approving or disapproving airline mergers because of its expertise in transportation issues. We believe that with such responsibility comes the need for conducting thorough and current analyses of all relevant issues. Without conducting such analyses, however, DOT based its merger decisions on the same set of assumptions about airline behavior that CAB had adopted in 1979. That is, airline markets, although concentrated, behave competitively.

Although evidence had been gathered by industry experts both inside and outside DOT casting doubt on the assumptions underlying DOT's merger policy, the Department did not examine the continued applicability of those assumptions to the airline industry, either through an industrywide study or in the context of its merger decisions. DOT did not conduct an industrywide study because it said that there was insufficient time owing to the number of merger cases it had to review. DOT also did not conduct studies aimed at examining the competitive conditions in the merger cases it handled. While the Assistant Secretary for Policy and International Affairs said that he had relied on the public counsel and the Department of Justice to develop new information, the public counsel saw its role more narrowly as one of ensuring that the ALJ received the same information and analyses that had been used in making prior decisions. As a result, DOT repeated the same analysis in each case and did not address the issues raised by the combined effects of new airline marketing and operational strategies. Further, DOT rejected the arguments presented in two separate cases by the Department of Justice.

We believe that, given the stakes involved, DOT should have conducted an in-depth analysis of the airline industry to test its assumptions that airline markets were contestable. Industry experts both inside and outside DOT believe that the airlines' competitive environment has been altered by changes in the airlines' marketing and operational strategies. Taken together, these changes give airlines the opportunity to dominate an airport or region and charge monopolistic prices on some routes.

The requirement that all airline mergers receive prior approval from DOT ceased to exist at the end of 1988. The Department of Justice now has the same airline merger authority it has in other industries. Justice Department officials' public statements about airline mergers indicate that the Justice Department will take all of the industry changes into account when analyzing future mergers.

While the Secretary of Transportation has stated publicly that DOT would no longer have any merger authority after 1988, we believe, and DOT now agrees, that the Department continues to have authority to bring actions to oppose mergers that violate the antitrust laws. This creates an anomalous situation. Unlike other industries, where the Justice Department and Federal Trade Commission have the authority to review premerger notifications and take action to halt the mergers, in the airline industry, the Commission only has the authority to review premerger notifications. Further, although DOT has the authority to take administrative actions against mergers, it does not receive or review the premerger notifications. There is no indication that the Congress was aware that this would be the result of the CAB Sunset Act.

Matter for Congressional Consideration

To treat airline mergers like mergers in most other industries, the Congress may wish to consider amending 15 U.S.C. 21 and 45 and 49 U.S.C. 1381 to ensure that only the Department of Justice and the Federal Trade Commission, rather than the Department of Transportation, have jurisdiction over airline mergers.

Recommendation to the Secretary of Transportation

If the Congress does not remove the statutory provisions that now give DOT authority to oppose mergers, we recommend that the Secretary of Transportation work with the Federal Trade Commission and Department of Justice to develop rules for reviewing premerger notifications as well as procedures for taking administrative actions against mergers that violate the antitrust laws.

Agency Comments and Our Evaluation

As requested, we obtained oral comments on a draft of this report from the responsible DOT officials. Their views are incorporated throughout the report as appropriate. In general, they agreed with our recommendation and said that DOT's long-standing position has been to defer to the Department of Justice on enforcement of the antitrust laws. On the other hand, agency officials said that this chapter did not give enough weight to the procedural problems faced by DOT in conducting an in-depth analysis of individual airline mergers and did not state DOT's opinion that it was prevented, by law, from shifting the burden of proof from merger opponents to proponents in the applications it reviewed.

DOT officials provided us with three reasons why the Department was unable to conduct an in-depth analysis in individual merger cases. First, the statutory 6-month time limit for oral evidentiary hearings was not sufficient to conduct an in-depth merger analysis. DOT officials told us that because of procedural constraints, they would normally have 3 weeks or less to gather the data and an additional 6 weeks to prepare exhibits.

Second, DOT's attempted transfer of its aviation data bases to the Transportation Systems Center in Cambridge, Massachusetts, made merger analysis more difficult. As a result of the attempted transfer, the data available for merger analysis were out-of-date. Thus, according to the DOT officials, the Department did not have the latest information on which to base its merger decisions.

Third, DOT officials told us that they relied on the Justice Department's merger guidelines in making their decisions. According to DOT, these guidelines take contestability into account by permitting mergers to take effect, if competition can be replaced in 2 years. DOT officials told us that it was not until mid-1988 that 2 years had passed after the first major merger case (Northwest-Republic) and mid-1988 data were becoming available only at the beginning of 1989. Thus, there was no way to calculate the effects of the mergers until well after they had occurred. These officials added that DOT will not know the true effects of the 1985-88 airline mergers until the Department's current competition study is completed.

On the basis of our review of DOT's merger functions, we disagree with the Department's analysis. While we recognize that DOT's formal hearing process limited the amount of time available to analyze merger applications, only four applications received such hearings. We believe that in order to be able to effectively analyze airline merger applications, DOT needed a firm understanding of airline industry structure that only an in-depth analysis could provide. If time did not permit such an analysis during the hearing process, then it was incumbent upon DOT to undertake such an analysis outside of the formal hearing process. Second, DOT officials stated that DOT did not have the data necessary with which to make an informed decision. As we testified in April 1988,[22] inadequate planning and processing caused the data difficulties DOT experienced. Airlines continued to submit the data, but DOT was no longer processing the information promptly. Further, DOT could have required the merger proponents to submit any additional in-house traffic data they possessed.

Third, DOT officials stated that only after they complete their competition study will they know whether or not the mergers should have taken place. We are pleased that DOT has undertaken a study of airline competition. However, as this report discusses, such a study ought to have been conducted while DOT had its merger approval authority. DOT's merger analysis should have addressed future competitive conditions before each merger was approved or denied. The Supreme Court, in United States v. Philadelphia National Bank, said that merger analysis

> "requires not merely an appraisal of the immediate impact of the merger upon competition, but a prediction of its impact upon competitive conditions in the future . . . . Such a prediction is sound only if it is based upon a firm understanding of the structure of the relevant market . . . ." [374 U.S. 321, 362.]

