UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF KANSAS

UNITED STATES OF AMERICA,	)	
Plaintiff,	)	
v.	)	**Case No. 99-1180-JTM**
AMR CORPORATION, AMERICAN AIRLINES, INC. and AMR EAGLE HOLDING CORPORATION,	)	
Defendants.	)	

REDACTED
MEMORANDUM IN SUPPORT OF THE RESPONSE OF THE UNITED STATES IN OPPOSITION TO AMERICAN'S MOTION FOR SUMMARY JUDGMENT

NON- CONFIDENTIAL VERSION -- REDACTED PURSUANT TO STIPULATED PROTECTIVE ORDER GOVERNING CONFIDENTIAL INFORMATION DATED SEPTEMBER 14, 1999

ORIGINAL MEMORANDUM FILED FEBRUARY 22, 2001

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I. INTRODUCTION

American moves for summary judgment on the United States' claims of monopolization and attempted monopolization of certain routes emanating from American's largest and most profitable hub -- Dallas/Ft. Worth ("DFW"). American cannot establish that there are no genuine issues of material fact, and its motion must fail for at least the following reasons:

- American engaged in a predatory pattern of conduct that was calculated to stifle competition from low cost competitors at its DFW hub and thereby enable American to maintain and/or acquire monopoly power on many DFW routes.
- The centerpiece of American's predatory conduct was repeated additions of capacity that had no rational business justification but for their anticompetitive effect.
- American's conduct was both exclusionary *and* below an "appropriate measure of cost" under settled law. *See Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993); *Instructional Sys. Dev. Corp. v. Aetna Cas. & Sur. Co.*, 817 F.2d 639 (10th Cir. 1987).
- The relevant costs of American's exclusionary conduct are the costs of adding the predatory capacity, not the "average variable" costs of serving an entire route.
- American had a dangerous probability of recouping its losses from the predatory capacity additions; indeed, it has already recouped those losses.
- American's "meeting competition" defense fails as a matter of law and fact.

In short, American is a monopolist that undertook a series of actions that were designed to, and that ultimately did, harm competition in certain airline city pair markets in violation of the Sherman Act. Despite American's efforts to obscure the legal issues and ignore the significant facts, nothing contained in its moving papers provides a basis for permitting it to escape the consequences of that unlawful conduct. This is a classic case of monopolization "in which a defendant's possession of substantial market power, combined with his exclusionary or

anticompetitive behavior, threatens to defeat or forestall the corrective forces of competition and thereby sustain or extend the defendant's agglomeration of power." *Eastman Kodak Co. v. Image Tech. Servs. Inc.*, 504 U.S. 451, 488 (1992) (Scalia, J., dissenting). Summary judgment must be denied.

II. SUMMARY OF BACKGROUND FACTS

American's DFW hub is the heart of its network and profits. In fact, while American's DFW traffic accounts for only of its domestic capacity, it provides of American's profits. (Gov't SOF at 4.4.)

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(Gov't SOF at 4.) Because it would take years for an actual or would-be rival to approach the scale and scope of American's DFW operations, American receives an important measure of protection from non-stop entry on DFW spoke routes. (Gov't SOF at 8.5.) American's operational advantages at DFW are further augmented by marketing programs designed to increase profitability by capitalizing on American's extensive service and market share. (Gov't SOF at 8.4.1.) Together, these factors allow American to attract a heavily disproportionate share of passengers in DFW city pair markets, a powerful advantage that American calls "origin point presence." (Gov't SOF at 8.4.) On many of its DFW routes, American is able to set supracompetitive prices and thus earn monopoly profits.

In spite of these advantages, in the mid-1990s, American's high prices at DFW faced a threat from low cost carriers ("LCCs"). These LCCs, which frequently had lower operating costs than American (Gov't SOF at 12), offered prices substantially below American's and attracted many passengers who would not otherwise have traveled at the higher prices set by American.

For example, after Vanguard started serving DFW-Wichita, the number of people who flew that route nearly doubled, from 7,300 in 1994 to 12,200 in 1995, as the average price for the trip went from $105 in 1994 to $70 in 1995. (Gov't SOF at 37.) Consumers were better off, but American was worried. It had studied the impact on Delta's revenues of the development of a small hub at Atlanta by an LCC known as ValuJet, and it did not like what that study revealed: "DL has lost $232M in annual revenue. Clearly we don't want this to happen to AA at DFW." (Gov't SOF at 15.)

To make sure that it did not "happen to AA at DFW," American developed the "DFW LCC Strategy," which was presented as a package to American's senior management on February 27, 1996. The package was titled "DFW Low Cost Carrier Strategy" (Gov't Ex. 43) and detailed American's strategy for competing with, among others, the LCCs that form the focus of this case: Vanguard, Western Pacific and SunJet, which had entered certain DFW spokes.[1]

REDACTED American personnel explicitly discussed the impact of American's strategy on the ability of the low cost carriers to survive at DFW. Thus, with respect to Western Pacific, the notes read in part: "get them out of DFW b/f [before] they are encouraged to put the [2nd flight] back in COS-DFW."

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[1] The presentation of the proposed strategy was met with approval by American's senior officers.

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As implemented, the DFW LCC Strategy took the following form: When faced with LCC competition on a DFW route, American would shift aircraft from other parts of its network to inundate the route with additional capacity sold at low fares; the purpose and effect of this conduct was to deprive the LCC of the very passengers that its low fares had attracted.[2] Unable to obtain the traffic that it needed to be profitable, the LCC was typically forced to withdraw, leaving American free to raise prices and reduce capacity. Thus, on the DFW-Wichita route, after Vanguard exited, American's price rose from $70 to $117 and the number of people who traveled on the route fell from 14,700 in 1996 to 7,600 in 1999. (Gov't SOF at 75.)

American knew that its DFW LCC Strategy made no economic sense except for its anticompetitive effect. There is no clearer statement of this knowledge than the words spoken by American's then-CEO, Robert Crandall, at the meeting in which the DFW LCC Strategy was discussed: "If you are not going to get them [LCCs] out then no point to diminish profit." (Gov't SOF at 18.5.1.1.) And American's strategy was a below-cost strategy. As Mr. Crandall had

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[2] American's DFW LCC Strategy differed from its established and profitable method of competing against Southwest Airlines, a well-established LCC that American knew it had no chance of driving out of business. When faced with competition from Southwest Airlines, American typically offered some seats at the same price that Southwest Airlines was charging, but

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But for the new, and therefore weaker, LCCs that it targeted with its DFW LCC Strategy, American recognized that simply matching the prices of LCCs was unlikely to drive LCCs out of DFW markets unless American simultaneously increased capacity enough to absorb nearly all of the passenger demand that might otherwise have flown the LCCs.

written to Congressman Dan Glickman, "when we sell tickets at Southwest's prices, we lose lots of money." (Gov't SOF at 54.) But when American implemented its DFW LCC Strategy, it *added capacity* in order to sell *more* tickets at "Southwest prices" -- and it did, indeed, lose lots of money. (Gov't SOF at 188-206.) *See* Sections IV.A and IV.B, *infra*.

With respect to each of the LCCs that are the focus of this case, shortly after the February 27, 1996, meeting, American did exactly what it said it was going to do: it significantly expanded capacity, dropped fares, and abandoned its customary yield management limitations on one or more routes served by these three LCCs (in the case of Vanguard, DFW-Kansas City and DFW-Wichita; in the case of Western Pacific, DFW-Colorado Springs; and, in the case of SunJet, DFW-Long Beach) to protect its dominance at DFW. At the same time, American undertook revenue-sacrificing actions in other DFW city-pairs served by the LCC to further weaken it.[3]

A. Vanguard Airlines

Vanguard Airlines began service between DFW and Kansas City in January 1995, with three daily flights. (Gov't SOF at 27.) At the time of Vanguard's entry, American was operating eight flights a day between Kansas City and DFW, while Delta operated six. (Gov't SOF at 28.) American responded immediately to Vanguard's entry into DFW-Kansas City by matching very

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[3] American implemented its DFW LCC Strategy in the four "target" markets where its capacity additions were below cost, and in six other DFW markets (DFW-Cincinnati, Denver, Newark, Oakland, Phoenix and Tampa); it had previously tested its strategy in two other DFW markets (DFW-Atlanta and Chicago Midway) (the eight collectively, "other anticompetitive conduct markets"). In all of these eight "other anticompetitive conduct markets," American's conduct made no rational business sense other than its anticompetitive effect on the LCCs with which American was competing. American's conduct in these eight markets constitutes important acts in furtherance of its overall scheme to monopolize.

aggressively Vanguard's low fares on all eight of American's existing flights between DFW and Kansas City. (Gov't SOF at 29.) The next month, Delta announced that it would be ceasing service between DFW and Kansas City by May 1995. (Gov't SOF at 30.) Then, in April 1995, Vanguard reduced its non-stop DFW-Kansas City service, converting two of its daily non-stops into connecting service (via Wichita). (Gov't SOF at 35.) By May 1995, therefore, with Delta's withdrawal from DFW-Kansas City and Vanguard's reduction of non-stop service on the route, American faced significantly reduced competition on DFW-Kansas City.

Nevertheless, Vanguard still served the market. Starting in June 1995, American added six more daily round-trips to its DFW-Kansas City service, for a total of fourteen. (Gov't SOF at 31.)

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American realized that its capacity additions could have a negative impact on its profitability,

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despite facing no competition from Delta and reduced competition from Vanguard, the capacity additions were unprofitable -- they increased American's costs more than they increased its revenues. (Gov't SOF at 33.) In December 1995, Vanguard ended its non-stop service in DFW-Kansas City. (Gov't SOF at 34.) During the first half of 1996, American eliminated three flights per day and raised its fares 80 percent. (Gov't SOF at 38-39.)

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In DFW-Wichita, American had replaced jets with turboprops (through American Eagle) in 1994, claiming that jet service was losing money. (Gov't SOF at 35.2-35.3.) American had informed the Wichita Airport Authority that it would provide three daily jet flights between DFW and Wichita only if the Authority arranged a revenue guarantee of $13,500 per round-trip for American. (Gov't SOF at 35.5.) Rather than accept such an arrangement, the Wichita officials and business leaders helped convince Vanguard to introduce jet service from Wichita to DFW. Vanguard commenced DFW-Wichita jet service in April 1995 with two flights per day. (Gov't SOF at 35.) At the time of Vanguard's introduction of jet service in DFW-Wichita, both Delta and American continued to serve the route only with turboprops. (Gov't SOF at 35.1.)

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At the same time, American observed that Vanguard's one-stop service for DFW-Kansas City (via Wichita) was carrying significant traffic,

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In September 1996, Vanguard announced an expansion of its DFW service to include Phoenix, Cincinnati, and Kansas City (non-stop), thus presenting the prospect of a small competing hub at DFW. (Gov't SOF at 46.) American responded immediately. Despite the fact that Vanguard's announcement pertained to routes other than DFW-Wichita, American reversed its previous decision not to provide unsubsidized jet service in DFW-Wichita and instead introduced five daily jet flights to the DFW-Wichita route, expanding its seating capacity by 35% while making many more seats available at the lowest fares. (Gov't SOF at 50, 58.) In the DFW-Kansas City route, American accelerated to October its planned addition of two round-trips and added a third previously unplanned round-trip to begin in November. (Gov't SOF at 48.) American also responded by accelerating planned capacity additions in DFW-Phoenix and reintroducing DFW-Cincinnati service, which American had abandoned in 1994 because of its poor performance. (Gov't SOF at 59, 60.)

American knew that its actions against Vanguard in DFW-Wichita were unprofitable;

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Thus, American's capacity additions, together with the associated price and yield management actions, caused American's profitability on these routes, as measured by American's customary measures, to decline substantially, and indeed to become negative. Moreover, the revenue obtained from the additional passengers that American carried as a result of its capacity additions was less than the additional cost American incurred carrying those passengers.[4]

But the effect of American's conduct was as American had hoped. In November of 1996, Vanguard announced it would terminate its DFW-Wichita, DFW-Phoenix and DFW-Cincinnati service. (Gov't SOF at 69.1-69.3.) Shortly after Vanguard withdrew service from the DFW-Wichita route, American decreased capacity 30 percent and increased fares. (Gov't SOF at 69.3, 70, 75.) The increasing fares in Wichita got the attention of Senator Sam Brownback, who wrote Mr. Crandall in December of 1996, citing a report that indicated that "American's fares on this route have gone from $79.00 to $154.00 in the last week alone." (Gov't SOF at 72.)

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(emphasis added).) The reply ultimately sent to Senator Brownback, however, said only that "[d]uring the Fall of 1996, American's fares . . . were too low to allow us to earn a reasonable rate of return." (Gov't SOF at 74.)

Vanguard decided to focus on service to and from Kansas City, rather than DFW, and has

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[4] Indeed, in 1993, American's Senior Vice President for Marketing had written to Congressman Glickman and explained that American's 1992-93 "low-fare pricing test in the Dallas/Fort Worth - Wichita market" caused "revenues in this market [$93 or $94 per passenger] [to] drop[] below variable costs." (Gov't SOF at 55.) During the predatory period, the average market fare was $55, and American's average price was (Gov't SOF at 187.5, 187.6.)

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maintained service from Kansas City to DFW. (Gov't SOF at 76.) For over a year, American maintained capacity, fare, and yield management actions that kept the DFW-Kansas City route unprofitable for American. (Gov't SOF at 77.) Eventually, fares of both American and Vanguard increased on the route. (Gov't SOF at 78.)

B. Western Pacific

DFW-Colorado Springs is a seasonal route that typically has higher service in the summer season. (Gov't SOF at 80.) In 1994, American served DFW-Colorado Springs with four flights, adding a fifth flight in the high season. (Gov't SOF at 81.) In anticipation of Western Pacific's commencement of service between DFW and Colorado Springs, American added a fifth flight to its service in May 1995. (Gov't SOF at 84.) Western Pacific began service in DFW-Colorado Springs in June 1995 with two 737 flights per day. (Gov't SOF at 85.) After selective fare matching failed to stop Western Pacific, in July 1995 American increased capacity in DFW-Colorado Springs from five to seven daily round-trips to REDACTED

REDACTED American's average revenue fell below -- a substantial decrease from its Summer 1994 average revenue of approximately REDACTED

In January 1996, Western Pacific reduced its service in DFW-Colorado Springs to one daily round-trip. (Gov't SOF at 91, 94.)

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There was discussion that American should get Western Pacific out of DFW before it added back the second flight it had withdrawn. (Gov't SOF at 95.) Shortly after the DFW LCC Strategy meeting, American increased capacity by adding an eighth round-trip and using larger aircraft in May and June of 1996. (Gov't SOF at 96-98.) By July

1996, American's capacity in DFW-Colorado Springs had increased by more than 100% over the capacity that American had deployed on the route in the Summer of 1994. (Gov't SOF at 98.) After the end of the peak summer season, American opted to continue with eight round-trips, rather than make its usual seasonal reduction. (Gov't SOF at 99.)

