Comments of R. Bruce Wark[1]
Single Firm Conduct Hearings
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Introduction

I would like to begin my comments by thanking the committee for the opportunity to appear here today to offer my observations on Section 2 of the Sherman Act and its enforcement. As the in-house attorney at American Airlines responsible for competition matters, I hope to offer a unique perspective, one that is defined by the important, turbulent, and highly competitive nature of the airline industry.

I have chosen to focus my comments on Section 2 predatory pricing claims because within the last few years there have been two Circuit Court decisions relating to predatory pricing in this industry. More specifically, these cases address the legality of decisions by large network

[1] R. Bruce Wark is the Associate General Counsel for American Airlines. The opinions expressed herein, however, are solely his own.

carriers, like American, to match the prices of new entrants and adjust capacity in response to the new price point in the marketplace. The DOJ brought the first of these cases against American in 1999. I am happy to say that American prevailed in that dispute, when, in a July 2003 decision, the Tenth Circuit Court of Appeals affirmed an order granting summary judgment.[2] That decision found that the DOJ had failed to establish that American had priced its services on these routes below an appropriate measure of its costs, as required by the Supreme Court's decision in, among others, Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209 (1993).

The second recent predation decision relating to the airline industry came in a case brought against Northwest by one of it competitors, Spirit Airlines.[3] As in the case against American, the

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[2] United States v. AMR Corp, et al., 335 F.3d 1109 (10th Cir. 2003).

[3] Spirit Airlines, Inc. v. Northwest Airlines, Inc., 413 F.3d 917 (6th Cir. 2005).

District Court held that Spirit had failed to prove that Northwest had priced its product below its average variable costs on the routes in question, and, therefore, entered summary judgment. On appeal, however, the Sixth Circuit Court of Appeals reversed in a decision that, in my opinion, fails to apply the objective standards that are absolutely necessary to distinguish aggressive competition from illegal predation under Section 2.

I hope to use these cases to support two important themes. The first is that predatory pricing claims unconstrained by objective standards and based on unproven economic theories harm the competition that the antitrust laws were intended to protect. As Judge Easterbrook has explained:

> An argument that a practice is "predatory" is likely to point to exactly those things that ordinarily signify efficient conduct. . . Unless we have some powerful tools to separate predation from its cousin, hard competition, any legal inquiry is apt to lead to more harm than good. Given the general agreement that almost all price reductions, sales increases, additions to capacity, and so on are

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> beneficial, we need a very good ground indeed to treat a particular instance of such conduct as unlawful.[4]

These observations are consistent with the Supreme Court's guidance that "mistaken inferences of predatory pricing are especially costly, because they chill the very conduct the antitrust laws are designed to protect." [5]

The second, and related point, is that these objective standards should be clearly articulated. Clarity, in this regard, is particularly important because the antitrust laws can be punitive. The serious consequences of a finding that the antitrust laws have been violated forces companies to pull their competitive punches, especially when the lines separating aggressive competition from illegal activity are not clearly delineated.

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[4] F. Easterbrook, Predation Strategies and Counterstrategies, 48 U. Chi. L. Rev. 263, 266-67 (1981).

[5] As the Supreme Court said in Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 594 (1986), "cutting prices in order to increase business often is the very essence of competition." Similarly, in Atl. Richfield Co. v. USA Petroleum Co., 495 U.S. 328, 340 (1990), the Supreme Court observed, "Low prices benefit consumers regardless of how those prices are set."

Moreover, even when a defendant prevails, merely defending a Section 2 case is very expensive, and it diverts a tremendous amount of management's attention and company resources.

I recognize that, given the complexity of markets and U.S. business, perfect clarity of legal standards may be an unobtainable goal. Individual cases will always be decided on their own merits, and general legal principles will have to be adapted to unique facts. That said, clarifying legal standards in this area should be pursued whenever possible, and there are areas where clarification of legal standards can be immediately accomplished, such as a clear endorsement of average variable cost as the only appropriate measure of costs in a predatory pricing claim. Exceptions to that requirement, as was made in the LePage's Inc. v. 3M Co., 324 F.3d 141 (3d Cir. 2003), set back sound antitrust principles and enforcement policies.