Thus, we believe that to properly have administered its merger approval authority, DOT would had to have performed an in-depth analysis of airline industry competition during the time it was approving the various merger applications it received.

DOT officials also believed that their merger approval authority required them to place the burden of proof on merger opponents. It is true that under this authority, the merger opponent is required to prove that a merger is anticompetitive. However, our report discusses the relationship between DOT's belief in contestability and its decision not to use a federal court presumption that shifts the burden of proof from merger opponents to merger proponents when the transaction would result in significant increases in concentration. Further, in the NWA-Republic Acquisition Case (DOT Order 86-7-81) DOT argued that it did not choose to use the federal court presumption because it believed that most airline

[22] DOT Airline Industry Oversight (GAO/T-RCED-88-36, Apr. 21, 1988).

markets, although concentrated, were competitive. There was no indication in this case that DOT believed the statute prevented it from using the presumption, only that it did not believe it useful in the airline context.

Implementation of DOT Authority to Protect Consumers From Unfair and Deceptive Trade Practices

Pursuant to the CAB Sunset Act of 1984, the Congress gave DOT the responsibility to protect consumers from unfair and deceptive airline trade practices. Since assuming this authority in 1985, DOT has improved some aspects of its consumer protection functions by, for example, increasing the speed with which consumer complaints are handled. However, DOT's investigation and enforcement functions can be improved by implementing a clear set of priorities that permits DOT to coordinate its activities and efficiently use its limited resources. DOT's authority in this area was not altered by the termination of its merger approval functions in 1989.

Overview of DOT Consumer Protection Functions

The Airline Deregulation Act of 1978 did not explicitly address which federal agency would be responsible for protecting consumers from unfair and deceptive airline trade practices when CAB was terminated. In our June 1984 report about the expiration of CAB's legislative authority,[1] we stated that disposition of the Board's consumer protection responsibilities was unclear and that, without congressional action, there might be an unnecessary disruption in consumer protection.

To ensure continued government oversight, in September 1984, the Congress passed the CAB Sunset Act, which gave DOT responsibility for protecting airline consumers. The House report accompanying the act said that a continuing government role to protect airline consumers was necessary because

> "These problems involve important issues of health, passenger comfort, and social policy, and in these limited areas the solutions reached by the marketplace are not always acceptable."

The report also pointed out that the government has authority to protect consumers from unfair and deceptive trade practices in other industries as well.

DOT's authority to protect consumers from unfair and deceptive trade practices comes in large part from 49 U.S.C. 1381, which parallels the Federal Trade Commission's authority to protect consumers in other industries. DOT relies on separate statutory authority to regulate, among other things, airline charters and smoking. DOT regulations help define some of the prohibited practices. For example, DOT regulations protect

[1] Legislation Needed to Clarify Future of Consumer Protection and Federal Preemption After the Civil Aeronautics Board Sunsets (GAO/RCED-84-154, June 13, 1984).

airline passengers from ticket oversales, violations of the Consumer Credit Protection Act, and misleading advertising. In addition, DOT has broad authority to protect competition in the airline industry.

When DOT received consumer protection authority in 1985, it divided responsibility between two offices—the Office of Consumer Affairs in the Intergovernmental and Consumer Affairs Office and the Office of Aviation Enforcement and Proceedings in the Office of General Counsel. The Office of Consumer Affairs consists of two divisions. The Consumer Affairs Division receives and resolves complaints from individual consumers, while the Investigations Division investigates unfair and deceptive industry trade practices. The Office of Aviation Enforcement and Proceedings takes enforcement actions against persons who engage in prohibited trade practices or violate DOT's regulations.

Consumer Affairs Division

The Consumer Affairs Division has 13 staff members whose primary function is to receive and resolve individual consumer complaints. When a consumer complaint is received, it is referred to an analyst, who will open a case and record the complaint. If a complaint involves an area within DOT's jurisdiction, then the analyst will call the airline involved and attempt to resolve the problem. If the airline agrees to resolve the complaint, the analyst will call the consumer back to explain the solution. For example, if an airline agrees to pay for the loss of luggage, the analyst would contact the consumer and explain that the airline had promised compensation for the luggage and that if it did not arrive within a specified period of time, the consumer should contact the analyst again. At this point, the case is closed.

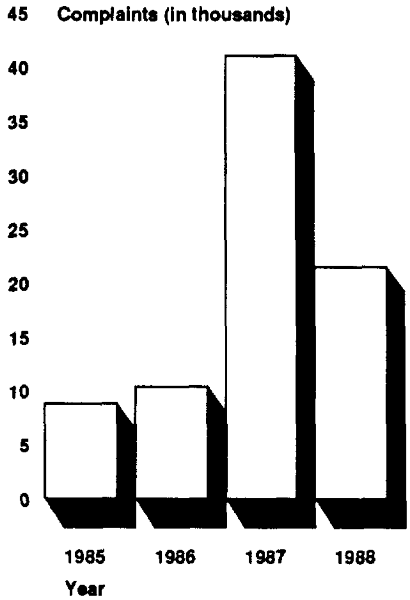
Analysts cannot solve some categories of consumer problems. For example, there are no DOT regulations providing a remedy for a single late flight. In those instances, the complaint is registered and the analyst contacts the consumer and explains that there is no solution available. The analyst will work with the consumer until the consumer understands that there is nothing DOT can do. At this point, the case is closed.

In 1985, the Consumer Affairs Division handled about 8,800 complaints against U.S. airlines; by 1987, this figure had grown to nearly 41,000, declining to about 21,000 in 1988. (See fig. 3.1.)[2] The types and rankings

[2]These numbers reflect complaints against U.S. airlines and do not include complaints registered against foreign airlines, cargo companies, travel agents, and tour operators, all of which are also handled by the Consumer Affairs Division.