From September 1996 through October 1997, American maintained and increased its expanded capacity on the DFW-Colorado Springs route. (Gov't SOF at 100.) Attempts by Western Pacific to establish a meaningful competitive presence in DFW-Colorado Springs by expanding beyond a single frequency were met with further additions of capacity by American -- including, in March 1997, the addition of three large 757 aircraft normally used on much longer routes, increasing American's capacity to three times what it was prior to Western Pacific's entry.[5] (Gov't SOF at 100, and 102-108.) As in the case of the actions against Vanguard, American's conduct drove its own profitability measures negative (Gov't SOF at 101) and the revenue obtained from the additional passengers that American carried as a result of its capacity additions and associated actions was less than the additional cost American incurred by carrying those passengers.

Western Pacific announced that it would begin reducing its DFW-Colorado Springs service in April 1997, and withdrew two of its DFW-Colorado Springs flights at the end of June 1997. (Gov't SOF at 111 and 114.) Less than a week after Western Pacific's withdrawal of these two flights, in the middle of its high summer season, American withdrew the three 757s that it had deployed in DFW-Colorado Springs in March. (Gov't SOF at 115.) In July 1997, Western

[5] Moreover, Western Pacific's new DFW-Denver service was met with pricing and yield management initiatives by American. (Gov't SOF at 112.)

Pacific stopped flying non-stop round-trips between DFW and Colorado Springs. (Gov't SOF at 116.) American responded immediately by reducing capacity on the route in August. (Gov't SOF at 117.) After Western Pacific resumed daily service in August 1997 with two flights per day, however, American too two flights. (Gov't SOF at 118.) Western Pacific finally abandoned DFW-Colorado Springs service in October 1997 and ceased operations altogether in February 1998. (Gov't SOF at 125 and 143.) After Western Pacific's exit from DFW-Colorado Springs, American removed capacity and increased prices, bringing its average revenue back up to $119. (Gov't SOF at 126-129.)

C. SunJet

In 1994, American withdrew jet service between DFW and Long Beach, California, a route that it identified as underperforming. (Gov't SOF at 150.) That same year, SunJet entered DFW with limited service to Long Beach, as well as to Newark. SunJet also began serving St. Petersburg, Florida, from DFW in February 1995. (Gov't SOF at 151.) SunJet's low fares between DFW and Long Beach drew passengers from the greater Los Angeles area. (Gov't SOF at 153.)

The February 1996 DFW LCC Strategy meeting of American's senior management included discussion of SunJet. The package presented at the meeting reflects concern that SunJet's route structure could lead to a small hub at DFW. The DFW LCC Strategy package recommended continued monitoring of SunJet and adoption of "a more aggressive response" should SunJet increase frequency on its existing DFW routes or add new DFW routes. (Gov't SOF at 163.)

In the fall of 1996, SunJet unwittingly did both of the things that would trigger American's

"more aggressive response": it added a third frequency to DFW-Long Beach and announced it would introduce a new DFW route -- Oakland -- in December 1997. (Gov't SOF at 171, 172.) American responded in each of SunJet's DFW markets: American decided to re-enter DFW-Long Beach in January 1997; American announced it would add a frequency in DFW-Oakland and began to offer a $198 round-trip fare; American eliminated the Saturday night stay requirement on its SunJet match fares in DFW-Newark; and American eliminated the Saturday night stay requirement and reduced advance-purchase restrictions on fares in DFW-Tampa (competing with SunJet's DFW-St. Petersburg service). (Gov't SOF at 173.)

Not surprisingly, American's initiation of service on the DFW-Long Beach route led to negative profitability on this route, as measured by American's customary measures. (Gov't SOF at 194.5.5.) The costs incurred in adding this route were greater than the revenues generated by the new route. (Gov't SOF at 191.2.4 and 194.5.5.) The introduction and operation of DFW-Long Beach service also had negative effects on the profitability of American's service between DFW and other Los Angeles Basin airports --

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SunJet gave up its DFW-Long Beach service in January 1998; it had already abandoned DFW-St. Petersburg in March 1997 and DFW-Newark in December 1997, and it never commenced service in DFW-Oakland. (Gov't SOF at 175, 179, 185.) After SunJet's exit, American increased fares in DFW-LGB. (Gov't SOF at 187.27.)

III. LEGAL STANDARDS

A. Summary Judgment Standard

The party seeking summary judgment must show "that there is no genuine issue as to any

material fact and that the moving party is entitled to judgment as a matter of law." Fed. R. Civ. P. 56(c); *Celotex Corp. v. Catrett*, 477 U.S. 317, 322 (1986); *Wichita Clinic v. Columbia Healthcare Corp.*, 45 F. Supp. 2d 1164, 1168 (D. Kan. 1999); *Mellon v. Cessna Aircraft Co.*, 7 F. Supp. 2d 1183, 1186 (1998). That party must first show the absence of evidence to support the other side's case. *Mellon*, 7 F. Supp. 2d at 1186. Only then must the nonmoving party demonstrate that there is a genuine issue for trial. *Celotex*, 477 U.S. at 324. Because the United States is the nonmoving party, "its evidence is to be believed; all justifiable inferences are to be drawn in its favor; its nonconclusory version of any disputed issue of fact is assumed to be correct." *Multistate Legal Studies, Inc. v. Harcourt Brace Jovanovich Legal and Prof'l Publications*, 63 F.3d 1540, 1545 (citing *Eastman Kodak*, 504 U.S. at 456); *see Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 587 (1986). Moreover, courts should be especially cautious before entering summary judgment where, as here, liability is likely to turn on factual questions about the purpose and effects of conduct whose existence is not disputed. *See, e.g., Eastman Kodak*, 504 U.S. at 482-86. Finally, on its novel "meeting competition" defense, American "must do more than put the issue into genuine doubt; [it] must remove genuine doubt from the issue altogether." *Alan's of Atlanta v. Minolta Corp.*, 903 F.2d 1414, 1425 (11th Cir. 1990) (discussing Robinson-Patman meeting competition defense). *See* Section VII, *infra*.

B. Elements of the United States' Claims

To prove monopolization under Section 2 of the Sherman Act, the United States must show that American (1) willfully acquired or maintained monopoly power in one or more relevant markets, and (2) did so by means of anticompetitive conduct, as distinguished from growth or development as a consequence of a superior product, business acumen, or historical accident. *See*

Eastman Kodak, 504 U.S. at 481; *United States v. Grinnell,* 384 U.S. 563, 570-71 (1966); *Full Draw Prods. v. Easton Sports, Inc.*, 182 F.3d 745, 756 (10th Cir. 1999). To prove attempted monopolization under Section 2, the United States must show that American (1) engaged in anticompetitive (*i.e.*, exclusionary or predatory) conduct, (2) had a specific intent to monopolize, and (3) had a dangerous probability of success in achieving monopoly power in a relevant market. *Spectrum Sports, Inc. v. McQuillan,* 506 U.S. 447, 455 (1993); *Full Draw,* 182 F.3d at 756.

Under both claims, the Court must analyze American's conduct to determine if it is a "scheme of willful acquisition or maintenance of monopoly power." *Eastman Kodak,* 504 U.S. at 483. Such "exclusionary" or "predatory" conduct, *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*, 472 U.S. 585, 602 (1985),

> involves aggression against business rivals through the use of business practices that would not be considered profit maximizing except for the expectation that (1) actual rivals will be driven from the market, or the entry of potential rivals blocked or delayed, so that the predator will gain or retain a market share sufficient to command monopoly profits, or (2) rivals will be chastened sufficiently to abandon competitive behavior the predator finds threatening to its realization of monopoly profits.

Neumann v. Reinforced Earth Co., 786 F.2d 424, 427 (D.C. Cir. 1986) (Bork, J.); *accord* ROBERT H. BORK, THE ANTITRUST PARADOX 144-45 (1978) (noting that, in any realistic theory of predation, the predator views its costs of predation as "an investment in future monopoly profits").

The analysis of the challenged conduct entails an examination of whether the conduct is ultimately inexplicable except on the basis of the monopoly returns expected as a result of creation or maintenance of a monopoly. *See generally Aspen Skiing,* 472 U.S. at 605-11; *Eastman Kodak,* 504 U.S. at 482-85; *Multistate,* 63 F.3d at 1550 (whether conduct is "an

abnormal response"). The Court must also examine the totality of American's conduct in determining whether it was anticompetitive. *Continental Ore Co. v. Union Carbide & Carbon Corp.*, 370 U.S. 690, 699 (1962). And evidence of intent helps explain "whether the challenged conduct is fairly characterized as 'exclusionary' or 'anticompetitive' . . . or 'predatory.'" *Aspen Skiing*, 472 U.S. at 602.[6]

Despite its recognition of these well-established legal principles -- indeed, perhaps because of it -- American argues that the Court should analyze the United States' claims with a myopic focus. Thus, claiming that the case concerns only the prices American charged, American contends that the sole question is whether the United States can show "(1) that the complained-of prices are below an 'appropriate measure' of the alleged predator's costs, and (2) that the structure and conditions of the market are such that the alleged predator has a 'dangerous probability' of 'recouping its investment in below-cost prices' through a subsequent period of 'sustained supracompetitive pricing.'" (American 1/8/01 Memo. at 22 (quoting *Brooke Group*).)[7]

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[6] Although American contends that in considering its motion the Court should disregard any "intent" evidence, this position is contrary to logic and the law. *See, e.g.*, *Aspen Skiing Co. v. Highland Skiing Corp.*, 472 U.S. 585, 602 (1985) (holding that evidence of intent is relevant to whether conduct is exclusionary, anticompetitive, or predatory); *United States v. United States Gypsum Co.*, 438 U.S. 422, 436 n.13 (1978) (holding that evidence of "intent may play an important role in divining the actual nature and effect of the alleged anticompetitive conduct"). Indeed, in the context of predatory pricing cases, the Tenth Circuit has recognized that evidence of intent is relevant to the predatory sacrifice inquiry where a plaintiff has shown pricing below total cost. *Instructional Sys. Dev. Corp. v. Aetna Cas. & Sur. Co.*, 817 F.2d 639, 649 (10th Cir. 1987).

[7] American has moved for summary judgment only as to the anticompetitive conduct element of the offense; thus, American has not sought summary judgment as to the existence of monopoly power in relevant DFW markets and its specific intent to monopolize. (American 1/8/01 Memo. at 17.)

Although the United States will make these showings, a broader array of evidence can establish the element of anticompetitive conduct. *See infra* Section IV.

IV. AMERICAN'S CONDUCT MADE NO BUSINESS SENSE BUT FOR THE PROSPECT OF MAINTAINING MONOPOLY POWER

The United States will show that American's conduct was anticompetitive -- that it did not make business sense but for the prospect of anticompetitive gain. The United States' evidence establishes this fact in a number of ways: by demonstrating that American behaved quite differently against the targeted LCCs than it did in other markets when it had no chance of driving out a low-cost competitor, Southwest (Gov't SOF at 203-206); by showing that, after LCCs entered, American reversed its prior decisions to abandon service in those markets (Gov't SOF at 35, 46, 50-51, 60, 151, 171-173, 176); by the fact that American's own internal route and flight performance measures -- the "Decision" measures it designed and consistently used to guide its route and capacity decisions -- took a steep decline and became negative when American saturated the four routes with extra capacity (Gov't SOF at 191-192, 194.5); by the acknowledgment of American's own senior management of what it was doing and why (Gov't SOF at 14-24); by showing that American researched the staying power of its LCC competitors and focused not on its own profits, but on driving the LCCs below their break-even load factor (Gov't SOF at 19-24, 189.4-189.7); and, most tellingly, by demonstrating that when American added capacity on the four routes that the United States has made the focus of this case -- the four "below-cost capacity" or "target" routes -- American's pricing was below cost -- by

several appropriate measures. (Gov't SOF at 191, 193.7, 194.5, 195.3.)[8]

American, however, asks the Court to ignore all that evidence. American instead proposes that the Court's analysis of predatory conduct be narrowly circumscribed to look only at American's prices and at *none* of its other conduct; to compare those prices to one -- and *only one* -- measure of American's costs; and, perhaps most remarkably, to select a measure (short run variable cost averaged over the whole route) that allows American to average the costs and revenues caused by its alleged predatory conduct (the capacity additions) with the costs and revenues of unchallenged conduct (American's other service on a route). In other words, American's capacity additions are so unremunerative that it has to construct an average in order to produce a price-cost test that American passes. But "averaging" a defendant's legal and illegal conduct is not an appropriate test in this case, if ever.

A. American's Capacity Additions Were Predatory Because They Made No Business Sense Except To Thwart Competition

The core of American's anticompetitive conduct was flooding routes with additional capacity when it made business sense to do so only in the sense that it served to stifle competition.

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[8]American is incorrect when it implies that it is inherently logical and necessarily lawful for it to add capacity to carry all the passengers who want to fly at new, low prices. (American 1/8/01 Memo. at 41-42.) American routinely decides to offer fewer low-fare tickets for sale than there would be customers willing to buy them. (Gov't SOF at 205.2-205.4; *see also* Gov't Ex. 398 at ¶¶ 127-139.) Thus, American's own business practices reveal that the decision to offer a low fare does not inherently require offering enough seats to carry all the passengers who would fly at that price, and American's capacity additions in this case went beyond a rational response to entry of a new competitor. (Gov't SOF at 189.8.)

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And so American increased capacity -- unprofitably -- in each of the four target markets by adding flights and/or by using bigger planes.

To determine whether conduct -- be it capacity expansion, tying (as in *Eastman Kodak*, *supra*), or sham litigation (as in *Neumann*, *supra*) -- is predatory or legitimate, courts ask whether that conduct made business sense. They therefore routinely define predatory conduct as conduct that makes economic sense only because it eliminates competition, and thus permits a monopolist to acquire or maintain monopoly power that allows it to obtain higher profits. *Matsushita*, 475 U.S. at 588-89; *see also Neumann*, 786 F.2d at 427. When the incremental costs of the conduct to the monopolist exceed its incremental benefits, a firm has engaged in a sacrifice that a rational, profit-seeking firm would not undertake unless there were some source of benefit to the firm, such as through the reduction of competition. *See* Janusz A. Ordover & Robert D. Willig, *An Economic Definition of Predation: Pricing and Product Innovation,* 91 YALE L.J. 8, 9-10, 16-17 (1981).