Despite two fairly recent Circuit Court decisions addressing predatory pricing claims in the airline industry, Section 2 standards remain unacceptably vague. Even worse, in my opinion, the Sixth Circuit's decision in Spirit fails to demand the objective standards necessary to show that aggressive competition has overstepped the bounds of the law, and as a result it is a decision that protects smaller competitors, rather than competition on the merits.

Overview of Competition In the Industry

Before discussing the AMR and Spirit decisions in more detail, I want to offer some general observations on the airline industry and how airlines compete. The airline industry is a backbone for much of U.S. commerce, and the antitrust scrutiny that we find ourselves under is, no doubt, a product of the important role that the industry occupies. Last year alone, American served approximately 100 million passengers, and we

took in over $20 billion in revenues. Yet, those figures, as impressive as they are, account for only about 20% of the domestic U.S. airline industry.

Until the early 1980s, airlines were regulated, but after deregulation the industry exploded, and air travel today, although far from perfect, is both largely affordable and convenient. Air fares have fallen significantly in real terms since the days of regulation, and American and other carriers offer thousands of convenient on-line connections that did not exist in the regulated environment. At the same time, new entrant carriers are consistently entering the market with new aircraft, lower costs, and new ideas as to how to succeed in this crowded and mature marketplace. One or more low cost carriers operate on over 80% of the routes that American flies.

Cleary, competition has served the air traveler well. Shareholders and other stakeholders,

however, have not fared nearly as well. American is the only legacy network carrier that has never filed for bankruptcy, and since the turn of the century we have lost billions of dollars. Since 2000, we have had only one profitable year – 2006 in which we eked out a profit margin that equates to roughly 1%. These results remind us that competition in this industry is not only dynamic, it is often brutal.

Each day the people at American are monitoring the market and are making pricing decisions on thousands of routes. In doing so, they are acting on an experience base that tells them, first, that air travelers are motivated by small differences in price, and second, that we are operating a network of interconnected routes, and decisions to retreat or change capacity on any individual route can affect other parts of the network. Given our cost structure and positioning in the marketplace, we believe that maintaining a robust network is a

competitive imperative. Our business folks are designing strategies that maximize our chances of success, and that success has been, and will always remain, inversely related to the success of our competitors. We are convinced that we have to be an aggressive competitor, and, in our business, that competition will always start with price.

Legal Advice In This Environment

As the world's largest airline operating in a highly competitive environment, we understand the importance of the antitrust laws to our market based economy. We have a long-standing antitrust compliance program, but the ambiguity in the law and the very competitive nature of airline industry make it a challenge to provide clear guidance on many questions under Section 2.

The best we can hope to accomplish as legal advisers, under these circumstances, is to sensitize our clients to potential Section 2 issues, and be prepared to answer questions in real

time, as issues arise. For reasons that I have already mentioned, prices do not remain constant in this business, and being non-competitive on price for even a short period of time can be costly. Thus, our advice has to be as real-time as the competitive market in which are clients are operating, and overly conservative advice can inflict substantial harm on the company. We do not have the luxury of a week to pull data and analyze issues, although we know that, if we end up in a dispute, those on the other side will review the data with the luxuries of both time and hindsight, and will be seeking to substantiate a position that is predetermined by the requirements of its claim. As I will explain shortly, I believe that Spirit was able to avoid summary judgment only by employing this sort of after the fact analysis.

Moreover, we have learned through experience that the DOJ's attorneys and economists have their own views of competition in the airline industry,

and those opinions are sometimes at odds with our own perceptions. Although we have the right to challenge these factual and legal assumptions, as we did in defending the case brought in Wichita, this is a position that we desperately want to avoid. Given the punitive nature of the antitrust laws and the inevitability of follow-on private class action litigation, which includes the prospect of treble damages, defending ourselves in this situation, irrespective of the courage of our convictions, is high stakes poker. Thus, I can think of several examples in which we have given advice or altered our conduct based not on what we thought was illegal, but on what we feared others might argue is illegal. In these circumstances, competition is likely being compromised.

