S. HRG. 105–936

AIRLINE COMPETITION

HEARINGS

BEFORE A

SUBCOMMITTEE OF THE

COMMITTEE ON APPROPRIATIONS

UNITED STATES SENATE

ONE HUNDRED FIFTH CONGRESS

FIRST AND SECOND SESSIONS

SPECIAL HEARINGS

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CONTENTS

TUESDAY, OCTOBER 21, 1997

THE IMPLICATIONS OF AIRPORT DEREGULATION

THURSDAY, MARCH 5, 1998

BARRIERS TO AIRLINE COMPETITION

TUESDAY, MAY 5, 1998

AIRLINE TICKETING PRACTICES AND ANTITRUST ENFORCEMENT

THE IMPLICATIONS OF AIRPORT DEREGULATION

TUESDAY, OCTOBER 21, 1997

U.S. SENATE,
SUBCOMMITTEE ON TRANSPORTATION
AND RELATED AGENCIES,
COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 1:44 p.m., in room SD–124, Dirksen Senate Office Building, Hon. Richard C. Shelby (chairman) presiding.

Present: Senators Shelby, Gorton, Bennett, and Byrd.

NONDEPARTMENTAL WITNESSES

STATEMENT OF DR. STEVEN A. MORRISON, DEPARTMENT OF ECONOMICS, NORTHEASTERN UNIVERSITY, BOSTON, MA

OPENING REMARKS OF SENATOR SHELBY

Senator SHELBY. The committee will come to order. We will go ahead and start. My colleagues are still in a caucus, but we do this every Tuesday.

I want to thank each of our witnesses for coming here today to share their expertise on an issue which affects thousands of Americans every day, that is, competition in the aviation industry.

The purpose of our hearing today is to examine a number of obstacles to free market competition among airlines in America and to determine what additional tools, if any, would be necessary for the Federal Aviation Administration to carry out its job in an environment in America of increased airline competition which all Americans I believe profit from.

The Fiscal Year 1998 Transportation Appropriations Conference Report provided a first step I believe in increasing competition at one airport in America by strengthening the competition allowed under the Wright Amendment at Love Field in Dallas, TX. The Wright Amendment inhibited competition in the Dallas-Fort Worth Metroplex by prohibiting direct service out of Love Field to any State which did not border Texas. Our bill changed the Wright Amendment to expand the number of States to which commercial jets may fly out of Love Field.

My preference would have been to repeal the Wright Amendment in its entirety so that all States could have greater competitive access to Dallas, TX, and final destination points served from there.

But in order to get the bill passed, I agreed to accept this first step—and it is a first step, but a big one—for the time being.

The purpose of this hearing today is to look beyond the initial step Congress made on access to Love Field and to look more broadly at barriers to competition across the entire national airport system. We want to explore and we want to consider what steps could and should be taken to inject greater competition into the Nation's system of air transportation.

We want to discuss other anticompetitive restrictions in place at other airports across the country. For example, four airports, Chicago's O'Hare, New York's LaGuardia and Kennedy, and Washington National, are governed by what we call the high density rule, and Washington National is also subject to a perimeter rule.

We hope to gain a better understanding today of how these restrictions affect competition, ticket prices for consumers, and the safety of our Nation's airspace. We also want to have a better understanding of how increased competition will have an impact on resource requirements for the FAA and the complexity of FAA's air traffic management mission.

The hearing will consist of two panels. The first panel will be composed of experts in the field of aviation economics and aviation marketing. Dr. Steven Morrison—Dr. Morrison, thank you for coming—professor of economics at Northeastern University is our first witness. And he has authored numerous articles and books on the airline industry and airline deregulation.

Our next witness is Dr. Fred Allvine. Is that correct?

Dr. ALLVINE. Yes.

Senator SHELBY. From Georgia Institute of Technology. Dr. Allvine is professor of marketing at Georgia Tech and has testified before the Congress on a broad range of issues, including competition in the industry.

Our last guest on the first panel is Dr. Jay Sterling, professor of marketing and logistics at the University of Alabama in my hometown of Tuscaloosa. Dr. Sterling has a 25-year career in the field of logistics and transportation and has written numerous articles on the subject during that time.

For the second panel, we have two representatives from the Department of Transportation. We have Mr. Jeff Griffith, Planning Director for the Air Traffic Operations at the Federal Aviation Administration. Mr. Griffith has extensive personal experience with airspace management and can speak definitively on the safety aspects of increased airport deregulation.

Finally, we have Mr. Pat Murphy, Deputy Assistant Secretary of Transportation for Aviation and International Affairs. Mr. Murphy has more years of experience at the FAA than his youthful appearance would indicate and is one of the most knowledgeable and thoughtful individuals in Washington on these matters.

I want to thank all of you for being here today. I think it is very important that we build the record, and this will be the first of some of the hearings we will address this issue before our Subcommittee on Transportation Appropriations, as well as the authorizing committee will do the same thing.

Your written testimony will be made part of the record in its entirety and, Dr. Morrison, we will start with you, if we can, anything you want to say.

Dr. MORRISON. Thank you, Mr. Chairman.

If I may give a brief summary of the effects of airline deregulation to provide a context for what we are going to be talking about in this panel and the next panel.

Senator SHELBY. You proceed. Yes, sir.

STATEMENT OF DR. MORRISON

Dr. MORRISON. From 1977, a year before deregulation, to 1996, we have seen about 31 percent more carriers per route. Long-haul routes have seen more entrants however. But as important or perhaps more important of how many carriers are entering, the question and the issue of who is entering. Deregulation has spawned the growth of the former intrastate carriers, particularly Southwest Airlines and new entrant carriers that typically have low cost and charge low fares.

In 1996, low-cost, or that is new entrant, carriers provided 18 percent of domestic passenger miles up from zero before deregulation, but that 18-percent number minimizes or understates the true effect of low-cost carriers because their presence in a market spreads beyond the number of miles that they provide. Low-cost carriers now are influencing fares in about 40 percent of U.S. city-pair markets.

The costs of providing service, costs per available ton-mile, are down 28 percent. The percentage of seats filled are up 25 percent.

The reason we care about these things is their impact on consumers and particularly their impact on fares.

Senator SHELBY. Dr. Morrison, would you repeat what you just said for the record about the cost?

Dr. MORRISON. Costs per available ton-mile are down 28 percent since 1977.

Senator SHELBY. OK.

Dr. MORRISON. This, of course, has implications for fares. If we compare yield, average fare per passenger mile in 1977 with 1996, down 40 percent. Now, anyone who looks at yield statistics will observe that there has been a downward trend in those figures since 1926 when the first data was gathered. So, the question of how much can we contribute to deregulation comes up.

Work I have done with Cliff Winston of the Brookings Institution suggests that about 60 percent of the decline in fares is due to deregulation. The other 40 percent would have happened anyway. So, fares are about, we think, 25 percent lower today than they would have been had regulation continued.

If we look at the effect in a more disaggregate level to see the role of new entrants, if you look at routes that have no new entrants or not serve any entrant carriers, fares are just 15 percent lower at those airports.

If we look at the other end of the spectrum at routes that have Southwest Airlines and other new entrants serving them, fares are 54 percent lower in 1996 than they were in 1978.

Fares are down on average, but not everyone has gained. Our work indicates that routes carrying about 80 percent of passengers to have lower average fares and that accounts for 90 percent of the passenger miles since these tend to be longer routes.

Overall, about $20 billion in savings attributed to deregulation fare savings, time savings, convenience, when we take all of the factors into account.

But as this hearing indicates, there are some trouble spots remaining and I want to spend the remainder of my time, such as it is, talking about some work I recently did on the effect of the Wright Amendment, perimeter rules, and slots on airfares.

The Wright Amendment creates an artificial scarcity at Love Field by limiting service to the four contiguous States. I took a look at the effect that that regulation and the relaxation that was recently passed that the three new States would have and found that fares to those three States are 44 percent higher than they would be once your amendment to the Wright Amendment takes place. So, 44 percent higher, about $72 a round trip, conservatively about $11 million a year.

If we considered the Wright Amendment being eliminated entirely and thus Love Field could provide competitive pressure in principle for all flights from Dallas-Fort Worth, the figure that I came up with was 76 percent. Fares are 76 percent higher to the noncontiguous States than they would be were there not a Wright Amendment. That's $133 a round trip or a whopping $800 million a year in higher fares.

Senator SHELBY. Explain that again, if you would. Seventy-six percent higher?

Dr. MORRISON. Yes.

Senator SHELBY. And that is because of the impediment there?

Dr. MORRISON. Yes; Love Field provides competitive pressure now against Dallas-Fort Worth for those four States that Southwest can fly to. Were that eliminated, my research indicates that the competitive pressure that Love Field would permit would—it currently causes fares to be 76 percent higher.

I have to caution, though, that although that's a big number, that that assumes that Dallas-Fort Worth could, in fact, be competitive for all flights to all destinations with Dallas-Fort Worth and it's not big enough to do that, but it does give an order of magnitude of how much these restrictions are influential, and on a route-to-route basis, I think the number is probably in the ball park. It is when one multiplies it by all routes that you get a number that may be a little too big to be fully believed.

So, the Wright Amendment by my reckoning creates multimillion, $800 million if you like, higher fares than would occur without it.

The perimeter rules that you mentioned at LaGuardia, a 1,500 mile perimeter, and Washington National a 1,250 perimeter, like the Wright Amendment these are restrictions that create an artificial scarcity designed to promote Kennedy Airport and Dulles Airport.