For example, in *Aspen Skiing,* 472 U.S. at 610-11, the Supreme Court held that, by refusing to continue a combined lift ticket with a nearby competing ski area or even to sell its lift tickets to the rival, the defendant had been "willing to sacrifice short-run benefits and consumer goodwill in exchange for a perceived long-run impact on its smaller rival." The Court did not require direct calculations of the short-run benefits and consumer goodwill foregone by the defendant, but reached its conclusion about the predatory nature of the defendant's conduct from

other evidence. *Id.* at 608-11; *see also Ortho Diagnostic Sys. Inc. v. Abbott Labs, Inc.*, 920 F. Supp. 455, 467-69 (S.D.N.Y. 1996).[9]

Here, there can be no dispute that the costs of American's substantial capacity additions in the four target markets exceeded the benefits of that conduct.[10] American's then-CEO Robert Crandall clearly expected this result when he endorsed the DFW LCC Strategy (Gov't SOF at 18.5.1, 18.5.3), and American's internal analyses confirmed it (Gov't SOF at 17-24, 200-202, 207-211.). Indeed, we do not understand American to argue otherwise, or to claim that it is entitled to summary judgment on predation if the general standard for examining exclusionary and predatory conduct applies. Rather, American asserts that, because American's response to the LCC threat also involved cutting prices, this conduct does not fall within the general standard for analyzing exclusionary and predatory conduct, but instead is subject to the particularized standard applicable to predatory pricing.

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[9] Similarly, with respect to the kind of predation involved in this case -- adding facilities to target a new competitor -- courts have found anticompetitive conduct without requiring price-cost evidence. *See Photovest Corp. v. Fotomat Corp.*, 606 F.2d 704, 718-19 (7th Cir. 1979); *Columbia Metal Culvert Co. v. Kaiser Aluminum & Chem. Corp.*, 579 F.2d 20, 31 (3d Cir. 1978) (holding that adding facilities was sufficient to support inference that defendant attempted to drive competitor out of business); *cf. In re E.I. du Pont de Nemours & Co.*, 96 F.T.C. 653, 745-46 & n.38 (1980).

[10] American's behavior in this case closely resembles the use of "fighting ships" by shipping cartels at the turn of the nineteenth century. To thwart new entry in a shipping route the shipping cartel would temporarily deploy capacity in the form of a "fighting ship" to combat the entrant. Courts found that the practice violated the Sherman Act. *United States v. Hamburgh-American S.S. Line*, 216 F. 971, 973-974 (S.D.N.Y. 1914), *rev'd on other grounds,* 239 U.S. 466 (1916). *See generally* Patrick Bolton et al., *Predatory Pricing: Strategic Theory and Legal Policy*, 88 GEO. L.J. 2239, 2244 (2000); Fiona Scott Morton, *Entry and Predation: British Shipping Cartels 1879-1929*, 6 J. ECON. & MGMT. STRATEGY 679 (1997); B.S. Yamey, *Predatory Price Cutting: Notes and Comments*, 15 J.L. & ECON. 129, 137-42 (1972).

Asserting that "[t]he conduct alleged here is predatory pricing," (American 1/8/01 Memo. at 20), American ignores the fact that the core of the United States' case is American's unprofitable capacity additions, with accompanying pricing, yield management, and other actions also a part of the strategy to eliminate competition.[11] American does little to explain or defend its restricted view. But the fact that pricing is part of the conduct does not transform American's conduct, consisting primarily of unprofitable capacity additions, into a predatory pricing case; if it did, any firm could immunize every conceivable form of exclusionary conduct from the reach of Section 2 of the Sherman Act simply by contemporaneously cutting price (but not pricing below an appropriate measure of cost). There is not the slightest support in the case law for this patently wrong proposition.[12]

Pricing is always part of a firm's competitive strategy. And the fact that American cut prices in response to entry is hardly remarkable. As one can see from a case such as *Kodak*, for example, the mere fact that there was a price for the copier parts and a price for the copier service that were involved did not transform that exclusionary and predatory conduct into a predatory pricing case. Finally, the fact that, as American notes, the United States has analyzed American's capacity additions in terms of its incremental costs and revenues hardly shows that this is a

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12 Indeed, when American was a plaintiff, it accused United of "predatory scheduling, *i.e.*, boosting its service levels when American seeks to introduce service in a new city-pair with the primary purpose of causing us to withdraw or modify our service." (Gov't Ex. 83 at 013861); *see also* (Gov't SOF at 189.3.) In making this allegation, American apparently was capable of distinguishing predatory capacity additions from predatory pricing.

predatory pricing case, for the bottom line in any analysis of predatory conduct, as mandated by *Aspen* and *Matsushita*, is whether the conduct involved a sacrifice of current profits that makes economic sense only if it results in monopoly profits in the future.[13]

Furthermore, there is an important difference between the predatory sacrifices incurred by a monopolist through addition of capacity and those incurred through mere pricing behavior. As American stresses, aggressive pricing is precisely the sort of competition that the antitrust laws are designed to promote, and so courts have adopted rigorous price-cost tests that permit aggressive pricing to be condemned only in the face of clear evidence of predatory sacrifice. *See Brooke Group,* 509 U.S. at 222-224; *Matsushita*, 475 U.S. at 593; *Instructional Sys.*, 817 F.2d at 648. Without such a test, any price that hurt a competitor could be challenged, and that prospect could chill legitimate competitive activity. The situation is quite different in a case like this, where the predatory sacrifice did not arise from foregoing pricing at higher levels, but rather flowed from other discrete actions -- capacity additions -- that did not make business sense except for their exclusionary effect. Because capacity additions are discrete actions, there is well-defined conduct whose incremental cost can be compared with the incremental revenue it generated. Here, American's capacity additions made American worse off (Gov't SOF at 191-192), but for their effect on American's LCC competitors. The new capacity

REDACTED but this change made sense to American -- only because it also excluded competition. REDACTED

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[13] American also observes in a footnote that "price and output are two sides of the same coin." (American 1/8/01 Memo., at 20 n.9.) But the same is not true of price and capacity -- and this case is about capacity.

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American's conduct in DFW-Wichita is illustrative. In February 1994, American terminated jet service on this route and substituted turboprops, after claiming that it had been "losing money" on the route, and after unsuccessfully soliciting a public subsidy from the Wichita Airport Authority to operate jet service (Gov't SOF at 35.2, 35.6, 35.7). Yet, after Vanguard announced service that appeared like the beginnings of a DFW hub, American not only restored its prior Wichita jet service, but put in five jet flights when it had offered only three with a public subsidy. (Gov't SOF at 58.) This conduct followed the model of predatory sacrifice through discrete actions: REDACTED

And Vanguard suffered losses and left the market, allowing American to withdraw capacity and return to charging monopoly prices and carrying fewer passengers. (Gov't SOF at 63, 65, 187.1-187.10.)

Because this case is about capacity additions and American's entire argument rests on the mistaken premise that this is a case only about predatory pricing, there is no need for the Court to go any further: it can properly reject American's summary judgment motion without further consideration. But as we will show, even if the Court should choose to analyze American's conduct under the standards used in predatory pricing cases, American's argument on predation is unsound.

B. Even If This Case Is Treated Purely As A Pricing Case, The Government's Evidence Meets The Tenth Circuit's Standard For Establishing Predatory Prices

1. The Tenth Circuit's *Instructional Systems* Decision Governs Here and the United States' Evidence Meets the Price-Cost Standards in *Instructional Systems*

In *Instructional Sys.*, 817 F.2d at 648, the Tenth Circuit set forth the standard for

measuring predatory conduct in a pricing case:

> prices below marginal cost or average variable cost are "a valuable indicator of predatory pricing," and prices "above average variable costs" but below average total cost can constitute predatory pricing "if other factors are present indicating unreasonably anticompetitive behavior."

Instructional Systems effectively establishes a safe harbor for prices above average total cost ("ATC"). *Id.*

At least four other circuits agree with the Tenth Circuit's approach.[14] American suggests that *Brooke Group* overruled this Circuit and four others *sub silentio*, and claims that average variable cost (AVC) is the only acceptable test for predatory pricing after *Brooke Group.*

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[14] The following circuits have recognized that marginal, variable, and total cost measures are all relevant to an inquiry of predatory pricing. **Sixth Circuit:** *Arthur S. Langenderfer, Inc. v. S.E. Johnson Co.*, 729 F.2d 1050, 1056 (6th Cir. 1984) (plaintiff bears the burden of proving that prices above AVC but below ATC are predatory; if plaintiff proves that prices are below AVC, then the burden shifts to the defendant to justify the prices); **Eighth Circuit:** *International Travel Arrangers v. NWA, Inc.*, 991 F.2d 1389, 1394-95 (8th Cir. 1993) (plaintiff overcame presumption that prices above AVC are legal by reviewing other factors indicating that the price charged was anticompetitive); *Morgan v. Ponder,* 892 F.2d 1355, 1360 (8th Cir. 1989) (prices above ATC are legal per se, plaintiff "must overcome a strong presumption of legality by showing other factors indicating that the price charged is anticompetitive" at prices in between ATC and AVC, and at prices below AVC "the burden of showing non-predation falls on the defendant"); **Ninth Circuit:** *William Inglis & Sons Baking Co. v. Continental Baking Co.*, 668 F.2d 1014, 1035-36 (9th Cir. 1981) (plaintiff has burden of proving with additional evidence that prices between AVC and ATC are predatory); **Eleventh Circuit:** *McGahee v. Northern Propane Gas Co.*, 858 F.2d 1487, 1496-1501 (11th Cir. 1988) (no circumstantial evidence of predatory intent for prices above ATC; other evidence viewed in conjunction with prices in between ATC and short run marginal cost (SRMC) provide circumstantial evidence of predatory intent; prices below SRMC, combined with other evidence, may prove predatory intent). The United States has been able to locate a reported decision in only one Circuit that follows the standard suggested by American in its motion. *See Stearns Airport Equip. Co. v. FMC Corp.*, 170 F.3d 518, 532 (5th Cir. 1999) (AVC as the proxy for MC is the appropriate measure of cost). But even in *Stearns*, the court noted that: "Ideally, an inquiry into whether a monopolist had sold his product below costs would look at the true marginal cost . . . ."

(American 1/8/01 Memo. at 24-25 & n.12.) *Brooke Group*, however, stands for no such proposition, because the parties in *Brooke Group* had stipulated for purposes of the litigation that the relevant measure of cost was AVC and the Supreme Court therefore did not address this issue. *Brooke Group*, 509 U.S. at 222 n.1. Indeed, the Supreme Court in *Brooke Group* expressly "decline[d] to resolve the conflict among the lower courts over the appropriate measure of cost," *id.*, citing its discussion of those differing standards in *Cargill, Inc. v. Monfort of Colorado, Inc.*, 479 U.S. 104, 117-18 n.12 (1986).[15] For purposes of defining an "appropriate measure of cost" applicable to predatory pricing cases, therefore, both *Cargill* and *Brooke Group* stand for the same proposition: until further word from the Supreme Court, each Circuit's resolution of the question stands. Because *Instructional Systems* was decided after *Cargill*,[16] *Instructional Systems* remains the law of this Circuit. American's suggestion that the Court disregard this binding Tenth Circuit standard must therefore be rejected.[17]

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[15] In *Cargill*, the Supreme Court found that simply defining predatory pricing as "pricing below cost" (without settling what measure of cost was appropriate) was "sufficient for purposes of this decision." *Cargill*, 479 U.S. at 117-18 & n.12.

[16] In fact, most of the cases discussed in note 14, *supra*, are post-*Cargill* cases.

[17] American suggests two additional reasons to adopt AVC as the standard; both are incorrect as applied in this case. First, American suggests that one reason why AVC is a good standard is that prices above AVC "contribute to covering the firm's fixed cost," citing *Pacific Eng'g & Prod. Co. v. Kerr-McGee Corp.*, 551 F.2d 790, 797 (10th Cir. 1977). (American 1/8/01 Memo. at 24.) While accurate if AVC is equal to or greater than MC, this proposition is not true when such above-AVC prices are below MC. 3 PHILLIP AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW, ¶ 740c at 386 (rev. ed. 1996) ("When output exceeds the level at which costs are minimized, marginal cost exceeds average variable cost. Adopting average variable cost as the predation test in this range runs the risk of allowing a firm to sell at a price below marginal cost while meeting the average variable cost standard"). *See* Section IV.B.2, *infra*.

Second, American claims that "prices at or above AVC will never lead to the exit of [an equally efficient competitor]." (American 1/8/01 Memo. at 24.) This proposition is not true in

As set forth immediately below, the United States' evidence in this case satisfies the *Instructional Systems* standard. First, it shows American's prices were below an appropriate measure of marginal cost in this case. Second, it shows American's prices were below ATC, and additional evidence demonstrates that American's conduct was unreasonably anticompetitive.

2. There Is Persuasive Evidence that American's Prices Were Below Marginal or Incremental Cost

A key issue presented by American's Motion is which measures of American's costs are the most probative evidence of predation in this case -- the marginal or incremental cost of the capacity actions, as the United States claims, or only the average variable cost for the route as a whole, as American claims. Both the underlying purpose of the cost inquiry and the weight of legal authority favor an examination of the incremental cost. *Instructional Systems* makes clear that prices below marginal cost ("MC") (the cost of the last unit of output), constitute "a valuable indicator of predatory pricing." *Instructional Systems*, 817 F.2d at 648. Price below marginal cost is a "valuable indicator" of predatory pricing because it is clear that the defendant would have been better off if it had not produced the last unit. Phillip Areeda and Donald F. Turner, *Predatory Pricing and Related Practices under Section 2 of the Sherman Act,* 88 HARV. L. REV. 697, 712-13 (1975); *see also Pacific Eng'g & Prod. Co. v. Kerr-McGee Corp.*, 551 F.2d 790, 797 (10th Cir. 1977) (marginal cost is valuable indicator of predatory pricing because "'[t]here is no reason consistent with an interest in efficiency for selling a unit at a price lower than the cost

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this case, where an LCC could efficiently serve a segment of the market, even while American continues to serve other segments of the market. (As Professor Stiglitz noted, such a (short run) AVC standard "runs a high risk of failing to detect predatory conduct".) (Gov't Ex. 396 at ¶ 155; *see also* Gov't SOF at 196.5.)

that the seller incurs by the sale.'"). Professors Areeda and Turner concluded that it is usually impractical to try to measure short-run marginal cost ("SRMC"), and therefore that an appropriate surrogate must be found in most predatory pricing cases. Professors Areeda and Turner proposed AVC as a surrogate that might often be useful, but based that judgment on the expectation that AVC is typically near (but not significantly below) marginal cost.[18] *Id.* at 717. And indeed, *Instructional Systems* acknowledges that prices below AVC can be "a valuable indicator" of predatory activity. American claims, however, that *only* AVC on the route as a whole is an appropriate measure of cost and that if its prices are above AVC, they are conclusively presumed lawful. This is not the law. Moreover, in this case, AVC is not an acceptable surrogate for MC, because here there is direct evidence of marginal, or incremental, cost.[19]

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[18] American is incorrect to suggest that Professors Areeda and Turner found "that prices at or above AVC should be conclusively presumed lawful." (American 1/8/01 Memo. at 24.) In fact, while that was once their position, Professors Areeda and Turner later recognized that because SRMC could exceed AVC, a "defendant monopoly should be allowed to rely on AVC only when it offers some evidence indicating that AVC is not significantly below SRMC." Phillip Areeda and Donald F. Turner, *Williamson on Predatory Pricing,* 87 YALE L.J. 1337, 1338-39 (1978); *accord* 3 PHILLIP AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW, ¶ 740c. American has not claimed that there is no genuine issue of fact regarding whether AVC is not significantly below SRMC in this case, and indeed, it could not do so. (Gov't SOF at 194.1.3.)