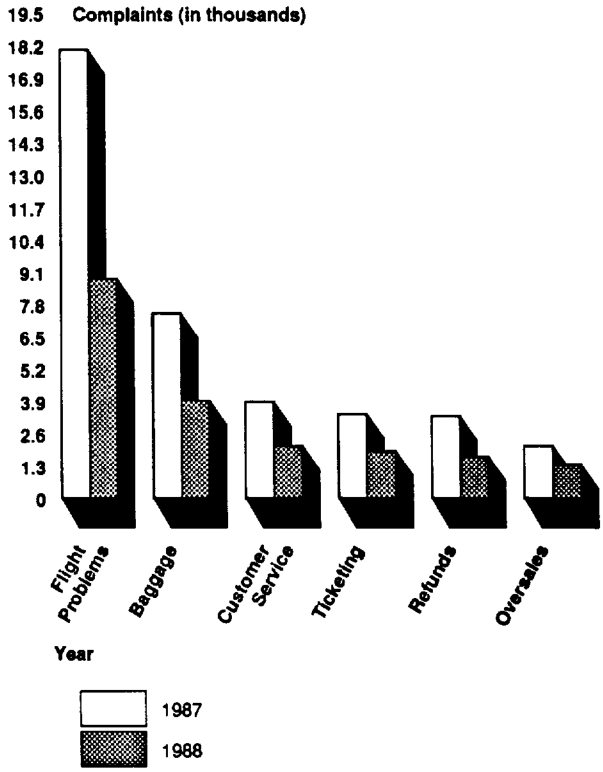
of complaints for 1987 and 1988 were similar. The largest single category of all complaints against domestic carriers consisted of flight cancellations and delays, which accounted for more than 40 percent of all complaints. The next largest category involved baggage problems, which accounted for close to 20 percent of all complaints; while customer service constituted about 10 percent of all complaints, and problems obtaining refunds for unused tickets, lost tickets, or fare adjustments accounted for about 8 percent of all complaints. (See fig. 3.2.)

Figure 3.1: Domestic Airline Consumer Complaints, 1985-88



Source: DOT Office of Consumer Affairs.

Figure 3.2: Airline Consumer Complaints by Category



Note: Ticketing includes all problems arising out of incorrect or incomplete fare information, as well as all airline or travel agent ticketing and reservation errors.
Source: DOT Office of Consumer Affairs.

In addition to its complaint handling functions, the Consumer Affairs Division answers consumer inquiries, provides consumer education, assists in rulemaking, and provides the public with general consumer information through publication of its Air Travel Report.

If it appears from the recorded complaints that an airline is engaged in a pattern of violations, then the Consumer Affairs Division will send the information to the Investigations Division for closer study.

Investigations Division

The Investigations Division employs one supervisor, two investigators, and one secretary. Using consumer and competitor complaints, as well as their own observations, the Division's supervisor and two investigators examine airline industry practices for violations of DOT's unfair or deceptive trade practices statute or regulations. The Division's primary objective is to ensure compliance with DOT regulations, so that consumers are protected.

The Division focuses its investigations on those unfair and deceptive trade practices and other consumer issues where DOT rules, orders, or statutory authority is clear. This includes, among other things, failure to file a charter prospectus, failure to refund money to airline consumers on time, and misleading fare information. However, if the Investigations Division comes upon a new type of violation, or a new variation of a previous violation, it provides the information to the Office of Aviation Enforcement and Proceedings (AEP), which determines whether or not to bring an enforcement action.

The Assistant Director for Consumer Affairs told us that the Division's work depends on the types of issues that AEP is willing to pursue. For example, although DOT is still charged with preventing rebates on international fares, DOT has determined that it will only enforce the statute where it finds fraudulent, deceptive, discriminatory, or anticompetitive rebates.

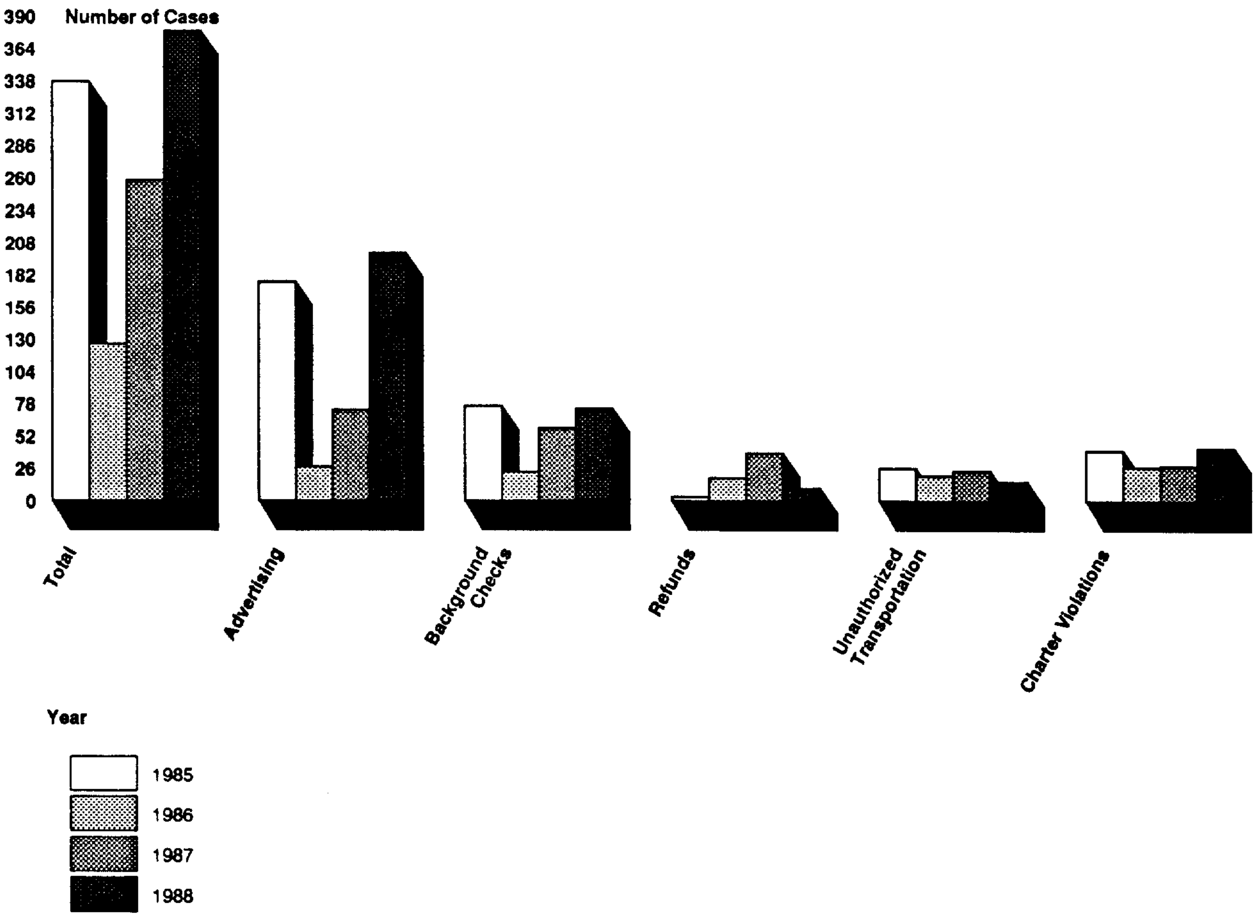
The Investigations Division also works on other matters at DOT. One of the two investigators devotes three-quarters of a year to background checks of persons holding or applying for authority to provide airline service. This task, conducted on a priority basis, involves examining DOT regulations, violations, and consumer complaints records. It also involves examining Securities and Exchange Commission documents to find out whether the Commission has any information regarding litigation or administrative proceedings involving persons under investigation. The Assistant Director for Consumer Affairs, in reviewing our draft report, said that background checks were performed by the Investigations Division because (1) four different DOT offices seek these checks, (2) the relevant DOT records are maintained by the Investigations Division and they are familiar with them, and (3) the Investigations Division, by independently doing the task, serves as a check and balance on the other offices.