A similar analysis that I did of those airports finds that long-haul fares at Dulles are 25 percent higher than they would be without the perimeter rule, and long-haul fares at Kennedy are 14 percent higher than without the perimeter rule, amounting to about $100 million at each airport annually in excess fares.

Bottom line, if you add up the perimeter rules and the Wright Amendment, you get something on the order of $1 billion which is certainly significant——

Senator SHELBY. Dr. Morrison, would you explain just for the hearing here and the audience the origin of the perimeter rule and what it does?

Dr. MORRISON. Well, I do not know its origin, but what it does in order to protect the two airports, Kennedy and Dulles, it limits flights from LaGuardia to airports within a 1,500-mile radius and it limits flights to and from National to airports within a 1,250-mile radius. Its origins I do not know, but designed to protect Kennedy and Dulles and push long-haul traffic to those airports in a similar vein to what the Wright Amendment does for Dallas-Fort Worth.

Senator SHELBY. And how much is the estimated cost to the consumer on that?

Dr. MORRISON. About $100 million each for the perimeter rules for each of the two airports.

Senator SHELBY. $100 million each.

Dr. MORRISON. Yes.

Senator SHELBY. OK.

Dr. MORRISON. Now, I treat slots separately because slots are a somewhat different issue because the Wright Amendment and the perimeter rules create artificial scarcities. That was their intention.

The high density rule which implemented slots was designed in 1969 to combat congestion, and so it does not create an artificial scarcity but was an attempt to deal with the real scarcity of landing and takeoff opportunities at those airports, airports of National, LaGuardia, and O'Hare and Kennedy, although my work shows that fares at Kennedy are not any higher than they would be elsewhere. But fares at National, LaGuardia, and O'Hare are some 11 to 15 percent higher than flights by the same carriers for comparable distances. That amounts to about $33 to $44 a round trip.

It is not clear, though, that eliminating slots would make people better off. The fact that slots have value—and one reads about values in the low millions of dollars for the right to take off and land at one of these airports in a peak period—indicates that if the slots were removed, the number of carriers using the airport would increase and presumably congestion would increase. So, it is not clear that passengers would, in fact, be better off with slots removed and nothing put in their place.

I have written in the past about the benefits of congestion pricing. I mention it in passing here, that whatever problems there are with slots, they may well be better than no slots at all, but there are other policies that could help like congestion pricing.

PREPARED STATEMENT

The restrictions of perimeter rules and the Wright Amendment date from either literally the regulated era or shortly thereafter, and removing them would yield significant benefits perhaps in the hundreds of millions or even a billion dollars.

Thank you.

[The statement follows:]

Prepared Statement of Steven A. Morrison

INTRODUCTION

Domestic aviation was deregulated in 1978 with the passage of the Airline Deregulation Act, ending 40 years of tight regulation by the federal government. Although airlines may now serve the routes they choose and charge the fares that the market will bear, some regulations remain regarding use of airports. Following a brief history of airline regulation and an assessment of airline deregulation, this testimony analyzes the effect of the Wright Amendment, airport perimeter rules, and slots on air fares.

A BRIEF HISTORY OF AIRLINE REGULATION AND AN ASSESSMENT OF AIRLINE DEREGULATION

The aviation age began in 1903 at Kitty Hawk, North Carolina, when Wilbur and Orville Wright performed the first power-driven, heavier-than-air, controlled flight. It was just 11 years later, in 1914, that scheduled commercial passenger service began. For $5.00 the St. Petersburg-Tampa Airboat Line carried passengers 18 miles between Tampa and St. Petersburg, Florida. Significant growth in the industry would wait until after World War I, and then it was mail rather than passenger transportation that developed.

The first regular airmail service began in 1918, operated by the Post Office. By 1927, the Post Office had contracted out all airmail service to private carriers. Private carriage was feasible because the federal government undertook the expense of constructing the air infrastructure (e.g., lighted civil airways and beacons for navigation).

Aviation continued to develop during the early 1930's, despite the Depression, because of significant technical advances in aircraft design and manufacturing. Reacting to new problems, in 1934 Congress passed an act that divided control of air transportation among three agencies. This also proved unworkable because carriers submitted ridiculously low bids to one agency (zero in at least one case) to win a mail contract, knowing that another agency had the power to raise rates that were too low. Finally, in 1938 Congress passed the Civil Aeronautics Act, which remained basically unchanged until deregulation in 1978. To implement the regulations, the Act created what was to become the Civil Aeronautics Board (CAB). This legislation, enacted during the Great Depression, reflected the widespread distrust of market forces that prevailed then and the belief that government regulation could improve the market outcome.

The Civil Aeronautics Act required carriers to have a certificate of public convenience and necessity issued by the Board. The 16 carriers operating when the Act was passed received "grandfather" rights and were granted certificates for the routes they served. Other applicants had to show that they were "fit, willing, and able" to perform the proposed service and that the service was "required by the public convenience and necessity."

Economists began criticizing CAB regulation as early as the 1950's. Gradually, more and more analysts accepted the position that the airline industry did not have characteristics that made economic regulation necessary. The critics argued that airline regulation had led to higher fares than would prevail in an unregulated market, yet the industry was not earning excess profits.

Since the Civil Aeronautics Act regulated "interstate air transportation," airlines operating only within one state were not subject to federal regulation. This aspect of the law set up an interesting "controlled" experiment of sorts: by comparing unregulated intrastate fares with fares on similar interstate routes, a measure of the effects of regulation could be obtained. One particularly influential study pointed out that in 1965 the fare charged by the intrastate carrier Pacific Southwest Airlines (PSA) between San Francisco and Los Angeles (338 miles) was $11.43, while the fare charged by CAB certificated carriers between Boston and Washington, D.C. (400 miles) was $24.65.[1]

In 1978, Congress passed and President Carter signed the Airline Deregulation Act. The overriding objective of the Act was reliance on competition. Entry regulations were phased out; since 1982 carriers have been free to enter any route they desire, as long as they are fit, willing, and able. Exit regulations were eliminated; carriers can now exit at will. Fare regulation was also phased out. In 1983, the CAB's authority over fares was eliminated. Carriers can charge whatever fares they desire. Finally, in 1985 the CAB ceased to exist; its remaining functions (e.g., review

[1] Michael E. Levine, "Is Regulation Necessary? California Air Transportation and National Regulatory Policy," Yale Law Journal, 74 (July 1965), pp. 1416–47.

of mergers, international aviation, consumer protection) were transferred to the Department of Transportation.

Without government restriction on route entry, airlines were free to enter (or exit) at will. Figure 1 shows the trend in the number of "effective competitor"[2] at the route level from 1977, the year before formal deregulation, through 1996. The number of carriers per route averaged about 1.7 in 1977 and rose to about 2.5 by 1986. Following the merger wave of the mid-1980's and bankruptcies in the early 1990's, there have been about 2.2 carriers per route since 1993, an increase of more than 30 percent since 1977.

In addition to the number of competitors on a route, the identity of those competitors is also important. Deregulation allowed entry by existing airlines into new routes but it also allowed the entry of new, usually low-cost, low-fare airlines into the industry. The extent of competition provided by these new entrants is shown in Figure 2, which distinguishes between Southwest Airlines and other new entrants. Competition by new entrants began rising immediately after deregulation until it reached a peak in 1985 at about 17 percent of domestic passenger miles. The importance of new entrants declined from 1985 until 1988 due to the acquisition of People Express by Texas Air Corporation in 1986 and the significant expansion of the prederegulation airlines. However, since 1989, the share of domestic passenger miles flown by new entrants has continued to increase and in 1996 reached nearly 18 percent, its all time high.

The extent of airline competition is of interest because of its effects on air fares. A simple way to look at the effect of deregulation on air fares is to see how air fares have changed relative to the overall price level. In particular, we can calculate real air fares by adjusting actual air fares by the changes in the Consumer Price Index (CPI). This is shown in Figure 3, which plots real airline yield from 1970 through 1996. (Yield is revenue per revenue passenger mile.) Real air fares have fallen under deregulation, regardless of when you consider deregulation to have started. As of 1996, air fares were 40 percent lower than their level in 1977. But can this decrease be attributed to deregulation? As the figure shows, yields had a downward trend even before the beginning of the deregulation movement. Here a counterfactual comparison is appropriate, in which actual deregulated fares are compared with what fares would have been if regulation had continued. Results of such a counterfactual for 1993 show that fares were 22 percent lower than they would have been had regulation continued.[3] From 1978 through 1993, the fare savings to travelers attributed to deregulation amount to $12.4 billion annually (1993 dollars).[4]

Table 1 takes a closer look and shows the average fare change on routes based on what types of carriers served them in 1996:4. Real fares on the average route declined by 32.2 percent between 1978:4 and 1996:4. However, the decline ranged from 14.7 percent on routes that were not served by new entrants in 1996:4 to 54.3 percent on routes that were served by both Southwest Airlines and other new entrants in 1996:4.[5]

AIRPORT RESTRICTIONS

Even though airlines have been "deregulated" as outlined above, legacies of regulation remain in the form of restriction on airport use.

The Wright Amendment

The Wright Amendment, enacted in 1979, placed restrictions on the use of Love Field in Dallas in order to protect Dallas-Fort Worth Airport (DFW). In particular,

[2] Because a simple count of carriers on a route would treat a carrier with a large market share as of equal importance as one with a small market share, a measure of competition that takes market share into account is appropriate. In particular, we use the inverse of the widely used Herfindahl index, which equals the sum of the square of each firm's market share. Thus, if two carriers each had a 50 percent market share, the Herfindahl index would be $0.50^2 + .0502^2 = 0.50$. Inverting gives two equal-sized competitors. The same result would occur with three carriers with market shares of two-thirds, one-sixth, and one-sixth.