Our experience with the DOJ in its predation case illustrates how Section 2's lack of clarity can lead to significant disagreement between industry and enforcement agencies, and how, at

least in our opinion, that overly aggressive enforcement action can threaten to harm the competition that the antitrust laws were intended to protect. It is important to note, however, that although we disagreed with the DOJ's theories and decisions in that case, we have never questioned the good faith of those who were involved at the DOJ. Despite differences of opinion, I have no doubt that those who decided to pursue the case against American believed in the merits of their arguments and believed that they were fulfilling their obligation to protect competition and consumers. Indeed, if they are like most lawyers that I know, I suspect that, despite the loss, they still believe they were right, and it was the courts that got it wrong. These good-faith, but extremely important, disagreements simply highlight the problems with the current state of jurisprudence under a Section 2 predation claim.

Discussion of AMR and Spirit

I now intend to turn to our dispute with DOJ in some more detail, and I would like to begin by putting that dispute in its historical context. In the mid to late 1990s, the airline industry, like the rest of the U.S. economy, was operating near the peak of the business cycle. American and other large network carriers were profitable, and although those profit margins were generally in the single digits and modest when compared to other industries, they were very good when compared to the industry's historical returns.

In response to these market conditions, a number of new entrants entered the market. Some, such as AirTran and Frontier, are still flying today, and are generally perceived as being successful. Other new entrants, that were less well managed and financed, have disappeared. The failure of some new entrant service led to concerns that the markets were failing and that the actions of incumbent airlines, like American, in matching

new entrant pricing and expanding output were harming airline competition. Studies were commissioned that purported to show that airlines were operating from "fortress hubs." The Department of Transportation even considered re-regulating pricing in the industry when an incumbent carrier matched prices or expanded output in response to new entry.

That regulatory initiative, fortunately, failed, and the following five or so years demonstrated that the marketplace for airline services was more dynamic and resilient than the advocates of regulation had imagined. By the early 2000's, JetBlue and other new entrants had proven that a well financed and managed new entrant could succeed, and ironically, much of this new growth was in the locations like Denver and Atlanta, which were once among the alleged hub "fortresses." Even more ironically, the alleged predators, like American and Northwest, either filed for bankruptcy

or teetered on the brink, while new entrant, low cost carriers became the most profitable and fastest growing segment of the market.

DOJ's case against American and Spirit's case against Northwest raised an array of legal and factual issues, but, for illustrative purposes, I am going to focus on two of the most important: (1) the relevant market, and (2) the appropriate measure of costs for determining predation.

Let me start by addressing how the Sixth Circuit dealt with the question of relevant market in the Spirit decision. As mentioned, in that case Northwest matched Spirit's pricing and increased capacity on routes served by Spirit, which arguably forced Spirit to exit from these routes. Yet, even after Northwest reduced its price and incurred additional costs in expanding output, its revenues on the route exceeded any reasonable measure of its average variable costs. As a result, if the relevant market was defined as airline services on

these routes, Spirit's case failed because it could not show that Northwest had priced its product below an appropriate measure of its costs, as required by Brooke Group. These undisputed fact led the District Court to enter summary judgment.

The Sixth Circuit reversed on appeal. The court concluded that Spirit and its experts had established a genuine issue as to a different definition of relevant market, one that divided passengers flying on the same airplanes. In order to reach the conclusion necessary for its claim – that is, that Northwest's revenues in some relevant market were less than its variable costs -- Spirit's experts had to exclude some portion of revenue that Northwest was earning on these routes during the alleged predation period. To accomplish that objective, they argued that revenue from two types of passengers should be excluded: (1) those traveling on these routes with a connecting itinerary, and, even more surprisingly, (2) those

that paid more than $225 for a ticket. That analysis, of course, was completely unrelated to any analysis that Northwest would have undertaken at the time it decided to add and price new capacity on these routes. Northwest, instead, would have asked a more straight-forward and appropriate question; that is, with new lower fares and additional capacity would it be able to generate sufficient revenue, from any and all types of passengers, to cover its costs? A yes answer to that question should have been the end of Spirit's claims. Spirit's segregation of passengers who paid more than $225 from those who paid less than $225 into separate relevant markets is an artificial, after the fact, analysis that should not have created any genuine issue of fact.