According to the Assistant Director for Consumer Affairs, the Investigation Division's workload is ordered so that cases with potential for large harm get priority. These include noncompliance with DOT regulations and instances where consumers have not received the travel services for which they paid. For example, airlines operating before they have authority, the stranding of passengers, and deceptive advertising would all be priority cases. In 1985, the Investigations Division opened 337 cases. By 1988, this figure had grown to 378.[3] In 1988, the largest number—about 52 percent—involved advertising, including Superbowl advertising. The next largest number—about 20 percent—involved background checks of persons holding or applying for authority to provide airline service. Problems with charter flights made up about 11 percent of the cases investigated,[4] while approximately 3 percent of the cases involved consumer problems in obtaining refunds. (See fig. 3.3.) The DOT officials reviewing the report said that the Investigations Division handles considerably more cases than those that are officially opened.

[3]Of the cases opened in 1988, 256 had been closed by March 1989.

[4]This does not include the Superbowl, escrow account, or special event investigations.

Figure 3.3: Caseload—Investigations Division, DOT Office of Consumer Affairs



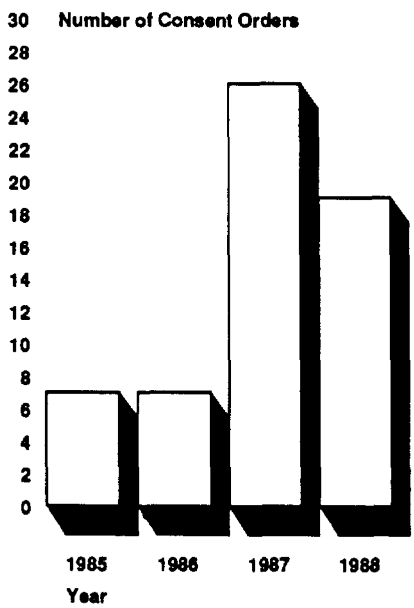
Note: "Advertising" includes Superbowl cases; "Charter Violations" include only charter cases.
Source: DOT Office of Consumer Affairs, Investigations Division.

The amount of time devoted to different issues is not necessarily reflected in the number of cases handled in each area. In mid-June, as a result of discussions with us about accurately measuring its workload, the Investigations Division instituted a record-keeping system to monitor the time spent working on various issue areas. During the last 6 months of 1988, the Investigations Division reported that it spent 40 percent of its time working on charter cases, 32 percent on background checks, and 10 percent on advertising cases. The remainder of the time was spent on a variety of issues, including refunds and unauthorized air transportation.

Office of Aviation Enforcement and Proceedings

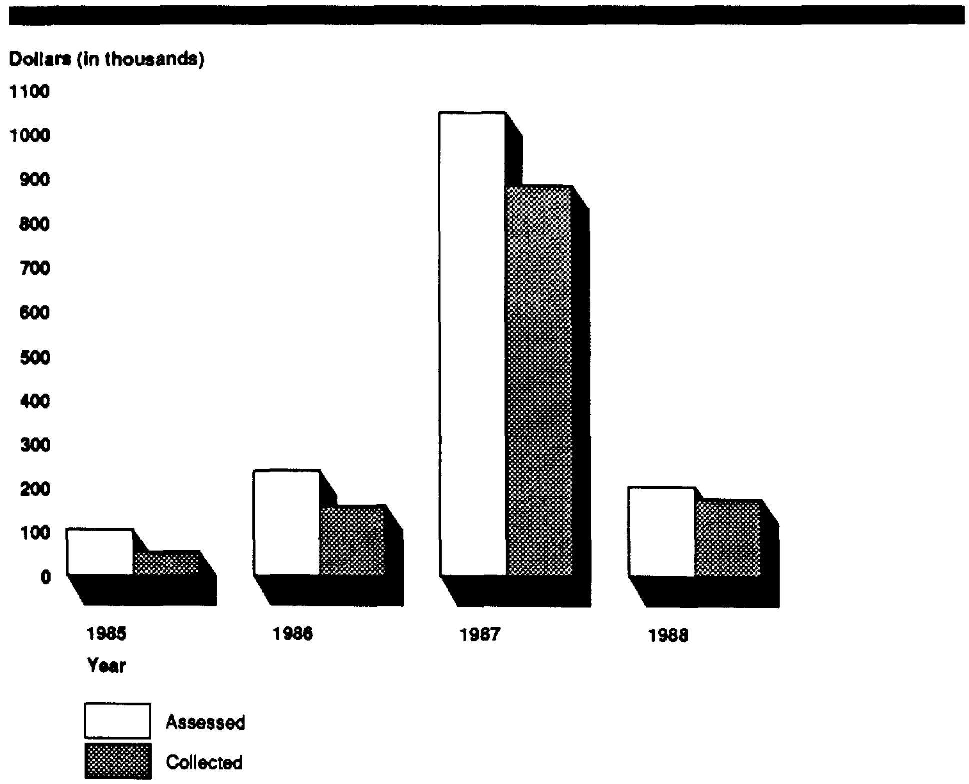
The Office of Aviation Enforcement and Proceedings, located in DOT's Office of General Counsel, is staffed by eight attorneys who prosecute violations of DOT's unfair and deceptive trade practices statute and regulations and act as public counsel in merger, fitness, employee protection program, Program Fraud and Civil Remedies Act, and international route cases. The number of consent orders obtained by AEP increased from 7 in 1985 to 19 in 1988, and the amount of fines collected as a result of these consent orders increased from $53,500 in 1985 to $883,700 in 1987 and decreased to $174,500 in 1988. (See figs. 3.4 and 3.5.)