[3] Of course, one has no way of knowing for sure what regulated fares would be. However a good guess can be made with an updated version of the fare formula that the CAB used during the last few years of regulation. See Steven A. Morrison and Clifford Winston, "The Evolution of the Airline Industry" (Washington, DC: The Brookings Institution, 1995).

[4] It should be noted that this figure does not take into account that the lower fares that most travelers enjoy today come at the expense of restrictions (e.g., minimum stay of a Saturday night) that are much more prevalent than during regulation.

[5] These figures suggest the importance of Southwest Airlines and other new entrants in generating fare savings under deregulation. However, these figures likely overstate this importance because, for example, Southwest and other new carriers may simply have entered those routes where fares were most out of line with costs. Had they not entered, other carriers may have.

airlines using Love Field may only offer flights to other cities in Texas or to the four contiguous states (Arkansas, Louisiana, New Mexico, and Oklahoma). A recent change to the Wright Amendment enlarges the list of approved states by three to include Alabama, Kansas and Mississippi. Love Field is the home base of Southwest Airlines, a low-cost, former Texas intrastate carrier. By prohibiting Southwest (or other carriers) from flying to non-contiguous states, airlines offering flights to non-contiguous states from DFW are subject to less competition than they would be in the absence of the Wright Amendment. Figure 4 shows, for 1978 through 1996, the extent by which fares from (or to) DFW to (or from) the three states covered by the recent change (before it took effect) exceed fares to the four contiguous states.[6] In 1996, the last full year of data available, fares to the three new states were about 44 percent higher than fares to the four contiguous states to which Southwest Airlines provides competitive pressure. This amounts to about $72 per round trip. A conservative estimate of its overall impact is $11 million annually.[7]

Figure 5 reports results of a similar analysis that compares fares to/from DFW to/from (all) non-contiguous states with fares involving the four contiguous states. Results for 1996 indicate that fares to non-contiguous states were about 76 percent higher than fares to the contiguous states, amounting to about $133 per round trip. However, this figure likely overstates the impact of removing the Wright Amendment completely because it assumes that "Southwest-style" competition could be offered to all domestic destinations that are served from DFW, which seems unlikely, given the market niches that Southwest and other low-cost carriers have chosen and the limited capacity of Love Field. However, if this limitation is not considered, the aggregate fare savings from eliminating the Wright Amendment exceed $800 million annually.

Finally, notwithstanding Southwest Airlines' significant contributions to the fare savings from deregulation outlined above, nonetheless, due to their dominant position at Love Field, they do charge higher fares there than they do on routes involving other airports they serve. Figure 6 shows that in 1996 Southwest charged 15 percent higher fares (about $18 per round trip) from Love than from other airports.

Perimeter Rules

Perimeter rules exist at New York's LaGuardia Airport and at Washington's National Airport. In particular, flights to or from LaGuardia that exceed 1,500 miles are prohibited as are flights to or from National that exceed 1,250 miles. Like the Wright Amendment, these rules are designed to limit competition among airports and promote Dulles Airport in Washington and Kennedy Airport in New York as long haul airports.

Figures 7 and 8 show results of analyses similar to that done for the Wright Amendment. In the Washington case, for example, average fares by carrier for flights to/from Dulles longer than 1,250 miles were compared with comparable flights (100 mile bands) by the same carrier that did not involve Dulles. The same procedure was used for flights longer than 1,250 miles. As shown in the figures, in 1996, long-haul fares at Dulles were nearly 25 percent higher ($83 per round trip) and at Kennedy they were nearly 14 percent higher ($48 per round trip). However, these figures likely overstate the impact of removing the perimeter rules because (see below) the ability of airlines at LaGuardia and National to exert competitive pressure on airlines at Kennedy and Dulles is limited because operations at the former two airports are constrained by "slots." Notwithstanding this qualification, removing the perimeter rules could save passengers in New York $100 million per year and save passengers in Washington $90 million per year.

Slots

Since 1969 there have been regulatory limits ("slots") on the number of takeoffs and landings that air carriers (and others) may conduct each hour at four major airports, Chicago O'Hare, New York LaGuardia, New York Kennedy, and Washington

[6] The results in the figure were obtained by first comparing average fares (including frequent flier tickets) that carriers charged to/from DFW to the four contiguous states with fares that the same carriers charged for flights of the same distance (using 100 mile bands) on routes not involving DFW. Next, the same procedure was used to compare fares from DFW to/from the three additional states. The results in the figure combine the two results in the following way. For example, in 1996 fares from DFW to/from the three new states were 8.9 percent higher than comparable flights elsewhere. Fares to/from DFW to the four contiguous states were 24.3 percent lower than comparable routes. Thus, fares from DFW to/from the three new states were $(1 + 0.089)/(1 - 0.243) - 1 = 43.9$ percent higher than flights to/from the four contiguous states.

[7] The estimate is conservative in that the per-passenger figure is (only) multiplied by the number of passengers who took one-way or single-destination round-trip flights (that returned to the initial point of origin). Thus, the number of passengers affected is understated.

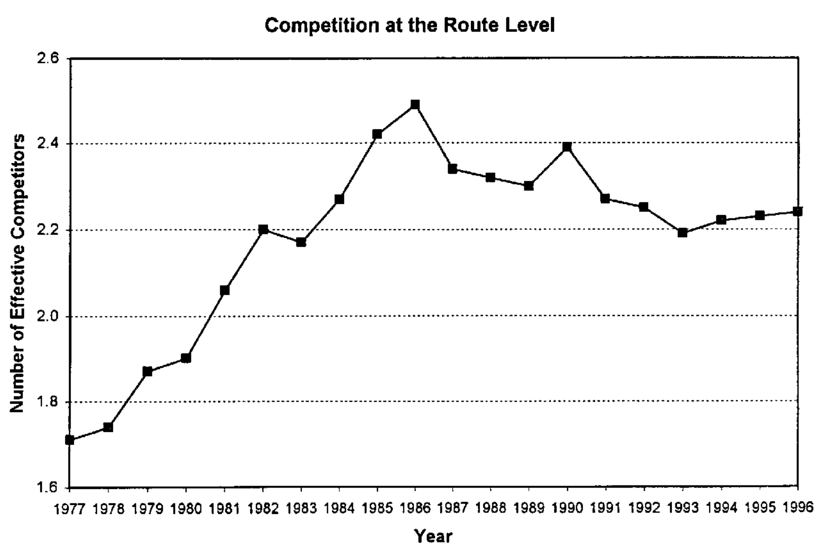
National. These limits mean a loss in departure frequencies and in the extent of competition, both of which hurt travelers on routes involving these airports. Figure 9 shows estimates of the extent to which fares by carriers operating at these airports exceed the fares those carriers charge for similar flights (100 mile bands) involving other airports. In 1996, these premia ranged from 11 to 15 percent ($33–$44 per round trip) on routes involving Chicago O'Hare, New York LaGuardia, and Washington National compared with what the same carriers charged for flights of similar distance (100 mile bands) that did not involve slot-controlled airports. Fares at Kennedy Airport were not higher than on comparable routes.

Unlike the Wright Amendment and perimeter rules, which were designed to reduce competition (among airports), slots were designed to reduce congestion. Nonetheless, slots do reduce competition. However, although eliminating slots may well reduce air fares, the increased trip times due to increased congestion could make travelers worse off overall. A better solution would be to eliminate slots and replace them with congestion pricing. Congestion pricing amounts to charging aircraft for their takeoffs and landings according to the cost of the delay that each aircraft imposes on other aircraft. During peak travel times, when one plane can delay many others, the cost would be high; during off-peak periods the cost would be low, perhaps nothing. Current airport fees are based on aircraft weight and have nothing to do with delay costs. Congestion charges should reduce delays from congestion by encouraging planes, especially general aviation and commuter planes, to use congested airports during off-peak periods or to switch to less congested airports.

SUMMARY AND CONCLUSION

Airlines were deregulated nearly twenty years ago, but vestiges of regulation remain in the form of constraints on airlines' use of airports. Table 2 summaries for 1996 the possible effect of eliminating these restrictions. Although the figures in the table overstate the likely effect of eliminating the restrictions because they assume that other constraints (e.g., airport capacity) are not binding, they do provide a perspective on the magnitude of the problem—on the order of $1 billion annually.

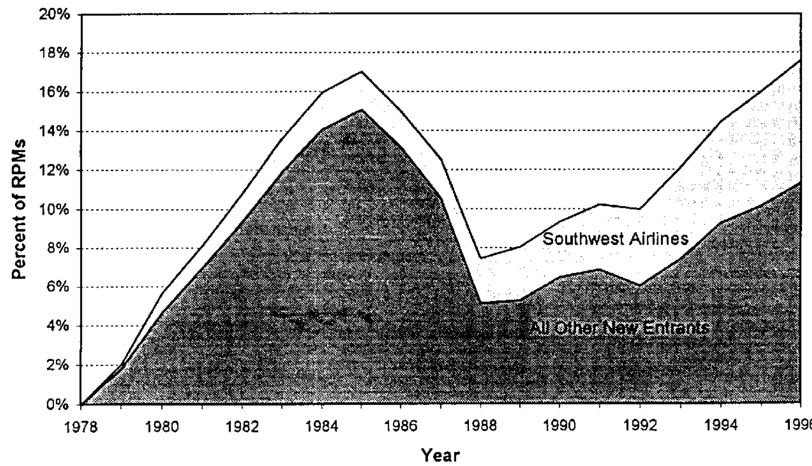
Figure 1



Source: Author's calculations from data in U.S. Department of Transportation, Data Bank 1A.