[19] Incremental cost is a more appropriate measure of cost than short run AVC under these circumstances. (Gov't SOF at 188.7.) American contends that "a plaintiff must prove that the defendant's products in the relevant market as a whole (*i.e.*, as alleged here, all flights on a route) were priced below cost." (American 1/8/01 Memo. at 31, citing *International. Travel Arrangers v. NWA, Inc.*, 991 F.2d 1389 (8th Cir. 1993); *Bushnell Corp. v. ITT Corp.*, 175 F.R.D. 584, 588 (D. Kan. 1997); and *Janich Bros., Inc. v. Amer. Distilling Co.*, 570 F.2d 848, 855-57 (6th Cir. 1977).) American's citation of these cases, none of which involved capacity additions, implies that the United States is improperly treating each flight (or group of flights) as separate relevant markets, each of which could be monopolized. It is clear, however, that the United States has properly alleged DFW city pairs as the relevant markets, and that our evidence shows that on each

While marginal cost is the additional cost of the last unit of output, "incremental cost" is the additional cost of a change in output of any magnitude, *e.g.*, the total cost of American's capacity additions in this case.[20] The use of incremental cost offers an important refinement of the marginal cost test advocated by Professors Areeda and Turner. As Professors Areeda and Hovenkamp wrote:

> Suppose, for example, that a firm refined 1000 gallons per day of its own gasoline, which has variable costs of $1 and which normally sells at a price of $1.10. Because this volume exhausts the firm's refining capacity, it then supports predation by purchasing additional gasoline at $1.06, and selling all its gasoline at a price of $1.03. In this case we have evidence of prices below marginal cost, even though they might be above average variable costs. The *incremental* gasoline costs $1.06, which is greater than the price of $1.03. Under the marginal cost test it does not matter that the firm's self-refined gasoline continues to have average variable costs less than the price, what matters is that the firm has increased output and cut price into a range in which incremental costs are greater than incremental revenue.

See 3 PHILLIP AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 740a (rev. ed. 1996).[21] This

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of the four target markets, American's capacity additions made the route as a whole worse off than before.

[20] Incremental cost (more precisely average incremental cost (for each unit)) can also be thought of as an average "avoidable" cost ("AAC"), or the "average per unit cost that a predator would have avoided during the period of below cost pricing had it *not* produced the predatory increment of sales." Patrick Bolton et al., *Predatory Pricing: Strategic Theory and Legal Policy*, 88 GEO. L.J. 2239, 2271 (2000). Professor Baumol first introduced the concept of AAC into the discussion of predatory pricing, as a "figure [that] must . . . include all pertinent portions of the product-specific fixed but avoidable costs, that is, all portions of such costs that can be escaped in the pertinent period of time." William J. Baumol, *Predation and the Logic of the Average Variable Cost Test*, 39 J.L.& ECON. 49, 58-59 (1996).

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hypothetical *is this case*: Neither American nor the hypothetical gasoline refiner may "average" their predatory conduct with their legitimate conduct.

The use of incremental cost also does not present the practicality problem that caused Professors Areeda and Turner to suggest the use of AVC in pure predatory pricing cases. While there are always difficulties in properly measuring costs, those difficulties are made relatively slight by the fact that the costs to be measured are all of those associated with a discrete event that actually has occurred, *e.g.*, an addition to capacity. Measuring the relevant incremental costs does not involve projecting costs in some hypothetical world.

Similarly, the Court in *Brooke Group* suggested that it would certainly be appropriate to find predation when pricing is below "some measure of incremental cost." *Brooke Group*, 509 U.S. at 223 (quoting *Cargill, Inc. v. Monfort of Colorado, Inc.*, 479 U.S. 104, 117-18 n.12 (1986)(quoting *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 585 n.9 (1986).) And, as then-Judge Breyer explained, "*ordinarily* the measure of a 'predatory price' is price below 'incremental cost.' That is to say, the addition to total cost (to the firm) of producing and selling additional output would exceed the return from selling that additional output." *Clamp-All Corp. v. Cast Iron Soil Pipe Inst.*, 851 F.2d 478, 483 (1st Cir. 1988) (quoting *Barry Wright v. ITT Grinnell Corp.*, 724 F.2d 227, 232-33 (1st Cir. 1983)) (emphasis in original) (citation omitted). Finally, American's own expert agrees that an incremental analysis is relevant.

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See Janusz A. Ordover and Robert D. Willig, *An Economic Definition of Predation: Pricing and Product Innovation*, 91 YALE L.J. 8, 16-17 (1981).

American's contention that incremental cost of the capacity addition is an unacceptable measure is a patent attempt to ignore the nature of the United States' allegations in this case and fails to acknowledge the weight of authority contradicting American's position. Instead, the relevant inquiry must focus on "the nature and purpose of the predation and on the mechanism by which competition might be impaired." 3 PHILLIP AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 742c1, at 418 (rev. ed. 1996). In this case, the "nature and purpose of the predation" were American's capacity additions to deny to LCCs the passengers they sought to serve -- passengers that American previously had rejected because they would not pay the high prices that American was charging. It was *only* when a low cost rival offered to serve these passengers that American became interested. By depriving its low cost rivals of these passengers, passengers that the LCCs needed to earn a profit, American sought to drive the LCCs from the market. In such a case, the analysis of American's incremental actions performed by the United States' experts is appropriate. *See C.E. Servs., Inc. v. Control Data Corp.*, 759 F.2d 1241, 1247-48 (5th Cir. 1985) (appropriate to examine pricing levels offered to select customers of the predatory target); *Marsann Co. v. Brammall, Inc.*, 788 F.2d 611, 613 (9th Cir. 1986) (appropriate to look at price offered to single customer if as a result of predatory sales to that customer, rivals are likely to be driven out of the market or excluded).[22]

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[22] American's expert wrote: "For each category of conduct, a different test of predation is needed . . . ." J.A. Ordover & G. Saloner, *Predation, Monopolization, and Antitrust*, *in* HANDBOOK OF INDUSTRIAL ORGANIZATION 587 (R. Schmalensee & R.D. Willig eds. 1989).

In this case, Professor Berry analyzed American's incremental costs. First, he compared the total incremental cost of American's allegedly predatory capacity additions with the incremental revenues that its pricing generated with that additional capacity. (Gov't SOF at 191.) *American fails this test where it can be applied.* (Gov't SOF at 191.2.) Professor Berry also calculated the average (*i.e.*, per passenger) cost of American's incremental output, and compared that to the average price[23] that the incremental passengers paid.[24] (Gov't SOF at 193.) *American also fails this test where it can be applied.* (Gov't SOF at 193.7.)[25]

American suggests that the tests used by Professor Berry constitute a profit maximization test.[26] This is not correct. Professor Berry's incremental cost tests ask whether "the addition to

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[23] Because American charges different fares to different passengers, any price compared to cost is necessarily an average price.

[24] Professor Berry compared American's incremental costs to the prices American charged for incremental passengers and also, in a comparison that is more favorable to American, compared the incremental costs to the average price on the route as a whole. (Gov't SOF at 193.7.)

[25] Professor Berry applied two additional price-cost tests that show American's price was below marginal cost. In his Test Two, Professor Berry compared American's prices to its long run average variable costs on the four routes for each month during the predation period. (Gov't SOF at 194.) As Professor Berry explains, long run AVC is a more appropriate proxy for short-run marginal cost than SR average variable cost in the airline industry. (Gov't SOF at 194.1; Gov't Ex. 398 at ¶ 218 ("in this industry, an appropriate implementation of the Areeda-Turner test is to compare price to long-run average variable cost.") In his Test Three, Professor Berry compared American's prices to long-run average variable cost to long periods of alleged predation in DFW-Colorado Springs and the second episode of DFW-Kansas City. (Gov't SOF at 195.) Where the period of predation is long, FAUDNC reflects the avoidable costs for that period. (Gov't SOF at 196.4, 194.2, 194.3.)

[26] As support for this mischaracterization, American refers to its Statement of Uncontested Facts at 229, which is an incomplete excerpt from Professor Stiglitz's deposition testimony. (American 1/8/01 Memo. at 29.) While Professor Stiglitz does explain in that testimony that Professor Berry's price-cost tests illustrate that American had a more profitable alternative, he

total cost (to the firm) of producing and selling additional output would exceed the return from selling that additional output." *Clamp-All Corp.*, 851 F.2d at 483 (quoting *Barry Wright,* 724 F.2d at 232-33) (citation omitted). Professor Berry's incremental tests do not involve a search for some hypothetical point of profit maximization. They simply look at what American did (the incremental addition to capacity), and ask if that action made American better off or worse off. American's conduct fails these comparisons, showing that American's conduct is below cost.[27]

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also explains in the portion of the testimony omitted by American that the nature of a price-cost test is to assess whether there is some clear alternative course of action that a firm could have taken that would have been more profitable. (Gov't Ex. 346 at 281:3-282:25). Professor Stiglitz further testified that Professor Berry's Test 4 is essentially an implementation of a price-marginal cost test. (Gov't Ex. 346, at 282:8-282:15). In fact, what American says about "profit maximization" (American 1/8/01 Memo. at 29), is really another re-argument of its claim that the Court can only look at "the route as a whole" -- not at American's disputed actions (the capacity increment).

[27] Moreover, American's efforts to show that it passes a short-run AVC standard are wasted because the time period American has chosen is too short. American's experts Professors Ordover and Baumol agree that the appropriate time period for defining variable costs is not a short-run period; rather both testified that a medium-to-long run period such as 18 months is reasonable in this case. (Gov't SOF at 188.8, 196.2.) Professor Hovenkamp also takes a broader view of AVC than American. *See* 3 PHILLIP AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW, ¶¶ 739d and 739e, at 376-77 (rev. ed. 1996) (relevant costs include portions of both "advertising and other general promotional expenditures" and general overhead expenses such as "management and clerical expenses");

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The short-run measure of AVC proposed by American, VAUDNC-AC, does not capture the longer-run variable costs that the 18 month time period proposed by American's experts necessitates. Instead, a proper implementation of the standard proposed by Professors Ordover and Baumol requires application of a longer-run measure of AVC, namely American's decision accounting measure Decision FAUDNC, which reflects the economic impact of exiting a route. (Gov't SOF at 196.2, 196.3, 196.4.) Applying this measure, even to the route as a whole, American fails in each of the four target markets. (Gov't SOF at 194.5.) Given that there is a factual dispute about whether FAUDNC is an appropriate measure of AVC in this case, summary

3. American's Prices Were Below ATC and Other Evidence Shows Its Conduct Was Anticompetitive

The United States' evidence also satisfies the alternative standard of Instructional Systems: American's prices were below ATC and other evidence shows that its conduct was anticompetitive. It is undisputed that American's prices were below its own internal cost measure, FAUDNC. (Gov't SOF at 194.5.)[28] And American argues (American 1/8/01 Memo. at 33) that "[u]sing FAUDNC as the basis for a test of predation is thus effectively equivalent to adopting an average total cost test."[29] Thus, it is clear that American priced below ATC.[30] Under

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judgment is not appropriate.

[28]American developed Decision FAUDNC with extensive effort and expense, and used it extensively in making business decisions. (Gov't SOF at 194.2.)

[29] American also recognizes that FAUDNC is somewhat more favorable to it than a pure ATC test, since FAUDNC excludes "certain corporate general and administrative expenses." (American 1/8/01 Memo. at 33 n.18.) Moreover, FAUDNC includes a contribution from the "upline" or "downline" revenue of connecting passengers. (Gov't SOF at 194.3.10.) Professor Berry concludes that use of FAUDNC is favorable to American because if price is below FAUDNC, it is surely below ATC. (Gov't SOF at 194.6.)

By way of contrast, American does maintain a financial accounting measure for route performance that reflects the type of fully allocated cost measure described by Areeda and Hovenkamp.

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The measure also fails to include methodologies that American developed for its Decision FAUDNC measure that were intended to reflect the true economic performance of a route, such as upline/downline contribution. (Gov't SOF at 198.2, 194.2.1.)

[30] American also suggests that Decision FAUDNC is an inappropriate measure of cost because "allocated costs . . . are never appropriate for a cost-based test for predation." (American 1/8/01 Memo. at 36.) Because the correct inquiry is whether the activity related to production of the alleged predatory product (or, in this case, to the route as a whole) can be

Instructional Systems, therefore, the Court is obliged to consider the other evidence gathered by the United States of the anticompetitive nature of American's conduct.

In *Instructional Systems*, the Tenth Circuit found prices above AVC could be predatory, in part by relying on evidence (1) of dramatic price changes when the entrant entered and exited the market, (2) that the firm's conduct deviated from its ordinary practice, (3) that the firm intentionally set price below that at which it could make a profit in order to take business from the entrant, and (4) of non-price conduct indicative of predatory intent. *See Instructional Systems*, 817 F.2d at 648-49. These same types of evidence are present here.

First, there is substantial evidence of dramatic price changes when an entrant entered and exited the market: American's prices fell and rose dramatically as LCCs entered and departed American's routes.[31] *See* chart in Section V.D.2, *infra*.

Second, American's conduct departed from its ordinary practice in many ways. For example, American abandoned its usual means of competing with a low cost carrier that it could not drive out (Southwest), *i.e.*,

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in favor of its DFW LCC Strategy when competing with LCCs that

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reduced or redeployed by ceasing production of the alleged predatory product, and because Decision FAUDNC is the outcome of American's best efforts in performing precisely this inquiry, there is clearly a disputed factual issue whether American's allocations of costs in FAUDNC are appropriate for use in this case. (Gov't SOF at 194.2-194.3.) Indeed, certain costs incurred by American specific to its actions in LCC are underallocated by FAUDNC to the route. (Gov't SOF at 194.3.9.)

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it could drive out. American also departed from its usual practice

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in order to add capacity.

And on some occasions, American had to reverse its previous "ordinary practice" in order to attack an LCC -- for example, putting jets back in Wichita when it had previously refused to do so without a large public subsidy. (Gov't SOF at 35.3-35.7, 50-51.)