Figure 3.4: Caseload—DOT Office of Aviation Enforcement and Proceedings



Source: DOT Office of Aviation Enforcement and Proceedings.

Figure 3.5: Fines Assessed and Collected: DOT Office of Aviation Enforcement and Proceedings



Source: DOT Office of Aviation Enforcement and Proceedings.

DOT Has Limited Criteria for Judging Its Consumer Protection Efforts

DOT has not prepared formal written priorities to guide the functioning of its consumer protection activities. We were able to identify informal goals and priorities, though, through conversations with the heads of the Consumer Affairs, Investigations, and AEP offices. In general, they stated that DOT looks for patterns of unfair and deceptive trade practices. Cases with the potential for the most harm get priority. This includes those instances where carriers do not comply with DOT regulations (e.g., failure to obtain certification before offering air service) or where consumers have not received the travel services for which they paid. DOT's prioritization of problems is illustrated by the way it handled the bankruptcy of a charter company in 1987. The company halted services, leaving many passengers stranded overseas and others in need of refunds. DOT sought to (1) bring the stranded passengers back from abroad, (2) halt the bankrupt company's advertising that it believed was illegal, and (3) obtain refunds for the consumers.

DOT Has Improved Some Consumer Protection Functions

Since inheriting consumer protection authority from CAB in 1985, DOT has improved several of its consumer protection functions, including how consumer complaints are handled and the amount and extent of its enforcement activities. DOT has also conducted an investigation into airline scheduling.

Consumer Complaints Handling Has Improved

DOT has increased the speed with which consumer complaints are handled when compared with CAB. While the Board required consumers to submit complaints in writing and responded in writing to the airlines and passengers, DOT generally handles complaints over the telephone.

At CAB, when a written consumer complaint about an airline was received, a copy was sent to the carrier for resolution. The company had 30 days to respond; however, that deadline could be extended to 60 days. In a July 1978 report,[5] we found that approximately 60 percent of all complaints were not answered within the first 30 days. Further, our report found that while CAB staff kept track of airline response time, they acted primarily as a referral agency and did not take an active role in resolving individual complaints. In reviewing our report, DOT officials said that even though some cases were old, there was always a CAB employee monitoring the complaint's progress, and it was not closed until it was resolved.

In contrast, DOT staff will discuss the complaint with callers to determine whether or not the complaint involves a violation of DOT regulations. In those instances where no DOT regulations cover the complaint, such as where one flight arrives late, the staff will dispose of the complaint without contacting the airlines. DOT officials told us that the DOT staff will give the consumer the number of the carrier's consumer affairs office and suggest that the consumer contact the carrier. Where there appears to be a violation of DOT's statutes or regulations, the staff will contact the airline directly in an attempt to resolve the complaint. As a result, most cases are closed within days of the initial complaint. From January 1988 through October 1988, the Consumer Affairs Division received 21,917 cases. As of November 1, 1988, only 342 remained open.

[5] Airline Passengers: Are Their Consumer Rights Protected? (CED-78-143, July 20, 1978).

Enforcement Workload More Closely Relates to Consumer Concerns

Since 1987, there has been a greater correlation between the complaints DOT has received and AEP's enforcement actions. Approximately one-quarter of AEP's 1987 cases and one-half of its 1988 cases involved unfair and deceptive trade practices. AEP obtained consent orders for, among other things, unrealistic scheduling, code-sharing violations, denied boarding compensation, refunds, deceptive advertising, and displays on computerized reservation systems that misrepresented fares.

This is an improvement over the situation when AEP first assumed responsibility for consumer protection. Specifically, of the seven consent orders the Office of Aviation Enforcement and Proceedings obtained in 1985, only three represented violations of consumer protection regulations, and all three were violations of DOT's charter regulations. During 1985, however, the largest number of complaints DOT received involved flight problems, followed by mishandled baggage, and difficulties in obtaining refunds.

DOT's Investigation of Airline-Scheduling Practices

Airline delays and scheduling problems have caused the most consumer complaints since DOT received authority to prevent unfair and deceptive trade practices. DOT's regulation governing airline-scheduling states that unrealistic scheduling is an unfair and deceptive trade practice.

In 1987, the Office of the Secretary conducted an investigation of airline-scheduling practices. During the course of the investigation, DOT discovered that many flights did not arrive within 15 minutes of their posted schedules. DOT officials involved believed that this constituted unrealistic scheduling, and the data were turned over to the Office of Aviation Enforcement and Proceedings for enforcement action.

According to the Assistant General Counsel for Aviation Enforcement and Proceedings, DOT determined that between the available evidence and the vagueness of DOT's scheduling regulations, the Department could not ensure success in an administrative proceeding against the airlines. He added that an enforcement action would have taken up to 2 years before any corrective action could have been ordered. As a result, in

August 1987, DOT entered into six settlement agreements[6] with the airlines[7] under investigation covering four major airports.[8] These agreements covered about 10 percent of all domestic flights.