Figure 2

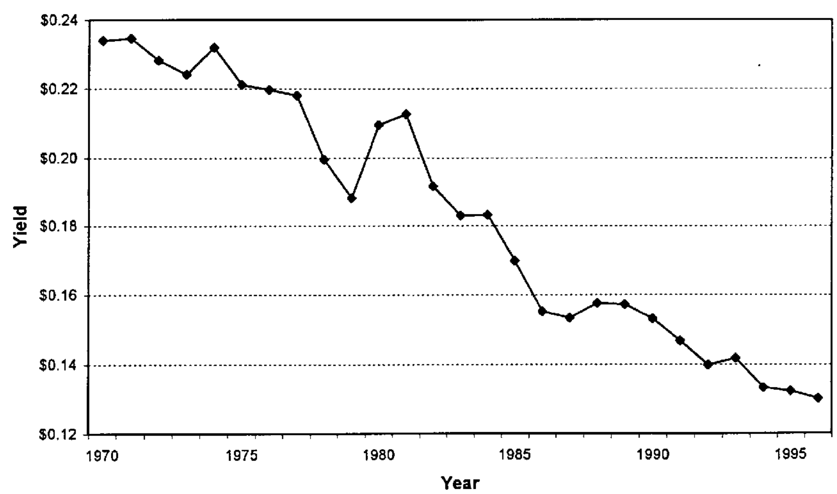
Percentage of Domestic Revenue Passenger Miles Flown by New Entrant Carriers



Source: Author's calculations from data in U.S. Department of Transportation, Form 41.

Figure 3

Average Fare Per Mile Adjusted for Inflation (Systemwide Operations: 1996 dollars)



Source: Author's calculations using data from the Air Transport Association.

Table 1.—Average Change in Real Fares between 1978:4 and 1996:4. For All Domestic Routes Served in Both Periods

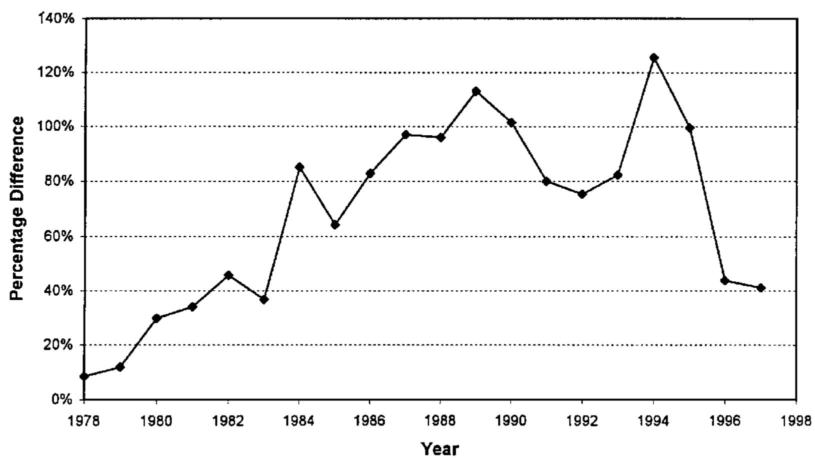
[Percent (Using 1996:4 passenger weights)]

Type of Route	*Fare Change*
Routes not served by new entrants in 1996:4 (5,983 routes)	−14.7
Routes served by new entrants in 1996:4 but not by Southwest Airlines (1,579 routes)	−30.5
Routes served by Southwest Airlines in 1996:4 but not by other new entrants (372 Routes)	−47.2
Routes served by both Southwest Airlines and other new entrants in 1996:4 (360 Routes)	−54.3
All Routes (8,294 routes)	−32.2

Source: Steven A. Morrison and Clifford Winston, "Regulatory Reform of U.S. Intercity Transportation," in J. Gomez-Ibanez, W. Tye, and C. Winston, eds., "Essays in Transportation Economics and Policy: A Handbook in Honor of John R. Meyer" (Washington, DC: The Brookings Institution, 1998).

Figure 4

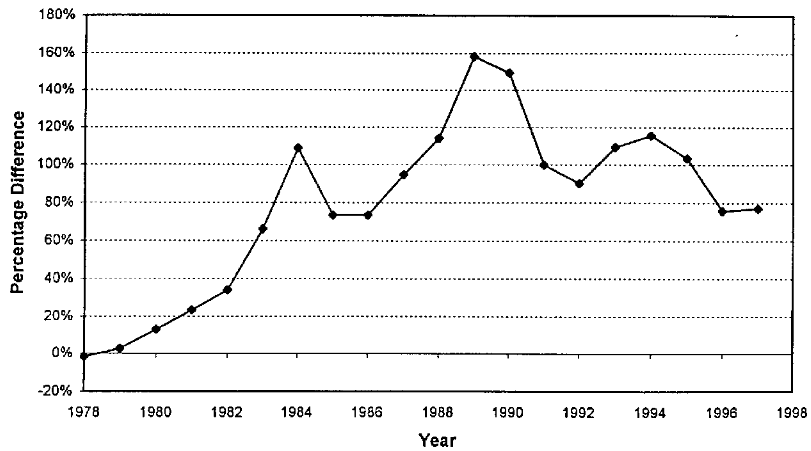
Fares from Dallas-Ft. Worth Airport (DFW) to Alabama, Kansas, and Mississippi Relative to Fares from DFW to Arkansas, Louisiana, Oklahoma, and New Mexico (adjusted for distance)



Source: Author's calculations from air fare data in U.S. Department of Transportation, Data Bank 1A. Data for 1978 are for the fourth quarter. Data for 1997 are for the first quarter.

Figure 5

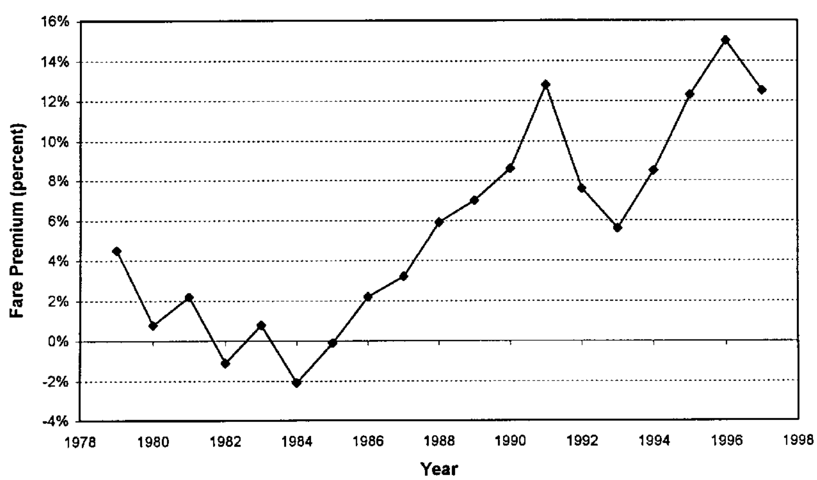
Fares from Dallas-Fort Worth Airport (DFW) to Non-contiguous States Relative to Fares from DFW to Contiguous States (adjusted for distance)



Source: Author's calculations from air fare data in U.S. Department of Transportation, Data Bank 1A. Data for 1978 are for the fourth quarter. Data for 1997 are for the first quarter.

Figure 6

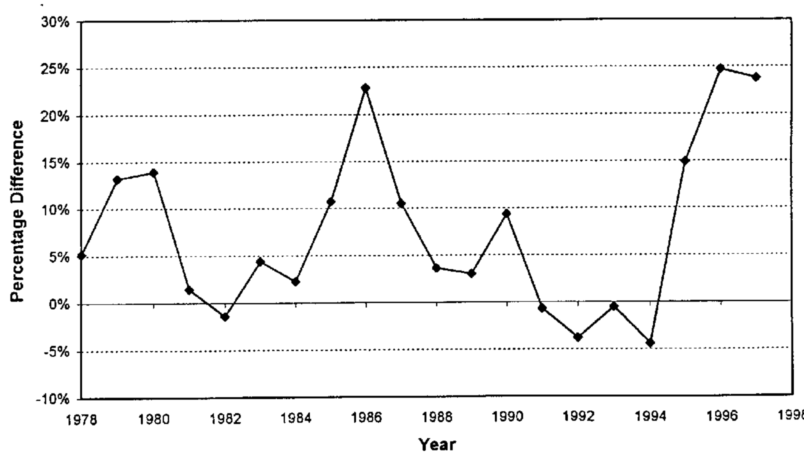
Southwest Airlines' Fares at Dallas Love Field Relative to their Fares at Other Airports (adjusted for distance)



Source: Author's calculations from air fare data in U.S. Department of Transportation, Data Bank 1A. Data for 1997 are for the first quarter.