Third, this defendant, as in *Instructional Systems*, intentionally set unprofitable prices in order to take business away from its rivals. Here, there is strong evidence that American's capacity additions were unprofitable. In particular, the fact that the capacity additions fail an incremental cost/incremental revenue examination shows how unprofitable were its actions. (Gov't SOF at 191-193.) American asks the Court to *ignore* its unprofitable capacity and pricing practices solely on the ground, clearly rejected in this Circuit, that its prices are above AVC (on an entire route). But evidence that American's capacity additions in LCC markets consistently made it worse off is clearly evidence of intentional unprofitable decisions. (Gov't SOF at 192.)

Fourth, the category of non-price conduct indicating predatory intent brings us full circle; the focus of this case is non-price predation: the addition of unprofitable capacity for the purpose of driving LCCs from American's DFW hub. Moreover, there is evidence of additional conduct that was part of the predatory scheme, such as ramp counts to keep tabs on the LCCs and studying their balance sheets and calculating their break-even load factors.

In total, in this case the additional evidence that American's conduct was anticompetitive -- that it made no business sense unless it eliminated competition -- is compelling. Indeed, American's CEO said so: "If you're not going to get them [LCCs] out, then no point to diminish

profit." (Gov't SOF at 18.5.1.1.)

American does not want the Court to consider this other evidence because of the heavy damage it does to its defense. But Tenth Circuit law calls for consideration of such evidence.[32]

Thus, the United States has demonstrated that American's prices were below the most appropriate measures of cost. American has therefore failed to establish that it is entitled to summary judgment.

C. American's Conduct, Pursuant to Its Predatory Scheme, in the Other Anticompetitive Conduct Markets May Be Considered by the Court

In concert with its predatory actions against the LCCs in the four below-cost capacity markets, American sought to augment its efforts to drive the LCCs from DFW by taking additional actions in the following types of markets: (1) markets in which the LCC offered non-stop service from DFW;[33] and (2) markets in which the LCC offered connect service and

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[32] American's insistence that the only appropriate measure of ATC is long-run incremental cost ("LRIC") (American 1/8/01 Memo. at 36) is equally misguided. American can cite no case in the Tenth Circuit for such a proposition. But in any event, in this case LRIC is less than or equal to ATC, because FAUDNC is less than ATC and is a reasonable measure of LRIC in this case. (Gov't SOF at 194.2, 194.3, 194.6.) Contrary to American's *post hoc* assertions concerning its Decision FAUDNC profitability measure, there is a genuine issue of fact with respect to whether Decision FAUDNC represents LRIC.

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Therefore, American's assertion that the Court should ignore Professor Maher and Professor Berry's assertions on this point (American 1/8/01 Memo. at 37) is simply wrong.

[33] These other markets are: DFW-Cincinnati, Phoenix, Oakland, Newark, Tampa and Denver. (Gov't SOF at 59, 60, 112, 173.)

American targeted the connect service with non-stop service. American's actions in these "other anticompetitive conduct markets" were taken without regard to whether American sacrificed profitability in the process. American contends that the Court cannot review its actions in these additional anticompetitive conduct markets merely because the United States' experts have not offered below-cost evidence concerning these markets; this contention is contrary to well-settled law.

In assessing whether American's conduct is anticompetitive, the Court must examine the totality of American's conduct. For example, it is possible that a single act that serves no legitimate business purpose and is intended to exclude a rival might nevertheless have so modest an effect on competition as to not violate the Sherman Act. However, a coordinated campaign of such acts that in the aggregate has the requisite impact on the marketplace is unlawful. *See Aspen Skiing*, 472 U.S. at 611 n.43 (stating that evidence that "would not be sufficient in itself to sustain the judgment" is consistent with a finding of monopolization); *Continental Ore*, 370 U.S. at 699 ("plaintiffs should be given the full benefit of their proof without tightly compartmentalizing the various factual components and wiping the slate clean after scrutiny of each"); *City of Anaheim v. Southern Cal. Edison*, 955 F.2d 1373, 1376 (9th Cir. 1992) ("it would not be proper to focus on specific individual acts of an accused monopolist while refusing to consider their overall combined effect"); *Aspen Highlands Skiing Corp. v. Aspen Skiing Co.*, 738 F.2d 1509, 1522 n.18 (10th Cir. 1984) ("Plaintiff's evidence should be viewed as a whole. Each of the [defendant's acts] viewed in isolation need not be supported by sufficient evidence to amount to a § 2 violation. It is enough that taken together they are sufficient to prove the monopolization claim."), *aff'd* 472 U.S. 585 (1985); *City of Mishawaka v. Am. Elec. Power Co.*,

616 F.2d 976 (7th Cir. 1980) ("It is the mix of the various ingredients of utility behavior in a monopoly broth that produces the unsavory flavor.").

Courts have mandated that a defendant's conduct be examined in its totality for at least two good reasons. First, were courts to decline to look at the totality of a defendant's conduct, a monopolist could avoid liability by inflicting a thousand anticompetitive cuts, many perhaps causing only small injury in isolation, that collectively extinguish or disable competition in a relevant market. Second, a monopolist could engage in anticompetitive conduct in a market that, for a variety of reasons, does not standing alone rise to the level of a violation in that market, despite the fact that the conduct furthered the monopolist's violation in another market. Neither result is dictated by either the Sherman Act or any of the cases interpreting or applying it. Here, American engaged in a coordinated campaign of such acts in the "other anticompetitive conduct markets" as part of its broad and predatory DFW LCC Strategy. Surely such conduct is relevant in determining whether American's conduct is anticompetitive.

While a discussion of this conduct is fully set out in the United States' Statement of Facts, filed concurrently herewith, one example is illustrative. In September 1996, Vanguard Airlines announced that it would expand its DFW operations on October 1, in part by introducing non-stop service with one frequency per day in the DFW-Cincinnati market. American had previously abandoned this market in 1994 as underperforming and

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Nevertheless, after Vanguard's announcement, American quickly decided to add three frequencies per day in this market, to match Vanguard's fares, and

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The United States does not claim that American's conduct in DFW-Cincinnati would be sufficient alone to prove a monopolization claim in any market. However, when viewed in conjunction with American's predatory and below-cost actions against Vanguard in DFW-Kansas City and DFW-Wichita, the intent of American's actions in DFW-Cincinnati becomes clear: to attack Vanguard from every angle possible to ensure that Vanguard would not gain a foothold in DFW. Thus, to understand fully American's broad predatory DFW LCC Strategy, the Court must view American's actions in DFW-Cincinnati -- as well as its actions in the other anticompetitive conduct markets in which American competed with LCCs -- in conjunction with and as relevant to the predatory sacrifice evidence concerning the four below-cost capacity markets.

V. A GENUINE ISSUE OF FACT REMAINS AS TO AMERICAN'S PROBABILITY OF RECOUPING ITS PREDATORY SACRIFICE

In any monopolization case, the plaintiff must prove that the effect of defendant's conduct was to create or preserve monopoly power, and that the conduct itself was anticompetitive (did not make economic sense absent the benefits to the monopolist of reduced competition). *Multistate,* 63 F.3d at 1550. In predatory pricing cases, a more particularized showing of

"recoupment" is required.[34] In *Brooke Group*, the Supreme Court explained that recoupment can be established by evidence of supracompetitive prices:

> there are two means by which one might infer that [defendant] had a reasonable prospect of producing sustained supracompetitive pricing in the [relevant market] adequate to recoup its predatory losses: first, if [product] output or price information indicates that [market behavior] in fact produced supracompetitive prices in the [relevant market]; or second, if evidence about the market and [defendant's] conduct indicate that the alleged scheme was likely to have brought about [supracompetitive pricing in the relevant market], even if it did not actually do so.

Brooke Group, 509 U.S. at 230-233. Although a plaintiff's proof of monopoly power and anticompetitive conduct should not be limited to "recoupment" evidence in predatory capacity cases such as this (*see* Section IV.A, *supra*), the United States has in fact marshalled substantial evidence that supracompetitive prices have persisted in many DFW routes and because of the structure of those markets, supracompetitive prices were likely to result from American's conduct. *See infra* Section V.D. There is therefore a genuine issue of material fact on the probability of recoupment.

A. American Failed to Move for Summary Judgment on the Monopoly Power Element of the Offense, But Inconsistently Asserts that No Genuine Issue of Fact Exists as to Recoupment

American does not move for summary judgment on the monopoly power element of the offenses with which it is charged. (American 1/8/01 Memo. at 18.) Yet it inconsistently claims that recoupment cannot occur because it does not have monopoly power. On this issue,

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[34] In predatory pricing cases, a plaintiff who establishes both monopoly power and anticompetitive conduct may nonetheless fail if it cannot show that the rewards of the anticompetitive conduct (recoupment) were reasonably expected to be greater than the predatory losses incurred. Thus the recoupment inquiry serves as a "rationality check" for the plaintiff's theory in predatory pricing cases.

American offers a flimsy attempt to claim that there is no factual dispute about its absence of monopoly power. (American 1/8/01 Memo. at 50-54.) But, if American believed that, it should have moved for summary judgment on that element of the offense.

American's claims are easily summarized. First, it argues that entry barriers in all DFW routes must be low because some entry has taken place in some DFW routes. (American 1/8/01 Memo. at 51-52.) Second, it asserts that the major airlines that serve some of the routes from DFW (particularly Delta Airlines and Southwest Airlines) can discipline American's monopoly power. (American 1/8/01 Memo. at 52-53.) Third, it asserts that, if the United States contends that American needed to engage in strategic behavior to discourage entry, then the remaining entry barriers must of necessity be low. (American 1/8/01 Memo. at 53-54.)

American cannot have it both ways. Either it has monopoly power, in which case it cannot establish that there is no genuine issue of fact concerning the probability of recoupment, or it must demonstrate to the Court that it does not have monopoly power, in order to prevail on summary judgment on the recoupment issue. In any event, the United States has submitted extensive evidence of American's monopoly power on the DFW routes (Gov't SOF at 1-11, 187), including evidence of the DFW "hub premium" (Gov't SOF at 4), persistent supracompetitive fares on DFW routes (Gov't SOF at 2-3, 5-6), significant "natural" entry barriers at DFW (Gov't SOF at 8), and the creation of a strategic entry barrier based on American's reputation for predatory conduct. (Gov't SOF at 214-219, 220-224, 265-266, 269, 300, 314.) In light of this substantial evidence, it is indisputable that a genuine issue of material fact exists as to American's probability of recoupment.

B. The Scope of a Recoupment Inquiry Is Not as Narrow as American Claims

American's motion for summary judgment on the recoupment issue is grounded in a misapprehension of the legal standard in several key respects. First, it is not necessary for the United States to calculate *actual* recoupment and prove it occurred; it is enough to show, *ex ante*, that sustained supracompetitive pricing was *likely*, even if it did not occur. Second, American is simply wrong when it asserts that the Court may consider evidence of American's prospects for recoupment only in the four below-cost capacity markets.

1. The United States Need Not Calculate and Prove that Actual Recoupment Has Occurred

American inexplicably argues that summary judgment is warranted because the United States cannot establish "actual recoupment." (American 1/8/01 Memo. at 43-50.) Although proof of actual recoupment clearly would satisfy a plaintiff's burden, and the United States has offered direct evidence of such actual recoupment in this case *(see* Section V.C *infra)*, proof of actual recoupment is not required. *Brooke Group*, 509 U.S. at 224, 232-33.

"'[R]ecoupment' refers to an *ex ante* judgment, made before the defendant commits its resources to predation. The plaintiff must show that, looking from the time period immediately preceding the alleged predation, a reasonable firm would have anticipated profitable returns to predation." 3 AREEDA & HOVENKAMP, ANTITRUST LAW ¶ 727c (rev. ed. 1996).[35]

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[35] *See also* Patrick Bolton, et al., *Predatory Pricing" Strategic Theory and Legal Policy,* 88 GEO. L. J. at 2269-70 ("Since *Brooke* requires only a showing of probable recoupment, proof of actual recoupment is not a necessary ingredient of predation."). Indeed, proof of actual recoupment would not be possible if the facts demonstrated an unsuccessful attempt to monopolize. *See Colorado Interstate Gas v. Natural Gas Pipeline*, 885 F.2d 683, 695 n. 20 (10th Cir. 1989) ("[I]t is no defense to an attempted monopolization charge that the defendant's attempt to monopolize proved to be unsuccessful.") (citing *United States v. American Airlines,*

2. The Law Does Not Limit Recoupment to the Markets Where Illegal Conduct Occurred

a. A Defendant May Recoup by Stifling the Growth of Potential Entrants in Related Markets

American argues that recoupment in markets other than the below-cost capacity markets is not legally cognizable. (American 1/8/01 Memo. at 54.) The Tenth Circuit has made it clear however, that the recoupment inquiry need not be limited to the market where the predatory acts have taken place. In *Multistate*, the Court declined to dismiss as a matter of law claims that predatory pricing conduct in one market could have anticompetitive effects in another market:

> Here, where [plaintiff] has presented evidence that it was probably the most likely challenger to the Defendants' monopoly *in the Colorado full-service market*, we cannot say as a matter of law that Defendants would find it economically irrational to price below cost *in the MBE [Multistate Bar Exam] market* . . . as part of a larger scheme . . . to deprive [plaintiff] of the resources necessary to continue its full-service market incursions.

Multistate, 63 F.3d at 1549 n.6 (emphasis added).

Ignoring *Multistate*, American relies on cases where the plaintiff failed to establish a causal nexus between the alleged predatory conduct and the exercise of monopoly power in the alleged recoupment market.[36] Since the United States has alleged in its complaint that American has

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Inc., 743 F.2d 1114, 1119 (5th Cir. 1984)). To hold otherwise would effectively require a plaintiff to wait until recoupment was complete before filing suit. Of course, *ex post* evidence is relevant as an "aid in determining what was reasonably anticipated" by the predator. 3 AREEDA & HOVENKAMP, ANTITRUST LAW ¶ 727c (rev. ed. 1996).