The agreements permit the affected airlines to have individual flights more than 15 minutes late up to 50 percent of the time and more than 30 minutes late up to 25 percent of the time over a 3-month period at these four airports without incurring any penalties. If a flight did not meet these standards, the airline could present DOT with a plan for improving flight performance that, if accepted, guaranteed no enforcement action in the following 3 months. However, at the time of the settlement, these airlines' late flight average was already below 50 percent. We spoke with the officials responsible for the settlement, and they told us that the 50-percent standard was used because the standard was achievable and would, therefore, foster settlements instead of litigation. The DOT officials who reviewed this report said that, even with this standard, the airlines involved had to take drastic steps to gain compliance with the settlement agreements.

All the settlement agreements with these specific standards expire on September 1, 1989. There are no similar standards for the rest of the industry, although DOT says that it will continue to review the necessity for one.

As a result of the investigation, in September 1987 DOT issued a regulation requiring that airlines report actual arrivals and departures of nonstop flights. The regulation applies to all airlines accounting for at least 1 percent of domestic passenger revenues and all such airline arrivals or departures at airports with at least 1 percent of domestic enplanements—29 airports.

This regulation has had two benefits. First, it has provided travel agents and airline passengers with information about the reliability of each flight's timetable, thus permitting passengers to plan accordingly. Second, it has provided planners with a better picture of why planes are delayed than the data that were used before.

[6]A seventh agreement was reached with Pacific Southwest Airlines in April 1988 covering its scheduling practices at San Francisco International Airport.

[7]The six airlines are Delta Air Lines, Eastern Air Lines, Continental Airlines, USAir, United Airlines, and American Airlines.

[8]The airports involved were Atlanta, Hartsfield; Boston, Logan; Chicago, O'Hare; and Dallas-Ft. Worth.

DOT Missed Opportunities to Protect Consumer Interests

While DOT has improved some of its consumer protection functions, we identified several areas where DOT missed opportunities to adhere to its own set of informal priorities or to work with other regulatory agencies to develop regulations to address major consumer concerns.

Major Pattern of Violations Overlooked

DOT officials told us that for investigation and enforcement purposes, they look for patterns of violations in consumer complaints. Neither the Investigations Division nor the Office of Aviation Enforcement and Proceedings, however, followed up when DOT received 35 refund cases involving one company—World Travel Vacation Brokers. In 1987, the Investigations Division received 38 complaints from consumers who wanted refunds on tickets they had purchased; 35 of these refund complaints involved certificates sold for a $29 round-trip air fare to Hawaii by World Travel Vacation Brokers.

Complaints regarding refunds of these certificates made up about 90 percent of the Investigations Division's refund workload, and almost 15 percent of the Division's total caseload. After bringing World Travel Vacation Brokers' advertising into compliance with DOT standards, the Division did not pursue the matter because World Travel Vacation Brokers provided refunds to consumers at the Division's request. Investigations Division officials said that they had informed AEP about the complaints regarding World Travel Vacation Brokers. However, AEP never pursued the matter any further.

Independently, in late 1987, the Federal Trade Commission obtained a court order halting World Travel Vacation Brokers' deceptive trade practices and freezing its assets. The court found that:

- World Travel Vacation Brokers sold between 600,000 and 700,000 $29 round-trip certificates for air fare to Hawaii.
- At no time was a $29 round-trip air fare to Hawaii available; rather, the certificate holder paid the commercial rate available for the date and point of departure requested.
- The consumer could obtain a refund of the value of the certificate within 3 days after its receipt. In most instances, the consumer would not be aware of the true costs of the trip until after the 3 days had elapsed.
- The company was in violation of the Truth in Lending Act and had engaged in deceptive advertising practices.

DOT Did Not Follow Up on Unauthorized Air Transport

In August 1987, the Assistant Attorney General of the Consumer Assistance Section of the New York State Attorney General's Office called DOT to explain that New World Airways had stranded about 300 passengers in Grenada. He talked with analysts in the Consumer Affairs Division as well as attorneys in AEP, seeking their help in getting the travelers back. DOT officials told us that they were not able to act on the information he gave them because it was incomplete. As part of their review of this report, they said that they were unaware that 300 people were stranded. They also told us that they asked the New York State Assistant Attorney General to call back if he received any information that would require action by DOT. New York State's Assistant Attorney General, however, was under the impression that DOT would not help bring back the stranded passengers, and the state of New York arranged to bring the travelers back from Grenada.

Owing to a lack of coordination at DOT, neither the consumer affairs analysts nor the attorneys checked to see if there was anything further DOT could do. However, DOT's investigation records indicate that at the time the flight to Grenada was made, New World was not authorized to engage in any air transportation. Further, the stranding was not the first time New World Airways had violated DOT's regulations.

In July of 1987, the Investigations Division helped a consumer obtain repayment of a $16,000 deposit when it appeared that New World would breach its contract. DOT records also indicate that New World had, in violation of DOT regulations, signed and accepted money for this charter contract before filing the necessary paperwork with DOT. In addition, DOT records indicate that New World Airways brochures advertising unauthorized trips to Grenada had been disseminated. DOT did not investigate this apparent pattern of violations.

DOT's Advertising Policy Prompts State Action

Deceptive airline advertising has been a concern of both federal and state regulators. During our review, the Chief of the Investigations Division said that he believed many advertisers were knowingly violating DOT regulations. He told us that these advertisers would not comply because other advertisers were also in violation of DOT regulations. This statement is borne out by the Editor of Consumer Reports Travel Letter, who told us that airline industry advertising is among the worst in the country because the industry is both seasonal and competitive. He said that as a result, when one company produces a questionable ad that provides it with an advantage, other companies follow. The National Association of Attorneys General said that in some states, complaints about airline advertising practices ranked near the top of the complaint categories. The Association characterized this increase as alarming because prior to this time, complaints about the airline industry had not been noticeably different from complaints about other industries.