Figure 7

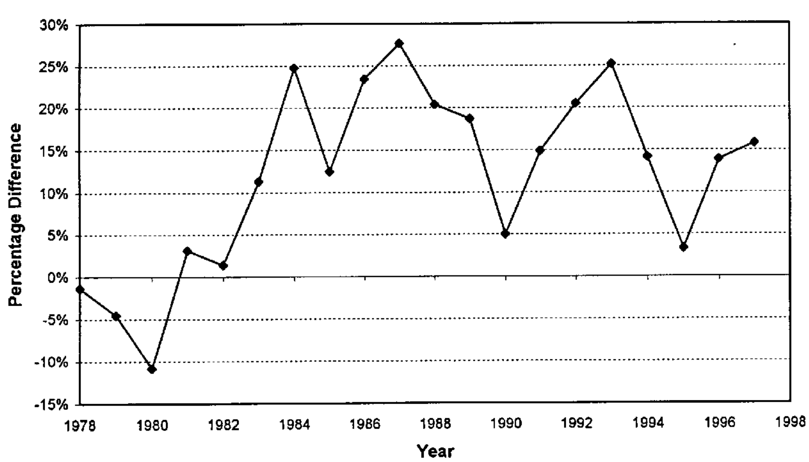
Fares from Washington Dulles on Routes Longer than 1,250 Miles Relative to Fares from Dulles on Routes Shorter than 1,250 Miles (adjusted for Distance)



Source: Author's calculations from air fare data in U.S. Department of Transportation, Data Bank 1A. Data for 1978 are for the fourth quarter. Data for 1997 are for the first quarter.

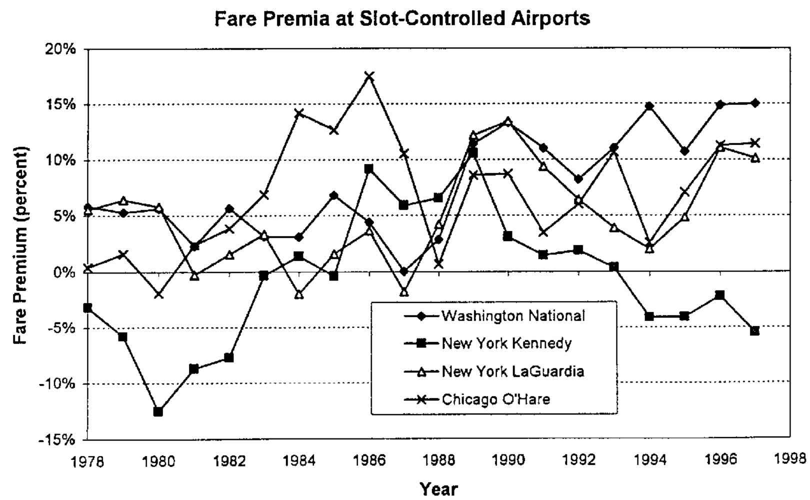
Figure 8

Fares from New York Kennedy on Routes Longer than 1,500 Miles Relative to Fares from Kennedy on Routes Shorter than 1,500 Miles (adjusted for distance)



Source: Author's calculations from air fare data in U.S. Department of Transporation, Data Bank 1A. Data for 1978 are for the fourth quarter. Data for 1997 are for the first quarter.

Figure 9



Source: Author's calculations from air fare data in U.S. Department of Transporation, Data Bank 1A. Data for 1978 are for the fourth quarter. Data for 1997 are for the first quarter.

TABLE 2.—THE EFFECT OF AIRPORT RESTRICTIONS ON AIR FARES

[Based on 1996 data]

Restriction	Cost		
	Percent	Per passenger (round trip)	Aggregate annual effect (millions)[1]
Wright Amendment	76	$133	$813
Perimeter Rules:			
At National	25	83	91
At LaGuardia	14	48	100
Slots:			
At National	15	44	
At Kennedy			
At LaGuardia	11	33	
At O'Hare	11	33	
Total			1,004

[1] Aggregate figures overstate the impact of eliminating these restrictions because other constraints would come into effect (e.g., Love Field does not have the capacity to exert competitive pressure for all flights from DFW to non-contiguous states. Aggregate figures are not given for slots because increased congestion could make passengers worse off on balance.

Source: Author's calculations. See text for details.

STATEMENT OF JAY U. STERLING, PH.D., C.P.A., ASSOCIATE PROFESSOR OF MARKETING AND LOGISTICS, UNIVERSITY OF ALABAMA, TUSCALOOSA, AL

Senator SHELBY. Dr. Sterling.

Dr. STERLING. I would like to start with some comments on the effects of deregulation as it applies to the hub and spoke system. As we all know, the hub and spoke system originated shortly after deregulation. The underlying goals were good, which was to take advantage of size and scope, economic, lock customers into using a carrier for the entire trip, and efficiently provide service to a broader expanded number of markets, and thereby squeeze smaller carriers out of major traffic lanes.

Although they are sound, in practice this hub and spoke system has created several major problems. Service to customers has deteriorated in the form of increased cancellations, late departures and arrivals, missed connections, and congestion. Does anybody really enjoy flying through a hub such as Atlanta, Dallas, or Chicago? Not me.

There is evidence that airfares originating and terminating at hubs are significantly higher than to and from outlying spokes. For example, if I want to fly to Dallas from Birmingham, the nondiscounted round-trip fare is $968. If I want to fly to Houston, which means I have to go through Atlanta, the fare is $307.

The number of flights into and out of these hubs has increased to such an extent that overcrowding capacity constraints are a severe problem, particularly during peak periods.

Because of the huge investments incurred to construct and build these hubs, carriers generally focus a disproportionate amount of time and effort on protecting these facilities against actual and would-be competitors.

Slots, or gates, become a premium commodity and are frequently controlled by the hub carrier in order to preclude increased competition such as Southwest.

Now, whenever customers are locked into using a single hub airport as their origin or destination, as I have said, airfares escalate to exorbitant levels. For example, if I want to fly to Atlanta, which is a 29-minute flight, it is $586; to Memphis, $529, another half-hour flight; to Dallas, $968, as I have said.

Conversely, whenever I can fly to a city with multiple airports, such as Chicago, Washington, DC, Detroit, I can get significantly lower fares, for example, to Chicago, $307. These are all nondiscounted Y fares that the business travelers typically use. To Washington, D.C. area for $250 and Detroit for $374. Why is this? Because each of these cities is served by multiple carrier airports.

And why? Because typically at a hub, an airline controls 60 to 80 percent of the traffic volume into and out of the hub.

I think the airlines have figured out that it is fruitless to fight for market share at these hubs when the principal carrier controls 60 to 80 percent of the business, and frequent flyer programs incent business travelers, which range between 60 and 75 percent of carriers' customers, to use the hub carrier for all of the trip's legs in order to gain necessary mileage. That is why fight for a few percentage points for a small piece of the pie when they can do the same thing at their own hub?

In a free market, competitive industry prices should put pressure on large carriers to transform themselves into airlines that look and operate like Southwest. That was the purpose of the Motor Carrier Act and one of the major purposes in the Rail Act, the Staggers Act in 1980. Those two acts have worked as they were intended to, but it has not worked in the airline industry.

One other area I need to cover before we leave deregulation is the area of customer service which is another major objective of deregulation. Service, in the form of on-time arrivals, length of flight times, baggage handling and stowage, comfortable, spacious seating has deteriorated, particularly in the past few years. Part of the problem is that the way the airlines report performance, on-time arrivals and on-time departures, is fictitious. It is smoke and mirrors. They have lengthened their flight times in order to make themselves look good. What we need to do is have measurements that measure themselves in the eyes of consumers, such as the number of cancellations, the number of missed connections.

Now, with respect to the Wright Amendment, I say rather than amend this amendment, I think that the whole thing, as you said, should be repealed. Allowing hub carriers such as American and Delta to set prices for the industry at DFW and determine and control the routes they wish to fly while simultaneously restricting low-cost carriers from both accessing the DFW airport and then trying to prevent them from flying similar routes from Love is both monopolistic and a restraint of trade.

How do we improve the airline environment? I have some specific recommendations I will briefly summarize.

We should encourage and nurture low-cost carriers by insuring that gates are made available at all airports and that they are included in the industry's proprietary reservation systems and not locked out.

Repeal all restrictive measures such as Wright.

Require that any price change to the airline fare clearing house must be offered for a minimum of 30 to 60 days. Today basically we have collusion and price fixing in the airline industry because they have access to the common reservation system that does not exist in any other industry I know of. They send signals to one another. Fares can last for 1 or 2 days as they send signals about what they like to do and they see, when they run it up the flagpole, if they do not get any reaction, they leave it stand. Otherwise, they pull it back based on what their competitors indicate with similar type of actions. By doing this, putting a fare in for 30 to 60 days, it might preclude some of this signaling.

Require that every gate owned by a carrier at a hub must be utilized a minimum number of times each weekday. This would prevent these carriers from gobbling up all the excess gates and trying to prevent other carriers from entering.

Stop penalizing industry's core market business travelers. One possibility would be to prohibit prices into a hub that are greater than the closest high volume destination through the hub. I do not know if this is practical, but something needs to be done. We talk about lower fares overall, but if you look at the Y class, the fares have accelerated, and those are the fares that most business travelers use because they make most of their plans at the last minute or have to change them.

Encourage and nurture travel agents rather than trying to put them out of business by continually cutting their commissions. Are these cuts primarily intended to reduce costs, or are they an attempt to stifle competition? Because as the role of travel agents declines, that means you have to call an 800 number or get it on the Web. Now, if I call Delta or I call American, they are not going to say, well, you can get a better deal on Northwest.

Encourage the major airlines to seek innovative ways to cut operating costs and overhead which is again, one of the major hoped for outcomes of deregulation, forcing carriers—and the same thing happened in the motor carrier industry and the rail industry—to cut costs.

Reexamine the hub and spoke concept. Is it as profitable as originally perceived given the huge capital investments, large fleets and manpower required to operate these facilities?