[36] *Advo, Inc. v. Philadelphia Newspapers, Inc.*, 854 F. Supp. 367 (E.D. Pa. 1994) is distinguishable on this point because that case did not involve any allegation or finding that the predatory conduct was connected to any scheme to create, enhance or maintain monopoly power in a second market. *Advo* held that the defendant could not recoup losses incurred in the predatory market (advertising circulars) with gains in the second market (newspaper advertising) because the alleged predation did not enhance market power in the newspaper advertising market.

monopolized or attempted to monopolize a substantial number of DFW routes, recoupment in any or all of them may be considered by the Court,[37] especially where, as here, there is substantial evidence establishing both the economic relationship between and among DFW spoke routes and the causal connection between markets where the challenged conduct occurred and the other monopolized markets.[38]

Where evidence of a connection between markets *does* exist, multi-market recoupment is a rational basis for engaging in predation. Where lower federal courts have found a nexus

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Id. at 376 & n.31. Instead, the court noted that the defendant already had the power to charge full monopoly prices in the newspaper advertising market. *Id.* Unlike the plaintiff in *Advo*, the United States has alleged -- and offered evidence in support thereof -- that American reasonably expected to recoup its predatory sacrifice by maintaining its market power. Similarly, in *Rockbit Indus. U.S.A. v. Baker Hughes, Inc.*, 802 F. Supp. 1544 (S.D. Tex. 1991), the plaintiff did not allege that predation permitted increased profits in a second market -- only that supracompetitive profits in the "recoupment" market enabled the defendant to afford its predatory campaign in the alleged predatory market or markets. *Id.* at 1552. In addition, the *Rockbit* plaintiff did not allege which specific markets the defendant had monopolized and the court could therefore not determine whether the defendant had monopoly power. *Id.* at 1550-1551 & n.5. Finally, the *Rockbit* plaintiff's theory required that the defendant fix prices with its competitors in the "recoupment" market to recoup. *Id.* at 1551-52. Unlike the *Rockbit* plaintiff, the United States has alleged and offered evidence that American has maintained its monopoly power in specific markets such that it reasonably expected to be able to recoup its predatory sacrifice.

[37] In addition, the United States will also offer evidence that American obtained recoupment benefits in some markets where it obtained high prices but is not alleged to have a monopoly (*i.e.*, markets where it faces limited competition with another major airline). American claims that such evidence may not be considered. (American 1/8/01 Memo. at 66-68.) While the evidence of such recoupment benefits is not essential to the United States' claim, this evidence is of a type addressed in *Brooke Group* (in a Robinson-Patman Act claim). The Fourth Circuit rejected this type of recoupment benefit, but the Supreme Court declined to accept this holding, *Brooke Group*, 509 U.S. at 230, although it found that the proof in that case was insufficient. Here, such evidence is offered only to sustain the plausibility of American's monopolizing scheme, *i.e.*, it demonstrates an additional source of future benefits that make the predation a rational, albeit unlawful, business strategy.

[38] Gov't SOF at 23.

between the anticompetitive conduct in one market and the enhancement or preservation of monopoly power in other markets, they have recognized that such a scheme could make predation a rational business strategy. *See, e.g., United States v. AT&T*, 524 F.Supp. 1336, 1369 (D.D.C. 1981) (in context of regulated industry, nexus existed between predatory conduct in one market and ability to obtain supracompetitive returns in another market).[39]

Scholarly literature further supports the conclusion that

> recoupment can occur in either the predatory market or in a strategically related market where the effects of the predation are felt. In either case, the exclusion or disciplining of rivals or potential rivals is the intended instrument of the predatory scheme, and the anticipated effect is the future raising of prices or increased revenues in a strategically related market.

Patrick Bolton et al., *supra*, at 2267-68. Another analysis, which the Third Circuit specifically approved in the *Advo* appeal, *Advo Inc. v. Philadelphia Newspapers, Inc.*, 51 F.3d 1191, 1196 n.4 (3d Cir. 1995), discusses a chain store that predates in one or a few geographic market(s) and recoups when its rivals in other markets "also respond by avoiding competition with the chain. As

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[39] American quotes a passage from *Brooke Group* stating that the recoupment inquiry requires "... a close analysis of both the scheme alleged by the plaintiff and the structure and conditions *of the relevant market*." (American 1/8/01 Memo. at 54, quoting *Brooke Group*, 509 U.S. at 226 (emphasis added by American).) American argues from this statement that the recoupment inquiry must be limited to the markets where predatory conduct occurred. Under Section 2 of the Sherman Act, however, "relevant market" refers to the market(s) monopolized or attempted to be monopolized. As noted above, the United States has alleged that the relevant markets monopolized by American are a number of DFW city pairs, and recoupment may therefore occur in any of them. In *Brooke Group* itself, the Court concluded that the scheme, as alleged by the plaintiff, required proof of likely recoupment within the market where the predatory conduct occurred, but only because that was the theory the plaintiff alleged: "Recoupment through supracompetitive pricing in the economy segment of the cigarette market is an indispensable aspect of Liggett's own proffered theory." *Brooke Group*, 509 U.S. at 232. Here the United States has alleged multi-market monopolization and recoupment. *Cf. Multistate*, 63 F.3d at 1549 n.6.

a result, prices also increase in the towns in which predation did not occur." Jonathan B. Baker, *Predatory Pricing after Brooke Group: An Economic Perspective*, 62 ANTITRUST L.J. 585, 590 (1994). The Third Circuit agreed that "[p]redation makes economic sense in such cases because the predator needs to make a relatively small investment (below-cost prices in only a few markets) in order to reap a large reward (supracompetitive prices in many markets)." *Advo*, 51 F.3d at 1196 n.4. (citing Jonathan B. Baker, *Predatory Pricing after* Brooke Group: *An Economic Perspective*, 62 ANTITRUST L.J. 585, 590 (1994)).

b. A Defendant May Recoup by Establishing a Reputation for Predatory Conduct

American asserts that it is "novel" and impermissible for the United States to allege that a reputation for predation can serve as a mechanism for recoupment in the form of a "strategic" entry barrier. (American 1/8/01 Memo. at 53-57.) The basic principle of how reputation can deter entry, however, is not novel but rather common-sense. In 1976, Professor (now Judge) Richard Posner explained the principle:

> If, however, a firm operates in a number of markets and faces actual or potential competitors each of whom is limited to one of its markets, it may find it worthwhile to expend considerable resources on crushing a single competitor in order to develop a reputation (for willingness to use predatory pricing) that may enable the firm to exclude other potential competitors without any additional below-cost selling.

RICHARD POSNER, ANTITRUST LAW 185-86 (1976).[40] American's experts agree. Professor

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[40] American argues that by asserting the existence of strategic entry barriers, the United States acknowledges that the "structural" or "natural" entry barriers in the DFW city pair markets are ineffective. (American 1/8/01 Memo. at 53-54.) No authority supports the proposition that strategic and natural barriers to entry cannot co-exist and complement one another. American's argument contains the fallacious assumption that entry barriers have to be either absolute or nonexistent. The United States' experts explain that strategic entry deterrence has value precisely in the situation where "structural" or "natural" entry barriers exist, but are not insurmountable. It

Baumol testified in his deposition that predatory sacrifices could be recouped through a reputation for predation, both in the market where predation occurred and in other markets. (Gov't SOF at 314.1.) And Professor Ordover has written that "courts should consider the future profit effects that flow from a reputation for toughness." 3 NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, at 81 (Peter Newman, ed. 1998). Indeed, as Professor Ordover, notes: "Strategic advantages . . . can build on the already existing natural advantages or be created by incumbent firms that get to choose their strategies before entrants." Janusz A. Ordover & David M. Wall, *Proving Entry Barriers: A Practical Guide to the Economics of New Entry,* 2 ANTITRUST 12, 15 (Winter 1998).[41]

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The only case cited by American specifically addressing the issue of recoupment through reputation supports the government's theory.[42] *See Advo, Inc., Philadelphia Newspapers, Inc.*,

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is in this common situation -- where natural entry barriers exist but are *not* absolute -- that establishment of a reputation for predation has added value to the predator. (Gov't SOF at 314.2.) Indeed, accepting American's argument would entail rejecting the very possibility of a cause of action for predation by a monopolist – for under American's logic the mere fact of entry and the incumbent's decision to predate would "contradict" the existence of natural barriers to entry and so defeat the monopolization inquiry.

[41] *See also* Bolton et al., *supra*, at 2269 (discussing both market conditions and the predator's conduct as affecting the predator's future ability to recoup), 2302 (stating the effect of a predatory reputation in terms of decreased likelihood of entry or reentry); Paul L. Joskow & Alvin K. Klevorick, *A Framework for Analyzing Predatory Pricing Policy*, 89 YALE L. J. 213, 227-231 (1979) (listing industry characteristics that serve as barriers to entry, including predatory reputation of incumbents).

[42] The other cases cited by American -- *Los Angeles Land Co. v. Brunswick Corp.*, 6 F.3d 1422, 1427 (9th Cir. 1993), and *United States v. Syufy Enters.*, 903 F.2d 659, 668 (9th Cir. 1990)

51 F.3d 1191, 1196 & n.4 (3rd Cir. 1995). *Advo* did not involve a market with natural entry barriers. Instead, entry was easy enough to "attract a stream of competitors." *Advo* also did not involve a defendant with monopoly power in multiple markets. *Id.* at 1202. While the court properly concluded that in those circumstances recoupment by means of reputation was implausible, the court did not foreclose the theory. Instead, the court explained that the theory as applied in that case "sweeps too broadly. *Without some limiting principle*, it would bar summary judgment in every predatory pricing case." *Advo*, 51 F.3d at 1202 (emphasis added). The court recognized, however, that in a case involving predation in a few markets in order to establish a reputation in other markets, predation is "economically sensible." *Advo*, 51 F.3d at 1196 n.4. Thus, contrary to American's characterization, *Advo* does not hold that recoupment through reputation inherently cannot be viable, only that it must be accompanied by other circumstances relating to the structure of the industry that make reputation a reasonable basis for recoupment under the facts of the case.

Moreover, the Tenth Circuit recognized in *Reazin* that reputational effects may form a

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-- do not address the issue of establishing recoupment by reputation. Rather, they address the issue of whether a defendant's reputation for perfectly legal competitive practices can alone serve as a basis for showing the existence of monopoly power. For purposes of this motion, American has conceded that there are genuine issues of fact with respect to monopoly power and the United States has substantial evidence (apart from American's acquisition of a reputation for engaging in predatory conduct) showing that American has monopoly power. In any case, to the extent that these cases stand for the proposition that successful anticompetitive conduct cannot be used to evidence the ability of a defendant to exclude competition, it is contrary to the controlling law of the Tenth Circuit. *Full Draw Productions v. Easton Sports, Inc.*, 182 F.3d 745, 756 (10th Cir. 1999) (allegation that defendants' boycott eliminated the only competitor to defendant's trade show demonstrates a significant entry barrier in the boycott itself); *Reazin v. Blue Cross and Blue Shield of Kansas, Inc.*, 899 F.2d 951, 971-972 (10th Cir. 1990) (evidence that alleged anticompetitive conduct excluded competition supported finding that defendant exercised monopoly power).

basis for an anticompetitive scheme. *Reazin*, 899 F.2d at 954. Summarizing the conduct in that case, the Court explained:

> The parties have attempted to make this case very complex, but the antitrust issues are relatively straightforward. Plaintiff's theory was that Blue Cross, alarmed by a perceived competitive threat from Hospital Corporation of American ("HCA") through its acquisition of . . . Wesley Medical Center ("Wesley"), determined to 'hurt' Wesley and thereby *send a message* to other hospitals not to do business with entities Blue Cross believed were competitors. . . . *The threatened termination of Wesley because of its affiliation with a Blue Cross competitor made other hospitals less willing to affiliate with, or enter into relationships with Blue Cross competitors.*

Id. (emphasis added). While the reputation mechanism in *Reazin* is different than the one presented in this case, the rationale for examining the reputation mechanism is the same -- to determine whether predation by a dominant firm is rational.

C. Even If Recoupment Were Limited to the Markets Where Illegal Conduct Occurred, American Had a Dangerous Probability of Recouping Its Predatory Sacrifice Within Those Markets

Although the law does not require that recoupment be confined to the market in which predatory conduct took place, there was a dangerous probability in this case that American could recoup its predatory investment within the four below-cost capacity markets. First, "output or price information indicates that [market behavior] in fact produced supracompetitive prices"[43] in the four markets. American's prices after the LCCs exited these markets were significantly higher than when the LCCs were present,[44] and higher than American's prices in comparable,

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[43] *Brooke Group*, 509 U.S. at 233.

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[44] Gov't SOF at 187 American's average fares went from to in DFW-ICT, from to in DFW-COS and to in DFW-LGB. In the first DFW-MCI predation episode, American's average fares went from to REDACTED

Cf. Brooke Group, 509 U.S. at 232-33 (proof of ability to recoup could be made through evidence that the scheme actually produced supracompetitive prices). Professor Berry

"competitive benchmark" DFW markets.[45] The price increases imposed by American in these four markets were accompanied by significant output restrictions -- American reduced the number of passengers traveling in the market and the number of frequencies serving the market, and reinstated its yield management procedures to raise average fares.[46]

The return to high prices greatly improved American's profitability in each of these routes. The DFW-MCI market, for example, went from being one of American's worst-performing routes during the first predation period to the "best in the West" in early 1996, after Vanguard's exit from non-stop service.[47]

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Of course, no carriers have entered any of these three routes despite the increased prices and reduced output.[49]

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demonstrates that the prices after LCC exit provides greater returns than American realizes in competitive routes. (Gov't SOF at 6.)

[45] Gov't SOF at 2; American's average fare in DFW-ICT in the 1998-99 time period was REDACTED its price in DFW-Amarillo, where it competes with Southwest.

[46] Gov't SOF at 187; *Brooke Group*, 509 U.S. at 233 ("Supracompetitive pricing entails a restriction in output.").

[47] Gov't SOF at 40.

[48] REDACTED

[49] Although Vanguard still serves the DFW-MCI market, American's predatory strategy in the second DFW-MCI episode had a reasonable chance of success at the time it was undertaken. Indeed, American's response did contribute to Vanguard's replacing its management and to its changing its corporate strategy. (Gov't SOF at 64, 66, 69.) An important success for American from this change in strategy was an end to the possibility that Vanguard would develop a mini-hub at DFW; instead it developed a hub out of MCI. (Gov't SOF at 69.) Moreover, American may

Notwithstanding all this evidence supporting the conclusion that American has been recouping in the four below-cost capacity markets, American asserts that there is no genuine issue in dispute with respect to whether in-market recoupment could occur. This assertion is based on American's ill-founded quibbling with the results of calculations performed by Professor Berry. In fact, Professor Berry's calculations demonstrate that there was a reasonable prospect of American recouping its predatory losses solely in the four below-cost capacity markets.

Professor Berry performed three calculations of actual in-market recoupment between the date of LCC exit and October 1999.[50] Professor Berry provides evidence that:

- After only one and one-half years, American had already recouped its predatory losses in DFW-ICT[51] and DFW-LGB. (Gov't Ex. 398, at ¶¶ 378-381, & n.188.)

- After only one and one-half years, American had recouped nearly all of its predatory losses in DFW-COS. (Gov't Ex. 398, at ¶¶ 378-381.)