According to the Assistant Director for Consumer Affairs, one of the priorities for the Consumer Affairs and Investigations Division was halting deceptive advertising because the potential for immediate harm was great. In an attempt to achieve compliance with DOT's advertising provisions, the Investigations Division launched an investigation into advertising practices in mid-1988. However, that investigation had to be halted because, soon thereafter, the Office of Aviation Enforcement and Proceedings decided to issue an order which would more clearly set forth the type of information DOT required in airline price advertising. Although the investigation was reinstated after the order was issued, it continued at a much slower pace because of the need to get new advertisements and the large number of background checks which take priority over consumer affairs work. In addition, 27 states sued DOT and obtained a Federal Appeals Court ruling vacating DOT's advertising orders because these orders should have been issued following Administrative Procedure Act provisions requiring public notice and comment.[9]

The confusion caused by DOT's policies, combined with the increased number of consumer complaints to state agencies led the National Association of Attorneys General to promulgate guidelines clarifying for the airline industry what conduct is permitted and what is prohibited as a matter of state law. These guidelines address issues of airline advertising, frequent flyer programs, and denied boarding compensation. For example, the guidelines point out that as a matter of state law, airlines are required to advertise limited availability of seats if there will not be enough seats at the advertised price to meet reasonably foreseeable demand.

DOT opposed a number of the guidelines, stating that they were preempted by federal statute that precludes states from regulating airline rates, routes, or services[10] or that they unduly burdened interstate commerce. For example, DOT claimed that the guideline requiring advertisers to include all surcharges as part of their advertised fares was clearly preempted by DOT regulations and orders. DOT interprets its regulations

[9]Alaska v. Dep't of Transp., Nos. 88-1348 & 88-1682, slip op. (D.C. Cir. Feb. 28, 1989).

[10]49 U.S.C. 1305.

to permit the listing of some surcharges separately from the advertised price. The states argued that the guideline was not preempted, stating that it was intended to ensure that consumers receive accurate fare information, and further that DOT had not followed appropriate Administrative Procedure Act provisions in issuing two of its orders permittin separate listing of surcharges. These two orders were overturned in Alaska v. Department of Transportation, Nos. 88-1348 & 88-1682, slip op. (D.C. Cir. Feb. 28, 1989) because DOT had not followed proper Admir istrative Procedure Act provisions.[11] However, the Alaska v. Departmen of Transportation case did not resolve the issue of state preemption in this area, which is currently the subject of litigation in state and federal court.[12]

One of the specific functions AEP is to monitor is airline advertising; however, one of the four advertising consent orders that DOT obtained in 1988 resulted from our investigation. During our work on this report, w discovered an apparently deceptive airline advertisement in the Washington, D.C., Metro subway that stops at DOT headquarters. We called th airline and determined that the advertised fare was not available. We reported the advertisement to DOT officials and subsequently testified before the Subcommittee on Transportation, Senate Committee on Appropriations, that the airline involved was advertising fares for which tickets could not be purchased. DOT initiated its own review of the airline's ads and determined that they were misleading. As a result, according to the DOT officials who reviewed our draft report, the advertisement was removed from the Metro within weeks of our initial call and further consumer harm was avoided.

[11] DOT has since announced that it will not prosecute airlines for separately listing the surcharges specifically identified in the two orders that were overturned because it does not regard this as an unfair or deceptive advertising practice.

[12] E.g., TWA v. Mattox, No. A-89-CA-067, slip op. (W.D. Tex. 1989) (The court issued a preliminary injunction against the state of Texas after finding that the state's power to regulate deceptive airline advertising was preempted by the Federal Aviation Act.) plaintiff's brief filed, No. 89-1142 (5th Cir. April 5, 1989); Wolens v. American Airlines, No. 89-CH 7554, slip op. (Cir. Ct. Ill., 1989) (Plaintiff sued for breach of contract after the defendant changed its frequent flyer program. Defendant's motion to dismiss the claim was denied after the court found that Illinois' fraudulent and deceptive business practice statute was not preempted by the Federal Aviation Act).

DOT Has Not Used Its Broad Investigative Power to Address CRSs' Anticompetitive Problems

In 1986, we reported on the potential anticompetitive effects of CRSs and recommended that DOT conduct a study of these effects.[13] DOT recently concluded such a study that provided extensive information on these systems but that did not draw conclusions about their potential anticompetitive effects or the need for action. After analyzing the study, we concluded that (1) airline-owned CRSs are earning excessive profits and (2) these profits reduce competition in the air passenger market because they artificially raise the costs of participating air carriers. These conclusions correspond to conclusions reached in analyses conducted over the past 6 years by the CAB, the Justice Department, and us. Therefore, in testimony before the Subcommittee on Aviation, House Committee on Public Works and Transportation,[14] we recommended that DOT take further action to ensure that the benefits of airline deregulation are not undercut by the anticompetitive effects of airline ownership of CRSs.

Conclusions

Our review of DOT's consumer protection activities provides a mixed picture. On the one hand, DOT has (1) improved the process of handling consumer complaints, (2) increased and focused its enforcement functions on major areas of consumer complaints, and (3) investigated airline scheduling—a major issue of consumer concern. On the other hand, we believe that, because of inadequate direction and coordination, DOT missed important opportunities to (1) address a major pattern of violations, (2) establish clear policy in important areas such as CRSs, airline scheduling, and airline advertising, and (3) more effectively use limited resources.

Given DOT's limited investigation resources, we believe that the Department must find more efficient ways to handle some of its consumer affairs functions. By simply implementing its own goal of detecting patterns of violations and more effectively coordinating the work of the Investigations Division and AEP, DOT could and should have taken action against World Travel Vacation Brokers for violations of the Truth in Lending Act and deceptive advertising. Similarly, we believe that a more coordinated effort by DOT and the states on a major area of consumer concern—airline advertising—is needed to improve DOT's own intermittent efforts in light of the Department's opposition to the National Association of Attorneys' General guidelines. Finally, given DOT's limited

[13] Airline Competition: Impact of Computerized Reservation Systems (GAO/RCED-86-74, May 9, 1986).