This is a decision that harms, rather than promotes, competition. The endorsement of this contrived analysis, at least for purposes of avoiding summary judgment, puts incumbent carriers

in the no win situation of either (1) not competing on price and product for every passenger, or (2) recognizing that it may have to face a treble damages jury trial brought by a competitor, if it should be too successful in the marketplace. Pricing and capacity decisions in the airline industry are made in the context of a very dynamic marketplace, and no airline can possibly anticipate how the next plaintiff may segregate passengers on the same aircraft into separate relevant markets, each of which must independently meet the tests under a predatory pricing claim.

I would now like to turn to the question of determining whether a defendant priced its product below an acceptable measure of costs. This issue, of course, provided the basis upon which American prevailed in its case against the DOJ. It was also, perhaps, the most hotly disputed issue in that case, since the facts showed early on that American's revenues on the routes exceeded its

average variable costs. This caused the DOJ to develop alternative tests, and American had to argue against cost measure that included at much as 97% of total costs and others that argued, in essence, that Americans' decisions failed to maximize profits. My point for purposes of this hearing is simply this: there was a great deal of disagreement as to what items of cost were properly included, how these costs should be calculated, and how revenue should be attributed to incremental costs. Although American prevailed on this basis, the Tenth Circuit's decision left many of these disputed questions unanswered. Like any good decision, the Tenth Circuit's ruling answered only the questions that needed to be addressed to reach its decision. Although the appellate court properly rejected the DOJ's cost theories, it did not leave a roadmap as to how costs should be measured in the next airline predatory pricing case. The Tenth Circuit also left unanswered the

important question of whether there should be a meeting competition defense in a Section 2 case.

The problem of residual uncertainty in the Tenth Circuit concerning these questions, however, is not nearly as problematic as the Sixth Circuit's treatment of this question. In what is certainly the most troubling statement in its decision, the court stated:

> [E]ven if the jury were to find that Northwest's prices exceeded an appropriate measure of average variable costs, the jury must also consider the market structure in this controversy to determine if Northwest's deep price discounts in response to Spirit's entry and the accompanying expansion of its capacity on these routes injured competition by causing Spirit's departure from this market and allowing Northwest to recoup its losses and to enjoy monopoly power as a result.

This statement from the Sixth Circuit offers no objective standards for distinguishing aggressive conduct by a large, but efficient, incumbent in the marketplace. It is inconsistent with the dictates of the Supreme Court in this area of the law, and it constitutes an open invitation for juries and

courts to condemn aggressive competition in order to protect less efficient, but smaller, competitors.

Final Observations and Recommendations

I want to wrap up my comments by offering some specific suggestions concerning Section 2 enforcement.

First, given the ambiguity in the law, and the harm that a false positive can have in this area of the law, regulators should proceed very cautiously. I suggest that, especially in the context of a pricing case, regulators and courts should consistently heed the Supreme Court's guidance that well founded claims are extraordinarily rare, and that overly aggressive enforcement can harm the competition that the antitrust laws were intended to protect. Predatory pricing claims are not an area of the law where regulators should pursue aggressive new theories or rely on untested economic theories.

Second, markets are more resilient than is often appreciated at the time. The experiences in our industry have debunked many of the theories and assumptions concerning the market -- like that of the fortress hub -- that motivated the Department of Transportation to consider re-regulating the industry, and encouraged the DOJ to file its lawsuit against American. Trusting markets to address perceived shortcomings is often the policy.

Third, definitions of relevant market should align with the competitive environment, as it was perceived at the time by those whose conduct is being contested. Relevant market definitions contrived by lawyers and economists after the dispute has ripened are often motivated by a pre-determined result and almost always fail to account for the full complexities of the market.

Fourth, there should be a meeting competition defense under Section 2. Such a rule would provide a clear line, and matching a competitor's prices,

in the hopes of competing for every last customer, is exactly what competitors are supposed to do. A competitor that cannot survive in the market at the price point it has chosen is not the type of efficient competitor that the antitrust laws should be protecting.

Finally, since aggressive competition and predatory conduct share the same characteristics, careful thought needs to be given to remedies before regulators commence litigation. Indeed, there were times when we would have liked to resolve our dispute with the DOJ, but we could not find any remedy that we did not consider competitively debilitating and that the DOJ staff considered acceptable. A predatory pricing claim is plainly an area of the law where over intrusive remedies can do far more harm than good.

I hope that the committee has found these comments useful, and I look forward to the moderated portion of our session.