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have been able to partially recoup its sacrifice within the DFW-MCI market by charging supracompetitive prices during late 1998 and early 1999 as a result of Vanguard's relaxation of its low fare strategy. (Gov't Ex. 398 at ¶ 381 & Table IA (measuring recoupment using zero FAUDNC as a baseline, American recouped $3,241,015 in the second MCI episode, for a net loss of $93,660.); *see Brooke Group*, 509 U.S. at 225 (discussing recoupment through "causing [rivals] to raise their prices to supracompetitive levels within a disciplined oligopoly").)

[50] Professor Berry's calculations only use data through October 1999 because that was the most recent data available through discovery.

[51] American disputes the facts supporting recoupment for DFW-Wichita, claiming that the base period for DFW-Wichita was improperly selected because it did not extend to a period prior to 1996. The propriety of the base period, however, clearly involves a disputed issue of fact. American's FAUDNC data (but not VAUDNC) for American Eagle for 1995 (upon which Professor Kalt's calculations rely) is of questionable validity. (Gov't SOF at 316.3.) Professor Berry did not use the questionable data for his recoupment calculations. In addition, Professor Berry has concluded that, for purposes of estimating the level of predatory losses in the recoupment exercise, using a period of several months prior to the predatory period is preferable. (Gov't SOF at 316.3.)

- After LCC exit from the markets, American was in the process of recouping (by earning supracompetitive returns) in DFW-ICT, DFW-COS and DFW-LGB. (Gov't SOF at 315.) It is reasonable to infer that American would continue recouping after October 1999.

- Using a measure suggested by testimony of American's expert, Professor Ordover,[52] American has already recouped its predatory sacrifice in each of the markets.[53]

In calculations of likely recoupment, *ex post* approximation of actual recoupment provides a reasonable assessment of the likelihood of recoupment from the perspective of the predator at the time the predation was taking place, and "reasonable estimates are all that can be expected." 3 PHILLIP AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 727c. Professor Berry's calculations provide such reasonable estimates.

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[52] Professor Berry performed calculations of recoupment based on a methodology proposed by Professor Ordover in his deposition. Essentially recognizing that the recoupment inquiry is designed to assess the probability of recapturing predatory losses rather than a mathematically precise calculation of losses and gains, Professor Ordover explained that his approach offered a rough estimate of whether a firm was recouping after exit. (Gov't SOF at 315.2.)

[53] Applying Professor Ordover's methodology reveals that American indeed has succeeded in earning more profits than it lost during the predatory episodes. (Gov't SOF at 315.2, 315.3.) Despite the fact that American's expert supported use of zero FAUDNC as a baseline for estimating recoupment, American argues that such a measure should be rejected as a matter of law because, according to American, use of such a baseline would imply that American is either predating or recouping in all markets that do not happen to have a FAUDNC return of exactly zero. (American 1/8/01 Memo. at 50, n.31.) American's argument proves too much. Any "competitive return" benchmark (including the "returns in Southwest-competitive markets" benchmark used by Professor Berry), if applied to all routes, would be subject to the same criticism (*i.e.*, every route would have results that fall above, below, or equal to the benchmark). Moreover, American's argument misconstrues the purpose of the recoupment exercise. It is not a test for predation. Nor is it a precise mathematical calculation of "damages." Rather, it is an exercise to evaluate the probability of recoupment.

Thus, the calculations by Professor Berry support the conclusion that American could and did recoup its predatory investment, *even if* the law confined recoupment to the markets where the illegal conduct occurred, *and* placed a time limit on recoupment. Moreover, because the inquiry is whether recoupment was likely *ex ante* -- at the time American initiated the predatory conduct -- the evidence of substantial partial recoupment up through a particular point in time supports a finding of likely recoupment. When this evidence of actual recoupment is considered in context with all the other evidence identified in *Brooke Group* as relevant to the recoupment inquiry, there is clearly a substantial question of fact concerning whether American was likely to recoup its predatory sacrifices within the markets where it engaged in predation.

D. There Is Evidence in the Record that American was Likely to Recoup Its Predatory Sacrifice

1. American's Own Documents Demonstrate the Existence of Conditions Consistent with Recoupment and Detail the Consideration of the Problem Created by LCCs and of the Cost and Likely Success of Actions Against Them

When it began developing its DFW LCC Strategy, the only significant potential threat to American's monopoly power in many of its DFW spoke routes was the potential development and growth of LCCs.[54] American had watched as several LCCs were able to establish successful

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[54] Other competitors were not significant threats. Delta Airlines, American's primary rival at DFW, had decided to downsize and de-emphasize its hub operations at DFW

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Southwest Airlines, a large and successful low-cost airline, with substantial operations at Dallas Love Field, was no threat to American's pricing and profits in routes other than the 13 Dallas routes Southwest operated at the time because Southwest was prohibited by statute from expanding its service from Love Field to points beyond a limited geographical area,

REDACTED Then, as now, service to Dallas by other major airlines was confined to service to and from their own hub airports and, in any event, entry and exit by major hubbing airlines has much less effect than

small-scale hubs at airports that also had large hubs operated by major airlines; these LCCs were able to charge low fares because they had very low operating costs.[55]

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study on the vulnerability of American's DFW routes to LCC entry. REDACTED looked at the impact on Delta's profitability of ValuJet's entry into Atlanta, and

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competition from Southwest on American's fares in DFW routes.

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[55] By February 1996, after just over two years of operation, ValuJet had grown, by February 1996, to an operation with 41 aircraft, serving 28 cities, including a hub and spoke operation at Atlanta with 22 spokes. (Gov't SOF at 13.4.1.)

REDACTED

[57] This effect is consistent with American's earlier, direct experience with a low-fare airline with a small hub at DFW:

REDACTED When Braniff did close its DFW hub in 1988, average fares on those

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The working group assigned to develop the DFW LCC Strategy was formed shortly after this study was completed. (Gov't SOF at 18.) American's development and implementation of the DFW LCC Strategy tracks the factors the Supreme Court outlined in *Brooke Group* as being appropriate for the recoupment inquiry, and demonstrates the rationality of American's predatory strategy. First, American focused on the precise impact its conduct would have on the LCCs it was targeting.[59] Thus, American's planners

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[60] and to research the financial condition, break even load factors, and of the LCCs.[61] At the meeting where American's senior

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routes did increase, by 13%. (Gov't SOF at 242, 244.)

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[59] *See Brooke Group*, 509 U.S. at 225 (the first *Brooke Group* recoupment inquiry is whether the activity in question is capable of "producing the intended effects on the firm's rivals. . . . This requires an understanding of the extent and duration of the alleged predation, the relative financial strength of the predator and its intended victim, and their respective incentives and will.")

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officers discussed the DFW LCC Strategy, the following questions were raised:

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"Western Pacific . . . get them out of DFW b/f [before] they are encouraged to put the 2nd [frequency] back in COS-DFW."

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Second, American had a clearly articulated expectation of recovering, in the form of later monopoly profits, more than the losses it believed it would suffer from its predatory conduct. *See Brooke Group*, 509 U.S. at 225. American understood that the benefits to American of its strategy -- maintaining its market position in DFW markets -- were significant. American had already, in its studies of the threat of LCC entry, examined the revenues and profits it might lose if it did *not* prevent LCC entry and expansion, *i.e.*, the amount that would be protected by inhibiting competition by LCCs at DFW. (Gov't SOF at 14, 16.) In addition, American's capacity planning department estimated that ValuJet's impact on Delta's annual revenues was to decrease them by $232 million annually, and noted "[c]learly, we don't want this to happen to AA at DFW." (Gov't SOF at 15.)[63]

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[63] *See also* Gov't SOF at 18.3; Gov't Ex. 149

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REDACTED However, staff recommended reevaluation if "[SunJet] increases frequency or adds spokes from DFW."[65] In short, American would proceed only if the cost-benefit ratio changed,[66] exactly the type of recoupment calculation envisioned in *Brooke Group*.

2. The Market Structure of American's DFW Hub Supports the Conclusion That American's Expectation of Recoupment Was Reasonable

Another approach to the recoupment inquiry is the examination of market structure to evaluate whether the predator had a reasonable expectation of maintaining supracompetitive prices long enough to make up for its predatory sacrifice. *See Brooke Group*, 509 U.S. at 226. There is substantial market structure and pricing evidence that American has monopoly power in DFW city pairs, and that its monopoly power has persisted over time.[67] The actions at issue in this case more than paid for themselves by assisting American to maintain its monopoly power.

American has been able to engage in sustained supra-competitive pricing in many of its DFW routes, including those identified by the United States as monopoly routes. (Gov't SOF at 2-6.) American's prices on the majority of its DFW routes, including those on which the United

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64 REDACTED

65 *Id.*; *see also* Gov't SOF at 23.3.2. And indeed, when SunJet did increase frequency and announce an additional spoke from DFW, American reacted by entering DFW-LGB. (Gov't SOF at 171-173.)

66 *See* Gov't SOF at 19.

67 The individual city pairs in which American has monopoly power in the provision of non-stop service are listed in Gov't Ex. 398, Berry Final Report, Ex. 1. The individual city pairs in which American has monopoly power in the provision of all airline service (both non-stop and connecting) are listed in Gov't Ex. 398, Berry Final Report, Ex. 1a.

States alleges monopoly power, have been substantially and persistently above competitive benchmarks. (Gov't SOF at 2-3.)

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American's power over price in its DFW monopoly markets is also illustrated by price changes in the four below-cost capacity routes:

Market	Avg. AA Price Before LCC Entry	Avg. AA Price During LCC entry	Avg. AA Price After LCC Exit
DFW-ICT			
DFW-MCI I			REDACTED
DFW-COS			
DFW-LGB	N/A		

(Gov't SOF at 187.1, 187.3, 187.7, 187.9, 187.11, 187.13, 187.15, 187.21, 187.23, 187.25, 187.27, and 187.29.)

Even with these high prices, its market shares in the monopoly routes (and for DFW traffic generally) have steadily remained at very high levels. (Gov't SOF at 1.)[69] The monopoly routes

[68] REDACTED American's average fare between DFW and Wichita during the 1998-99 time period was nearly twice the level of its fares in the DFW-Amarillo market ($112 vs. $62), where American competed with Southwest. Its average available walkup fares during a 6-month sample period were $210 for DFW-ICT and $124 for DFW-AMA, while the average available 7-day advance purchase fare was $148 in DFW-ICT and $57 in DFW-AMA. (Gov't SOF at 2.1.) Factors that affect the cost of serving a market, such as distance and density (number of passengers served by the airline) are comparable between the two markets.

[69] American's statements that American's share of total DFW traffic has recently fallen and that LCCs' shares of DFW traffic have risen are serious overstatements. In fact, American's share of total DFW available seat miles (ASMs)
REDACTED Meanwhile, LCC hubs at Atlanta and Denver have become successful on routes similar to the routes available at DFW. (Gov't SOF at 23.5.) Despite

experienced very little entry of any kind during the decade of the 1990s, and even less LCC entry, despite the persistent supracompetitive prices.[70] DFW-ICT, DFW-LGB and DFW-COS have not been entered by another airline notwithstanding the substantial post-exit price increases. (Gov't SOF at 7.8.)

An important reason why American is able to charge persistently high prices while inducing so little entry is that there are substantial, though not insurmountable, entry barriers into the DFW routes. (Gov't SOF at 8.) American's LCC strategy was intended (1) to drive out entrants who had attempted to overcome the barriers and had gained a tenuous foothold in DFW markets, (2) to prevent these entrants from expanding their foothold to other DFW markets, and (3) to reduce the threat of entry by others by making them factor a predatory response by American into their entry decisions.[71] (Gov't SOF at 23.) The airline industry has structural

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this fact, no LCC hub has grown at DFW and, indeed, DFW routes experienced entry less than half as frequently (1.0% v. 2.2%) as other major airlines' hub routes. (Gov't Ex. 398 at Exhibit 15.) Thus American's observation that "[n]o hub airport in the country is served by more LCCs than DFW" (American 1/8/01 Memo. at 51), should come as little comfort to passengers in DFW-ICT, DFW-Omaha, DFW-Indianapolis and other monopoly DFW markets that continue to experience high fares and no relief brought by low-cost entry.

[70] Gov't SOF at 7.1-7.4; Gov't Ex. 398 at Exhibits 1 & 1a.

[71] American argues that DFW is served by seven LCCs. (American SUF at 13.) However, careful review reveals that these facts actually provide evidence of American's domination of DFW. One of the LCCs -- Ozark -- serves a niche route from DFW that American does not serve. (Gov't SOF at 301-306.) Four LCCs -- American Trans Air, Frontier, Vanguard, and National -- serve DFW only from their respective hubs. (Gov't SOF at 76, 225-229, 252, and 288.) Finally, the remaining two -- Air Tran and Sun Country -- serve only their hub and a leisure destination that offers gambling (Gulfport and Las Vegas, respectively). (Gov't SOF at 225-227, 229, and 308.) American does not provide service on DFW-GPT. (Gov't SOF at 228.) Thus, American's claim that there are seven LCCs at DFW means only that American competes on six routes with six airlines: DFW-ATL (Air Tran); DFW-MDW (American Trans Air); DFW-DEN (Frontier); DFW-LAS (National, and Sun Country); DFW-MCI (Vanguard); and DFW-MSP

features that make it particularly susceptible to such a plan of strategic entry deterrence. (Gov't Ex. 396 at ¶¶ 28-35; Gov't SOF at 8, 214.)

3. The Substantial Evidence that American's Reputation Deterred Entry Creates a Genuine Issue of Fact as to American's Reputation and Ability to Recoup

An airline's pricing or capacity initiatives often depend heavily on the anticipated response of other airlines.

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(Sun Country). No LCC competes with American on any DFW route except those that go to an LCC hub. Given these facts, it is difficult to see how the LCC presence at DFW constitutes evidence of anything but American's monopoly power on DFW routes.

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Anticipation of responses by incumbents has an even greater impact on decision-making by smaller airlines. Entrants and would-be entrants frequently seek to fly below the "radar"of large incumbents, and to develop "niche" strategies that will not incite large carriers to respond aggressively. (Gov't SOF at 46.1, 169-170, 215, 220, 237-238, 254-257, 278, and 283.) Low cost carriers design their business plans to avoid overlapping hubs with major carriers. (Gov't SOF at 220-222, 254-256, 259, and 283.)[74] Investors and potential investors frequently inquire of start-up carriers about whether incumbents will "squash" them. (Gov't SOF at 224, 258, 290-291, 298 and 300.)[75] In sum, the airline industry is one where the reputation and probable

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response of one's rivals is important.