Is there a maximum size or capacity for a major hub beyond which frequent delays and turnaround times expand acceptable levels? This needs to be researched.

Have the airlines become so obsessed with catering to vacation, price-sensitive customers that long-term profitability is endangered unless they sock it to business travelers?

PREPARED STATEMENT

Finally, and I know this is controversial, but consider allowing foreign carriers to fly to destinations within the United States after their initial landing on the U.S. soil. This would certainly open it up for more competition.

That concludes my statement.

Senator SHELBY. Thank your, Dr. Sterling.

[The statement follows:]

PREPARED STATEMENT OF JAY U. STERLING

BACKGROUND INFORMATION

I am presently an Associate Professor of Marketing and Logistics in the Culverhouse College of Commerce and Business Administration at the University of Alabama in Tuscaloosa, Alabama. I have been employed by the University since 1984. My area of expertise and research interests focus on transportation and logistics management, the measurement and evaluation of marketing and distribution costs, and the determination of the profitability of business segments. I teach both an undergraduate and graduate course in logistics and a graduate course in marketing profitability analysis.

During my academic career, I have conducted over thirty research and consulting projects that were funded by either Alabama based or large national and multi-national firms. All of these projects involved transportation and/or logistics issues and concerns. I have also either conducted, or been a speaker at, over 100 transportation/logistics executive development seminars sponsored by various universities (e.g., Michigan State University, Northwestern University, the Universities of South and North Florida and the University of Alabama) and professional organizations (e.g., the Council of Logistics Management).

Prior to working on my Ph.D. at Michigan State University from 1981–1984, I spent twenty-five years in industry. I began my working career in 1956 with the international public accounting firm of Arthur Andersen & Company. In 1959 I joined Whirlpool Corporation, first as an internal auditor and then as a tax accountant. In 1967 I became the Controller for the newly created Physical Distribution/Logistics Division. As such, I was responsible for: Designing and managing the company's transportation and warehousing accounting systems; supervising all budgeting related activities; and, providing the data required to negotiate transportation and warehousing rates. In 1971 I was promoted to Director of Logistics Planning for the same division. In this capacity I supervised the development and implementation of the division's annual and long-range business plans, coordinated the division's data processing/management information systems resources and developed and measured the financial and customer service performance metrics for all logistics related activities.

In 1976 I left Whirlpool Corporation to become Director of Distribution for Heil Quaker Corporation (now International Comfort Products) in Nashville, TN. This company was a wholly owned subsidiary of Whirlpool at the time, but was subsequently sold to Inter City Products. Heil Quaker manufactured and sold central heating and cooling products. I was responsible for administering all logistics related activities: Transportation, warehousing, customer service/order management, forecasting/production planning and the private fleet operation.

From 1979 to 1981 I served as director of Distribution for The Limited Stores, Inc. in Columbus, Ohio. In this position, I managed all transportation activities from both our domestic and international suppliers into our Distribution Center in Columbus, as well as outbound to our retail stores, including a large private fleet operation. I also supervised a work force of approximately 220 people who processed, ticketed and distributed merchandise to our stores.

I have been an active member of the world's largest logistics based professional organization, the Council of Logistics Management since 1971. I have also published articles in all of the major transportation/logistics focused journals; including the Transportation Journal, the Journal of Business Logistics, the International Journal of Physical Distribution and Materials Management and Production and Inventory Management Review. I also serve on the Board of Directors of Mark VII, Inc., which is a large multi-modal transportation service company. Mark VII is the largest broker for intermodal and truckload transportation shipments and is also a leading "third party" provider of outsourced transportation and logistics activities. As such, it manages integrated logistics processes for fortune 1000 firms, such as Whirlpool Corp., Strohs, Coors, Frito-Lay, Oxy Chemical, Mobil Oil, Cott Beverage and Georgia Pacific. It also manages dedicated truck fleets for companies and is heavily involved with both air freight and marineland carriers in managing the import and export of containers for customers.

DEREGULATION IN THE AIRLINE INDUSTRY

Deregulation has literally revolutionized the transportation industry. Beginning with airlines (1978) and motor carriers and rail (1980), these Congressional acts have changed the way both shippers and carriers do business. The primary intent of deregulating any industry (e.g., financial institutions and telecommunications, as well as transportation) is to increase competition through a free market environment. Competitive market forces, in turn, should force managers of the firms involved to better control costs by increasing productivity and operating efficiency, provide customers with better service, and reduce the prices charged to customers. This theory has worked well in both the trucking and rail industries (notwithstanding the current Union Pacific/Southern Pacific merger related problems). Such is not the case in the airline industry. Airline industry analysts (both practitioners and educators) generally agree that the underpinning of the deregulation concept, a free market environment, has not flourished in a deregulated airline industry.

Initially, deregulation increased the number of competitors in the airline industry. However, with the exception of "feeder" (commuter) lines, many of these carriers have either merged or gone out of business in the ensuing 19 years. Operating profits of the scheduled airline industry have deteriorated. Only in the past two or three years have the largest carriers recorded profits. Many of these profits may be illusory, due to cutbacks and deferment of maintenance that eventually will have to be accelerated, and a looming horizon of significant new debt that will be required to replace a generally aging fleet. With the exception of Southwest Airlines, the major carriers have not solved their labor/management problems. A few, such as United (now effectively owned by its employees) have established low-cost operations to compete directly with Southwest's short-haul business. However, long-term they still face a problem similar to those faced by highly organized work environments (e.g., the U.S. auto, motor carrier and rail industries): How to restructure work rules and reduce uncompetitive wages that have resulted from years of suspect labor negotiations.

The industry has grown exponentially in terms of its infrastructure. Virtually every major carrier has restructured its service areas into a "hub and spoke" system. The goals underlying this concept were to take advantage of size and scope (economic), lock customers into using the carrier for the entire trip, efficiently provide service to a broader, expanded number of markets, and thereby squeeze smaller carriers out of major traffic lanes.

Although, in theory, these goals appear to be sound, in practice, the hub and spoke system has created several major problems, both for carriers and shippers:

1. Service to customers (passengers) has deteriorated in the form of increased cancellations, late departures and arrivals, missed connections and congestion (Does anyone really enjoy flying through a hub, such as Atlanta, Dallas or Chicago?)

2. There is evidence that airfares originating, and terminating at hubs are significantly higher than to/from outlying "spokes" (Please see Exhibit 1, which compares the non-discounted fares from Birmingham and Mobile Alabama.)

3. The number of flights into and out of these hubs have increased to such an extent that over crowding and capacity constraints are a severe problem, particularly during periods of peak business travel.

4. Because of the huge investments incurred to construct and build these hubs, carriers generally focus a disproportionate amount of time and effort on protecting these facilities against actual and would be competitors.

5. Slots (gates) become a premium commodity and are frequently "controlled" by the hub carrier in order to preclude increased competition, particularly from low-cost carriers, such as Southwest.

The final issue that must be addressed when discussing deregulation of the airline industry is "price". This industry is unique among all U.S. industries: It is possible, legally, to collude and jointly determine both pricing policies and specific, point-to-point airfares. To Airline Tariff Publishing Company (the airline fare clearing house) administers industry wide fares for all carriers. As a result "signals" are routinely sent by carriers to competitors in the form of fares possessing very short expiration dates. For example, it is possible for Carrier "A" to create monopolies in its strongest markets by threatening to cut prices in targeted competitor "B's" markets, if "B" tries to take share away from "A". Thus, this fare network is used to discipline dissidents, negotiate "common" fares, stifle competition, and thwart smaller and/or start-up carriers from offering discounts.

When this common sharing of fare information (signaling) is combined with the "hub and spoke" network several things happen:

1. Whenever consumers are locked into using a single hub airport as their origin or destination, airfares escalate to exorbitant levels. Exhibit 1 shows that if I want to fly from Birmingham Alabama to a hub with only one alternative airport, the fares will be significantly greater than if I were to fly to a hub city with competing airports.

For example the fare for the 29-minute flight to Atlanta is $586, to Memphis—$529 and to Dallas—$968.

Conversely, I can fly to Chicago for $307, to the Washington, D.C. area for $250 and to Detroit for $374. Why? Because each of these cities are served by multiple airports.

2. Fares to destinations beyond the monopolistic (single carrier) hub are typically less than to the hub itself. For example, I can fly to San Antonio for $445, to Lubbock for $448, to Albuquerque for $498, to Houston for $307 and to San Francisco for $601, versus the $998 it will cost me to fly to Dallas.

Why? Because one airline controls 60 percent to 80 percent of the traffic volume into and out of the hub.

Why does this dichotomy exist? I believe that airlines have figured out that it is fruitless to fight for market share when the principle hub carrier controls 60–80 percent of the market and frequent flyer programs incent frequent "business" flyers (60–75 percent of a carriers' customers) to use the hub carrier for all of a trip's legs in order to gain the necessary mileage required for free trips. That is, why fight for a few percentage points of a small piece of the pie, when they can do the same thing at their hub locations?

In a free market, competitive industry, prices should put pressure on large carriers to transform themselves into airlines that look and operate like Southwest (lower cost, no frills competitors)—in order to achieve sustained profitability. Unfortunately, Southwest is locked out of a majority of the U.S. airline reservations systems, as well as denied access to most of the major hubs because of the control of gates by the major hub carrier.

Research has shown that business travelers who account for upwards of 60 percent of passengers, normally pay the highest fares (non-discounted "Y" class) because of the need to make and change plans at the last minute. Therefore, the most important criteria when traveling is frequent and convenient on-time departures and arrivals. That is, they want the plane to arrive on-time, with no lost or damaged luggage. Time is money!