[14] Competition in the Airline Computerized Reservation System Industry (GAO/T-RCED-88-62, Sept. 14, 1988).

investigative resources, we believe that the interests of consumers would be better served if one of DOT's investigators were not required to spend three-quarters of a year conducting background checks of persons applying for authority to provide airline service, and instead, background checks were performed in another part of the Department.

Recommendations to the Secretary of Transportation

To make better use of its limited resources, we recommend that the Secretary of Transportation ensure that DOT coordinate its consumer affairs functions with state offices. Such coordination could include a strategy for sharing information and coordinating rulemaking and enforcement activities with the states.

Agency Comments and Our Evaluation

In commenting on a draft of this report, DOT officials said that this chapter was balanced, but disagreed with our characterization of the World Travel Vacation Brokers case, and with our conclusion that background checks of persons applying to provide airline service should be handled outside the Investigations Division. They had no comment on our recommendation that DOT coordinate its consumer affairs functions with the states.

With respect to World Travel Vacation Brokers, the DOT officials told us that this was a travel scam, which is generally removed from DOT's jurisdiction. They said that this was primarily a local Illinois problem that the state had handled. DOT officials pointed out that DOT did play a role in getting World Travel Vacation Brokers to change their advertisements to clarify what a consumer would obtain for a $29 certificate.

We disagree with DOT's characterization of this case as a primarily local matter removed from their jurisdiction. DOT has statutory jurisdiction over the issues involved—deceptive advertising and failure to refund airline consumers' money as required by law. In addition, there were between 600,000 and 700,000 certificates sold to consumers throughout the United States. The Federal Trade Commission's actions to stop the operation indicate that it too believed that this was more than a local matter. With regard to the steps taken by DOT to get World Travel Vacation Brokers to correct its advertising, we believe these were ineffective. In the fall of 1986, DOT obtained World Travel Vacation Brokers' agreement to clarify its advertising. However, even with the changes World Travel Vacation Brokers agreed to make, the court that heard the case said: "the disclaimers set forth in defendants' promotional materials were insufficient to alert consumers to the true facts."[15] We believe that given the pattern of refund problems that were brought to DOT's attention and DOT's ineffective response, this case indicates a lack of aggressive follow-up on DOT's part in an area where the Department had established priorities.

The DOT officials who reviewed a draft of this report disagreed with a proposal in that draft that background checks be done elsewhere in DOT. They said that (1) four different DOT offices seek these checks, (2) the Investigations Division personnel maintain the relevant DOT records and they are familiar with them, and (3) the Investigations Division, by independently doing the task, serves as a check and balance on the other offices.

Although we removed our proposal as a result of DOT's arguments, we continue to believe that the present system has a high cost in terms of investigations foregone. Of the three people available to conduct consumer protection investigations, one spends at least three-quarters of his time doing background checks. We believe that the Investigations Division's role is a vital part of DOT's airline consumer protection functions. Only through investigations and monitoring of the airline industry can DOT obtain and ensure compliance with its rules.

[15] FTC v. World Travel Vacation Brokers, 861 F.2d 1020, 1029 (7th Cir. 1988).

Organizations and Individuals Contacted During Our Work

Organizations

American Society of Travel Agents
American Airlines
Aviation Consumer Action Project
Boeing Computer Services
Consumers Union
Department of Justice
Department of Transportation
Federal Trade Commission
I.P. Sharp Associates
New York State Attorney General
Revere Travel
Texas Air Corporation
Trans World Airlines

Individuals

Dean Elizabeth Bailey, Carnegie Mellon University
John E. Gillick, Esq., Winthrop, Stimson, Putnam and Roberts
Professor Alfred Kahn, Cornell University
Professor Michael Levine, Yale University
Dr. Julius Maldutis, Salomon Brothers, Inc.

Acquisition, Consolidation, and Merger Applications Approved or Exempted by DOT

Merger	Date of Approval or Exemption
1. Muse Air—Contran	Feb. 15, 1985
2. USAir—Pennsylvania Commuter Airlines	May 24, 1985
3. Midway Airlines—Air Florida	June 11, 1985
4. Southwest Airlines—Muse Air	June 24, 1985
5. Presidential Airways—Key Airlines[a]	Aug. 30, 1985
6. United Airlines—Pan Am Pacific Division	Oct. 31, 1985
7. People Express—Frontier Airlines	Nov. 20, 1985
8. Piedmont Aviation—Empire Airlines	Jan. 23, 1986
9. Horizon—Cascade	Jan. 30, 1986
10. People Express—Britt	Feb. 19, 1986
11. Delta Air Lines—Comair	July 23, 1986
12. Northwest Airlines—Republic Airlines	July 31, 1986
13. United Airlines—Frontier Airlines[b]	Aug. 01, 1986
14. Presidential Airways—Key Airlines[c]	Aug. 13, 1986
15. Delta Air Lines—Jet America[d]	Sept. 10, 1986
16. Alaska Airlines—Jet America	Sept. 10, 1986
17. Trans World Airlines—Ozark Airlines	Sept. 12, 1986
18. Texas Air Corporation—Eastern Airlines	Oct. 01, 1986
19. Texas Air Corporation—People Express	Oct. 24, 1986
20. Delta Air Lines—Western Air Lines	Dec. 11, 1986
21. Alaska Airlines—Horizon	Dec. 23, 1986
22. USAir—Pacific Southwest Airlines	Mar. 04, 1987
23. American Airlines—AirCal	Mar. 30, 1987
24. World Airways—Key Airlines[e]	Apr. 28, 1987
25. USAir—Piedmont Aviation	Oct. 30, 1987
26. Braniff—Florida Express	Jan. 21, 1988
27. Hawaiian Airlines—Japan Air Lines	Dec. 21, 1988

[a]DOT granted an exemption permitting common control of both carriers.

[b]DOT approved United's plan to buy aircraft, airport facilities, and slots from Frontier, People Express, and Britt.

[c]Presidential acquired Key.

[d]Both Delta's and Alaska Airline's applications were approved to buy Jet America.

[e]World Airways bought Key from Presidential.

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