Moreover, there is evidence that American's reputation did delay or reduce the likelihood that LCCs would try to establish their own hubbing operation at DFW. (Gov't SOF at 63-69, 169-170, 215-219, 237-238, and 314.)[76] While American's reputation may be strongest for responding to perceived efforts of LCCs to establish hubbing-type operations at DFW, it also has a reputation for responding vigorously to any LCC entry at DFW, even from the LCC's own hub or base of operation. (Gov't SOF at 217-218, 250, 256-257, and 288.)[77] Even in one of the routes on which American used below-cost capacity, the effect can be seen: Ryan International Airlines ("Ryan") has been deterred from serving DFW from Wichita because of fear of a predatory response from American. (Gov't SOF at 292-300.)[78] American's reputation

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[76] For example, SunJet initially decided that it should limit its service to DFW to avoid a predatory response from American. (Gov't SOF at 169 (noting that SunJet intended to fly below American's radar by limiting its service to a level that SunJet perceived American would allow); Gov't SOF at 170 (noting that if a carrier moves from two to three flights per day, American responds).) Similarly, Braniff, a now-bankrupt carrier that used DFW as a hub until the early 1990's, understood that it was allowed to have only two or three percent of the DFW market. (Gov't SOF at 237-238 ("If [Braniff] got any bigger, [American] would squash him.").)

[77] For example, JetBlue would like to serve DFW from its JFK hub. (Gov't SOF at 267-268.) However, JetBlue has not yet entered DFW -- in part because of its concern about American's likely competitive response and JetBlue's financial ability to withstand large capacity increases from American. (Gov't SOF at 269-270.)

[78] Mayor Robert Knight and the City of Wichita's Air Service Task Force asked Mr. Ryan to design a business plan for improving air service to Wichita. (Gov't SOF at 295.) Ryan designed a plan to offer three daily flights from Wichita to DFW -- as well as to Chicago and Denver. (Gov't SOF at 296.) One of the reasons that Ryan and the City of Wichita have not implemented Ryan's plan is concern about the competitive response of American and the other dominant airlines. (Gov't SOF at 300; Gov't SOF at 298 ("I have absolutely no doubt in my mind what the majors will do, match, beat your fares, offer frequent flier miles, incentives to the travel agent, they put flights in front of you and behind you to increase the capacity far beyond what the demand is and sit on you until you are dead").)

contributed to delay of LCC entry on DFW routes. (Gov't SOF at 215-219, 250, 267-270, 288, and 297-300.)[79] DFW hub routes have experienced a lower rate of entry than routes of the hubs of other major airlines. (Gov't SOF at 7.5.) The Dallas-Fort Worth area has less LCC service than many other cities with major hub airports, especially those with an LCC hub -- even though DFW routes appear as suitable as LCC routes in other hubs. (Gov't SOF at 7.6, 314.7, 314.8.)

For purposes of the recoupment inquiry, Professor Berry made additional calculations to capture the enormous benefit reaped by American by virtue of its reputation for predatory conduct. Because the recoupment inquiry is an *ex ante* inquiry, *see* Section V.B.1, *supra*, and because American's goal was to deter or delay formation of an LCC hub at DFW, (Gov't SOF at 20-24), Professor Berry estimated the value to American of such deterrence or delay. He concluded that even a small reduction in the probability of an LCC hub, or of its delay, would readily explain American's otherwise inexplicable loss-making capacity additions. (Gov't SOF at 314.2-314.6 and 314.9.) Thus, what American intuitively knew, *ex ante*, as it prepared its DFW LCC Strategy, (Gov't SOF at 23), was confirmed by Professor Berry's calculations: If American could decrease the likelihood that it did not have to face an LCC hub at DFW, then its below-cost capacity additions were worth it.

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VI. AMERICAN'S "MONOPOLIZATION BY REPUTATION" ARGUMENT MISSES THE POINT

The United States' legal theory is straightforward: American enjoys monopoly power and profits on numerous DFW routes. A significant threat to these profits was the entry of low cost carriers at DFW who, like ValuJet at Atlanta, could establish a hubbing operation. An LCC hub would grow over time, becoming more efficient and entering more of American's DFW spokes.

American therefore responded aggressively to LCC entry in several markets, especially where it perceived a potential hubbing threat, and in four markets added capacity that failed to cover its costs. *See* Section IV.B, *supra*. In other markets, as part of this strategy, American engaged in conduct that was irrational (*i.e.*, not profit-maximizing but for its anticompetitive effect), but not necessarily "below cost" or likely to result in a monopoly in that market. *See* Section IV.C, *supra*. The benefit to American of this conduct was preventing Vanguard and SunJet from establishing or maintaining any kind of hubbing operation at DFW. American's illegal conduct not only drove LCCs out of their then-current DFW routes, but also prevented their future growth into other DFW spokes.

An added benefit to American of its illegal conduct was the creation of a reputation that it was prepared to respond illegally to threats of entry, especially hub entry, at DFW. This reputation protects American's monopoly power and helps explain the rationality of American's below-cost conduct.

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American argues that no court has found monopolization strictly by this mechanism (American 1/8/01 Memo. at 42-43), but it ignores the recognition by courts that effects in one market can be

motivated by a risk to a defendant's other monopoly markets. *Multistate*, 63 F.3d at 1549 n.6; *see* Section V.B, *supra*. Here, that logic is applied to the facts of American's conduct, and it is clear that it is appropriate for the Court to find that the mechanism that American intended is a rational one, and one that the law can reach.

American claims that there is a risk that it will be condemned by a reputation for lawful aggressive competition. But this misstates the role of reputation in the United States' case. American's reputation is only one mechanism by which the effects of its unlawful conduct were felt. Thus, ultimately, the importance of reputation in this case will turn on the legality of American's capacity additions and related conduct, which will be determined by the evidence at trial. If American did not engage in any unlawful conduct, there is no "backup theory" for a finding of monopolization solely as a result of reputation. In the final analysis, the United States will prove that American's illegal conduct was rational only because in the long run it preserved monopoly profits. The reputation American developed *as a result of its illegal conduct* only served to increase the benefits that American reaped from engaging in that conduct American's "monopolization by reputation" arguments thus miss the point entirely, and should be rejected.

VII. AMERICAN'S "MEETING COMPETITION" DEFENSE IS GROUNDLESS

American argues that it is entitled to summary judgment in this Sherman Act case based on a "meeting competition" defense to predatory pricing analogous to the meeting competition defense to price discrimination under the Robinson-Patman Act. (American 1/8/01 Memo. at 38-42.) American's version of this defense would apply even if the monopolist's prices are indisputably predatory, entrench its monopoly and harm consumers. Not surprisingly, no Sherman Act case holds that a meeting competition defense excuses predatory *pricing*, let alone

predatory *capacity additions* like the ones at issue in this case. The leading commentators oppose adoption of such a defense to Sherman Act predatory pricing because it would be severely anticompetitive. Even if the defense existed, American has failed to show that as a matter of undisputed fact it is entitled to its application here.

Because this case mainly involves a predatory scheme of capacity additions that made no business sense except to stifle competition from LCCs, American's proposed meeting competition defense does not apply here. There is no generalized meeting competition defense to monopolization claims that involve such predatory acts. Indeed, it is impossible to imagine what would have constituted "meeting competition" in the context of the predatory conduct found in *Aspen,* 472 U.S. 585, 586-595 (refusing to continue a joint ski ticket with competing ski resort), or the exclusionary conduct found in *Eastman Kodak,* 504 U.S. 451, 456-58 (limiting availability of replacement parts to competing independent service organizations).

Even if this were a predatory pricing case, there is no judicial authority for the proposed defense. American does not claim that there is any Supreme Court or Court of Appeals decision under the Sherman Act in which a defendant who engaged in predatory pricing was excused by a meeting competition defense. Rather, American relies (American 1/8/01 Memo. at 38-39) on the District Court's decision in *ILC Peripherals Leasing Corp. v. IBM Corp.*, 458 F. Supp. 423 (N.D. Cal. 1978). In quoting from *ILC Peripherals*, American ignores a key basis for decision: the plaintiffs' failure to show that any of IBM's prices were predatory. *Id.* at 433-434. Moreover, the Ninth Circuit has recognized that *ILC Peripherals* does not establish a general defense for meeting competition in a monopolization case. In *D&S Redi-Mix v. Sierra Redi-Mix and Contracting Co.*, 692 F.2d 1245, 1248 (9th Cir. 1982), the Ninth Circuit held that "no authority

allow[s] the defense of meeting competition when a company's prices dropped below its average variable costs." The Ninth Circuit then distinguished *ILC Peripherals*, noting that: "[a]ppellants' reliance on . . . *ILC Peripherals* is misplaced. [*ILC Peripherals* did not involve] a defendant whose prices were proved to be below its marginal or variable costs." *Id.* at 1248.[80]

American is equally unsound in asserting that "while the Tenth Circuit has not yet applied a meeting competition defense in a predatory pricing case, it appears to accept the validity of the defense." (American 1/8/01 Memo. at 39-40 (citing *Multistate,* 63 F.3d 1540).) In *Multistate*, the Tenth Circuit reversed summary judgment for the defendants who allegedly had, among other things, conspired to fix predatory prices of one of their bar review courses in violation of Section 1 of the Sherman Act. *Id.* at 1557. In rejecting the defendant's effort to dismiss the action at summary judgment on meeting competition grounds, the Tenth Circuit observed that "[d]etermining when the meeting competition defense applies to a predatory pricing claim can require substantial analysis." *Id.* at 1550 (citing PHILLIP AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 717' (Supp. 1994)). Section 717' of the 1994 Supplement states that "a monopolist's price below variable or marginal cost cannot be justified by the fact that he is meeting the lawful price of another." PHILLIP AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 717' (Supp. 1994). Thus, the best reading of *Multistate Legal* is that the Tenth Circuit has not determined whether the kind of meeting competition defense proposed by American

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[80] American, mainly in footnotes, cites several other cases that allegedly support its argument. (American 1/8/01 Memo. at 39 n.24, 42 n.27; and *see* 40.) Not one of the cases, however, involved a defendant who was found to have priced predatorily in violation of the Sherman Act, and so not one of the cases even faced, let alone decided in favor of, the existence of a meeting competition defense.

exists, and that it simply decided that the factual basis presented by the defendant did not require it to reach that issue.

As this analysis shows, the leading antitrust treatise provides cold comfort to American. *See also* 3 PHILLIP AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 748b, at 463 (rev. ed. 1996), (authors "propose forbidding a dominant firm from cutting prices to otherwise predatory levels in order to meet the promotional price of a new entrant"). Other scholarly commentary even more forcefully opposes a meeting competition defense. *See* Areeda & Turner, *Predatory Pricing and Related Acts Under Section 2 of the Sherman Act,* 88 HARV. L. REV. 697, 715 (1975) ("We would not permit a monopolist to price below marginal cost in order to meet the lawful price of a rival"); *See also* Bolton et al., *supra* at 2330 n.198 (noting that a "monopoly or dominant firm should not be permitted to sell below its short-run costs to meet the price of a new entrant or smaller rival.").

Professors Areeda and Turner also explain why a meeting competition defense to predatory pricing under the Sherman Act would undermine its goals. When a monopolist prices below marginal cost to meet a new entrant's promotional price, he "is not competing on the merits; the [monopolist's] response will destroy or greatly reduce the effects of the rival's promotional efforts, a result likely to be particularly serious for the new entrant, whose usual problem is precisely that of obtaining a profitable volume quickly enough to make start-up losses bearable." Areeda & Turner, 88 HARV. L. REV., *supra*, at 715. A meeting competition defense would allow an incumbent monopolist to use predatory pricing to quickly drive new entrants out of business -- or as an American official put it more colorfully in describing the DFW LCC strategy, to "get them out before they add [a flight]." (Gov't SOF at 95.)

Moreover, a meeting competition defense would require courts to decide whether a defendant effectively undercut a competitor by offering a superior product at the competitor's price. This in turn would require a complex, fact-intensive inquiry into difference in product quality and consumer preferences between defendant's product and his competitor's product -- a particularly burdensome task in the airline industry, which is characterized by differentiated service that varies in many ways across individual airlines. *See* Areeda & Turner, 88 HARV. L. REV., *supra,* 715-16; Gov't SOF at 317.1. Thus a court would have to take into account factors such as frequency of departures, time of departures, non-stop versus connecting service, jet or prop service, on-time arrival record, ticket restrictions, frequent flier plans, comfort of planes, politeness of staff, and perhaps even consumer perceptions of particular airlines.[81]

Even if this Court were to accept American's novel meeting competition defense to predation under the Sherman Act, American is not entitled to summary judgment, for it has failed to carry its burden of showing that there is no material issue of fact pertinent to the proposed defense. *Alan's of Atlanta v. Minolta Corp.,* 903 F.2d 1414, 1425-26 (11th Cir. 1990) (movant of affirmative defense must "do more than put the issue into genuine doubt; he must remove genuine doubt from the issue altogether").

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[81] The Court's inquiry would be even harder in light of the wide variety of prices airlines charge for any given type of service. Indeed, the intent of American's yield management is to charge different prices to different passengers in order to maximize revenue on a route. If, for example, an airline with a 100-seat flight offers 80 seats at $150 and 20 seats at $50, is it meeting competition for American to offer an entire 100-seat flight at $50? Or is it meeting competition only if American offers 20 seats at $50? There are not clear answers to such questions, but in an industry characterized by price discrimination (Gov't SOF at 318.1), it is clear that the questions would be numerous and answering them would be time-consuming.

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Finally, American *effectively* undercut LCC fares by nominally matching them while including extras that as a practical matter pushed its fares below the LCCs' fares. (Gov't SOF 319.1, 29, 43-44, 49, 59.1, 61, 113, 121, 163, 165.) Under the Robinson-Patman Act, from which American imports its meeting competition defense, the defense should be rejected when a seller effectively undercuts the competition by offering a more valuable product at a competitor's price. *See Porto Rican Am. Tobacco Co. v. American Tobacco Co.*, 30 F.2d 234, 237 (2d Cir. 1929) (holding that lowering the price of a cigarette to that of a "poorer grade cigarette" was not protected by the defense); *In re Anheuser-Busch, Inc.*, 54 F.T.C. 277, 292 & 301 (1957); *see also* Areeda & Turner, 88 HARV. L. REV. 697, 708 & n.29 (1975). It is clear that American coupled its fare matching with its frequent flyer program, which it considered the best in the industry (Gov't SOF 322.4.2), to effectively undercut LCC fares. Indeed, Western Pacific and SunJet did not even have frequent flyer programs. (Gov't SOF at 322.4.1.)[82]

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[82] Additionally, American undercut LCC fares REDACTED by offering advance seat selection, an amenity SunJet did not offer. (Gov't SOF at 322.3.)

VIII. CONCLUSION

American, by its summary judgment motion, seeks to evade the consequences of its actions by asking this Court to squeeze the United States' case into several overly narrow, theoretical constructs that would substantially deviate from the relevant law. The net result of American's efforts would be the legalization of a broad array of predatory actions that would discourage and defeat the growth of significant airline competition.

American has not established that the essential facts are undisputed and it has advanced a number of inaccurate propositions of law that are critical to its motion. American's motion should be denied.

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Respectfully submitted,

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