Before leaving this subject, we need to look at the area of customer service. This represents (or should represent) the output of a carrier's operations, and was one of the major, hoped-for benefits when the industry was deregulated in 1978. Unfortunately "service" in the form of on-time arrivals, length of flight times, baggage handling and stowage, and comfortable, spacious seating has deteriorated, particularly in the past few years. Based on my personal experiences as a frequent flyer and those of business acquaintances, the major airlines have not figured out this equation. They still focus on "frill" services, such as fancier meals, attractive gate areas, food courts at hubs and credit card or long-distance "deals". They invariably fail in providing sufficient time to make connections and minimizing flight cancellations. They are able to report consistently high on-time departures and arrivals to the federal government by resorting to "smoke and mirrors". For example a flight is officially counted as "leaving" when the ramp is pulled away from the plane, which can and does sit at its gate while luggage is still being loaded or the aircraft sits in the takeoff queue for lengthy periods. In order to make the numbers, airlines extend (pad) scheduled flight times to guarantee on-time arrivals, rather than address the real causes of these problems—over-worked ground crews and capacity constraints at hubs. Passengers now "carry-on" their luggage because they believe it won't get to their destination, will be damaged in-transit or will take too long to claim at congested airports. This has created a nightmare for flight attendants.

To summarize, deregulation of the airline industry has not achieved its primary goals of increased competition, higher service levels and lower costs. We should not infer, however, that deregulation in general is bad or won't work. One merely has to look at the successes achieved in both the motor carrier and rail industries to determine the significant benefits that can accrue to both carriers and shippers when carriers embrace and adopt the concepts of a free market environment.

WRIGHT AMENDMENT

The Wright Amendment was initially adopted in 1980 to insure that the Dallas Ft. Worth Airport (DFW) would protect the revenue stream required to pay off the bonded indebtedness incurred to build the airport in 1974. DFW is presently operating at or near capacity and recently completed a 3.5 billion dollar expansion to handle its continuing growth. Therefore, the need for this financial "security blanket" can no longer be economically justified. Rather than amend this amendment to redefine "56 seat" aircraft and add more states to its permissible geographic market area, the amendment should be repealed in its entirety.

If airlines are going to operate in an unregulated environment that fosters competition in a free market, fictitious barriers to market entry must be torn down. (Carriers can't have their cake and eat it too!). Allowing hub carriers, such as American and Delta, to set prices for the industry at DFW and determine and control the routes they wish to fly, while simultaneously restricting low cost carriers from both accessing the DFW airport (by denying them gates) and preventing them from flying similar routes and lanes from a competing site (Love Field), is both monopolistic and in restraint of trade!

This is not a Texas or Southeast issue. The Wright Amendment affects the heart of deregulation. Will carriers be permitted to fly from origins of their choosing to destinations they desire, will they be allowed to establish competitive prices without collusion with other carriers and will start-up, low cost carriers, be permitted to survive and grow into viable competitors? These are the real questions that need to be addressed.

Opponents to the repeal of the Wright Amendment contend that traffic congestion would increase since Love Field and DFW are only 6½ miles apart. This hasn't prevented Southwest from initiating over 130 flights a day. Nor is it a problem in other cities with multiple airports (e.g., Chicago, Detroit, Washington D.C. and Miami/Ft. Lauderdale).

Another argument against repeal is the noise that expanded service would impose on nearby residents. Since Love originated in 1917, the vast majority of the residential areas surrounding Love Field were consciously developed with the knowledge that an airport was adjacent to these residences. The following question needs to be asked: How will expansion of Love Field create additional problems, given the steady volume that already exists? Finally, American has threatened to transfer a portion of its daily flights from DFW to Love if Love's current restrictions are lifted. Is this a real threat or an attempt to usurp gates and control prices as it does at DFW?

HOW TO IMPROVE THE CURRENT AIRLINE ENVIRONMENT

In order to develop a free market environment with value based pricing, the airline industry must be converted to one that is founded on real competition. Some economists contend that an oligopolistic industry (a market that contains few suppliers) leads to higher prices and reduced competition. In practice, market concentration is often no advantage at all. A few heavy-weights fighting for a single market tend to do the work of many competitors, by increasing the degree of competition rather than diminishing it. Thus firms frequently piddle away their advantages.

For example, instead of coaxing consumers to buy higher quality, higher priced products, manufacturers in the packaged goods industry spend millions of dollars cheapening their products' images by offering allowances to retailers, coupons and price cuts. Two suppliers in the major home appliance industry account for two-thirds to three-quarter of the market (Whirlpool and General Electric) and the top five manufacturers account for 95 percent of the industry's annual volume. Competition is so fierce that price levels are virtually the same that they were in the 1970's. How have these firm's survived?—by constantly seeking improvements in manufacturing processes, information technologies and supply chain/logistics activities. Economists and CEO's have long associated high market share with high profits. Share has nothing to do with profits! If you want profitable market share, hire and develop better managers and produce better products/services!

In order to increase competition and thereby foster competitive, market based pricing in the airline industry, I recommend that Congress and/or the Federal Aviation Administration consider the following changes to existing laws and/or regulations:

1. Encourage and nurture "low cost" carriers by insuring that gates are made available at all U.S. airports and that they are included in the industry's proprietary reservation systems. That is, any airline that wants to fly out of an airport should not be barred from doing so.

2. Repeal all restrictive measures, such as the Wright amendment to encourage free access to all markets by any financially stable carrier. Legislation such as Wright restricts competition, hinders economic development and imposes undue costs on the flying public.

3. Require that any price change to the airline fare clearing house must be offered for a minimum of 30 to 60 days. This will drastically curtail the day to day signaling that permeates the industry and breeds collusion. Strictly enforce a ban on collusion.

4. Require that every gate "owned" by a carrier at a "hub" must be utilized a minimum number of times each weekday. This will prevent the dominant carrier from leasing gates to bar low-cost carriers such as Southwest.

5. Consider re-implementing the ban on predatory pricing that existed for all transportation modes prior to deregulation. That is, carriers should not publish regular (business related) fares that are less than their operating costs. This will reduce the present practice of socking it to segments that have no alternative choices in order to subsidize other customer groups or routes.

6. Stop penalizing the industry's core market, business travelers. One possibility would be to prohibit prices into a hub that are greater than the closest high volume destination through the hub (Thus the Birmingham to Houston fare would be the ceiling for the Birmingham to Dallas fare.).

7. Encourage and nurture travel agents rather than trying to put them out of business by continually cutting their commissions. Are these cuts primarily intended to reduce costs—or are they an attempt to stifle competition? Its very difficult to get the absolute best fare (regardless of the carrier) when one calls an airline's 800 number or accesses its Web site!

8. Encourage the major airlines to seek innovative ways to cut operating costs and overhead. For example why not outsource baggage handling activities, particularly at non-hub locations? A shared work force provided by a third-party firm would be more economical and efficient.

9. Reexamine the HUB and spoke concept. Is it as profitable as originally perceived, given the huge capital investments, large fleets and manpower required to operate these facilities? It certainly has not benefited the consumer. Missed connections, lost/damaged luggage, longer transit times, and cancelled flights are an everyday occurrence for most business travelers.

10. Frequent Flyer programs build brand preference/loyalty. The key questions are: Does this loyalty to one airline reduce competition? And, do these programs encourage airlines to not spend funds trying to please their customers? These issues need to be studied.

11. Is there a maximum size or capacity for a major hub, beyond which frequent delays and turn-around times expand to unacceptable levels? Should traffic at certain hubs be shifted to less busy airports? These concerns need to be analyzed and studied further.

12. Have the airlines become so obsessed with catering to vacation, price sensitive customers that long-term profitability is endangered unless they "sock it to" business travelers? The long-term profitability of carriers needs to be assessed, given the huge capital expenditures that are planned over the next ten years and recent decreases in maintenance spending.

13. Consider allowing foreign carriers to fly to destinations within the U.S., after their initial landing on U.S. soil. Several U.S. carriers are doing this in Europe and elsewhere. Such a move would significantly increase competition, worldwide.

Taken individually, the problems identified in this summary statement do not appear to be overly serious. However, when one combines them into a single profile, it is obvious that if the airline industry is to survive long-term and customers are to receive real value for their money, something more than a recommended patchwork approach is required. These recommended changes will also force major carriers to reengineer their business processes to reduce costs, and eliminate duplicate or non-value adding activities. Business Process Reengineering (BPR) is a concept that numerous companies in other industries have endorsed and adopted in order to increase their competitive position. The old approach of reducing workforces without changing by key processes and cutting wages are short-term approaches that frequently create more problems than they solve.

EXHIBIT 1.—COMPARATIVE NON-DISCOUNTED (Y) AIRFARES FROM ALA ORIGINS TO SELECTED DESTINATIONS AS OF OCTOBER 17, 1997

Birmingham to Dallas:	
Delta	$968.00
American	968.00
Continental	968.00
Northwest	970.00
Birmingham to San Antonio:	
Northwest	445.00
Continental	445.00
American	445.00
Delta	445.00
Birmingham to Lubbock:	
Northwest	448.00
Continental	448.00
American	448.00
Delta	448.00
Birmingham to Albuquerque:	
Northwest	498.00
American	498.00
Delta	498.00
American	498.00
Continental	652.00
Birmingham to Houston (Hobby Airport):	
Northwest	307.00
American	307.00
US Air	307.00
Delta	307.00
Birmingham to Houston (Intercontinental):	
Northwest	307.00
American	307.00
Continental	307.00
Delta	307.00
Birmingham to Boston:	
Northwest	1,302.50
Delta	1,300.49
United	1,300.49
US Air	1,300.49
Birmingham to Buffalo:	
Northwest	1,054.00
United	1,052.00
US Air	1,052.00
Delta	1,052.00
Birmingham to LaGuardia (New York):	
Northwest	1,054.00
United	1,052.00
US Air	1,052.00
Delta	1,052.00
Birmingham to Newark (Newark, NJ):	
Northwest	1,054.00
US Air	1,052.00
Delta	1,052,00
United	1,052.00
Mobile to Washington (National Airport):	
Delta	925.00
Northwest	295.00
Continental	386.00
Mobile to Baltimore (Washington):	
Northwest	1,021.00

Continental	1,019.00
Delta	1,073.00
Mobile to Washington (Dulles Airport):	
Northwest	295.00
Continental	386.00
Delta	925.00
Birmingham to Chicago (O'Hare):	
Northwest	307.00
United	307.00
Delta	307.00
US Air	307.00
Birmingham to Chicago (Midway): Delta	307.00
Birmingham to Washington (National):	
Northwest	854.00
United	852.00
US Air	852.00
Delta	852.00
Birmingham to Baltimore:	
Delta	250.00
US Air	250.00
United	250.00
Northwest	904.00
Birmingham to Washington (Dulles Airport):	
Northwest	854.00
Delta	852.00
US Air	852.00
United	852.00
Birmingham to Detroit:	
Northwest	374.00
Delta	374.00
US Air	374.00
United	374.00
TWA	374.00
Birmingham to San Francisco:	
Northwest	601.00
Delta	601.00
United	601.00
American	601.00
US Air	601.00
Birmingham to Seattle:	
Northwest	624.00
Delta	624.00
American	624.00
US Air	624.00
United	624.00
Birmingham to Memphis:	
Delta	529.00
Northwest	529.00
Birmingham to Atlanta: Delta	586.00
Birmingham to Charlotte:	
US Air	779.00
Delta	779.00
Birmingham to Mobile:	
Delta	553.00
Northwest	553.00

STATEMENT OF DR. FRED C. ALLVINE, PROFESSOR OF MARKETING, GEORGIA INSTITUTE OF TECHNOLOGY, ATLANTA, GA

Senator SHELBY. Dr. Allvine.

Dr. ALLVINE. Senator, I very much appreciate, applaud your undertaking these hearings. I think they are very important, as I will try to explain in a moment. It is courageous on your part that you do it. The airline industry would rather not have a careful examination of how the structure of competition has changed dramatically. There are considerable costs to questioning what has happened in the airline industry that I think we all fairly well understand.

Let me state that we just finished the 10-year anniversary of the stock market crash and the Government looked into the problems of the original crash and put in action to see that it did not happen again. And we went smoothly over this anniversary. Gray Friday and Black Monday we just passed.

We are now coming up on the 20th year anniversary of deregulation of the airline industry. If my math is any good, 1978, 1988, and 1998 will be the 20th year anniversary. I hope that other committees will look at deregulation and determine where it is working and where it is not working and try to fix what is not as good as it might be.

Let us look at the first decade following deregulation. The founders of deregulation in Congress hoped to stimulate competition, and there was a huge number of new entries. Fares remained very low. Competitive services were high.

The second decade I think is entirely a different situation, Senator. We have seen 95 percent of the airplanes that came into existence in the first decade following deregulation, they are gone. We see more than one-half of the airlines that were in business at the time of deregulation, they are gone: Eastern, Piedmont, New York, Republic, PSA. You go on and on and on and on.

Over the past decade, we have seen a dramatic change in the structure of competition. I think the committee needs to carefully look at what has happened in the United States. Our studies show that about one-third of the United States remains very competitive and has benefitted from deregulation. That is the western and the southwestern parts of the country. The eastern third of the country and the north-central part of the country are finding rapidly diminishing benefits of deregulation.

We had one of the longest price wars in the history of any industry in the early 1990's. It cost the industry $13 billion and it wiped out scores of competitors in the industry. What was created in its place were large hub airports in the major cities where airline concentration soared from 1978, 1988 to 1997.

The major airlines I believe are on a course to destroy the benefits of deregulation in the eastern half of the country and the upper midwest. You hear—and I think it is correctly stated—that they have developed a hub and spoke system and a fortress hub is increasingly——

Senator SHELBY. Doctor, how did they destroy the competition?

Dr. ALLVINE. With this price war that went on from 1990 to early—the mid-1990's, 1993, 1994, it just drove out of business. It was so bad that even Northwest and Continental sued American for its predatory behavior, and it just wiped out scores of competitors and left the airline industry very concentrated and increasingly concentrated in the eastern half and the north-central part of the country and came out of this thing the major airline hubs.

Studies from the GAO, even from the DOT, which we will hear from in a while, showed fares in hub markets are oftentimes 30 to 70 percent higher than in competitive markets. Atlanta, my home city. We will talk about that if we have a chance.

So, fundamentally what we have is a split personality of the airline industry. Deregulation has worked in the Southwest and the West. The rest of the country is being stifled. It has become increasingly concentrated with monopoly power to raise prices considerably above the competitor, and that is Minneapolis. And that is Chicago O'Hare. And that is Pittsburgh. And that is Cincinnati. And that is Atlanta, GA. And that is Dallas, TX, and the like.

So, I think that we have to look at and recognize what is going on. What the major airlines have done is they developed their high market share hubs and they protect them by predatory pricing. They lower prices 40, 50, and 60 percent only during the time when a low-cost competitor comes in, and once that competitor is gone, up goes the price. It is like a $40,000 automobile company lowering its prices temporarily to meet the prices of an $18,000 automobile company, driving out of business, then increasing their prices back. That is how ludicrous it is, Senator, of what is going on in this country.

What can be done? I think there are several things.

One, continue the hearings. The airline industry does not want careful examination of the efforts to wreck deregulation in the eastern part of the country. It is excellent what you are doing and I encourage you and applaud you. And I know there are costs to you and costs to me and costs to Georgia Tech that we speak out.

No. 2, have the GAO do some further studies and report back to you. Have them look at market concentration in the hubs and show how they have increased over the last 10 years.

No. 3, I recommend that Congress look at both the DOT and the DOJ and see if they are capable of using the authorities they have to protect competition in America. The study that we have done of the DOT behavior, it is pro large business time and time and time again. Even today, where the second wave of discount is virtually destroyed, the DOT is basically sitting on the sidelines like a major business publication and doing nothing to try to reinvigorate the competitive process.

The DOT did a study in April 1996, and they mislabeled the report. They talked about the low-cost airline revolution saving American citizens $6 billion. They saw it wrong, Senator. They should have looked at the other two-thirds of the country and shown that the monopoly powers were costing this country $10 billion or more.

So, I am suggesting to you, Senator, that it is very courageous to undertake these hearings and that more needs to be looked at, what we can do to make the airlines more competitive.

I think with one or two final comments, if I could, I would like to talk about Atlanta, GA.

Senator SHELBY. You go ahead.

Dr. ALLVINE. Atlanta, GA, is one of those hub cities. Eastern Airlines went out of business in the early 1990's like so many other airlines did as we had the price wars. The Federal Government did not do anything about those price wars. Delta's market share in Atlanta went up 50 percent. Delta became the monopolistic carrier on 65 percent of the flights or thereabout. They have no competition on 75 percent of the flights. They have 75 percent or more of the flights.

There was a major corporation based in Atlanta, GA, that a couple years ago instructed publicly their employees to fly any line but Delta Airlines if at all possible. The problem was there were no alternatives in that highly concentrated market.

Looking on at what is happening, just this past week I learned that the Chamber of Commerce—and it has not been in the newspaper—has asked for bids from consulting firms to look at what they can do in Atlanta, GA, to increase competition and to drive prices down in this market area. That is very serious when you take the home city of Delta Airlines, that the Chamber feels so threatened with these high fares, that something has to be done.

My final comment is I checked the fares to fly to Washington today. The fare to Dulles, where I came into, was considerably lower. The fare premium was 130 percent more for Delta Airlines to fly to Washington National than to Dulles. I said, gee, what about if we look at New York City. Let us compare Newark to LaGuardia. It was a 135 percent increase in terms of a slot-controlled airport.

You are looking at the right issues, Senator, and we need to look at predatory pricing. The Justice Department and the DOT talk about doing something on predatory pricing. They have done nothing. They have done absolutely nothing. They sit there while the second wave of discount airlines has almost been obliterated in this country.

PREPARED STATEMENT

So, unlike Steve, I am not very comfortable about what is happening in two-thirds of the United States. Deregulation is being destroyed by monopolistic practices in a growing portion of this country, Senator.

I thank you.

Senator SHELBY. Thank you, and I thank all of you.

[The statement follows:]

PREPARED STATEMENT OF FRED C. ALLVINE

OVERVIEW

I applaud this committee for starting hearings Examining Ways To Make The Airline Industry More Competitive. In a historical sense it is very appropriate to do this. Over the past few days there has been considerable discussion regarding the 10 Year Anniversary of the 1987 Stock Market Crash. Introspection into what went wrong led the Federal government to take steps to try and assure that such a meltdown would not happen again.

Next year will be the 20th Anniversary of De-regulation of the Airline Industry and I encourage this committee to take a long hard look at the extent to which de-regulation of the airline industry has and has not worked. There is no questions about the general benefits of de-regulation in the airline industry. However, I believe you will find on closer examination that several of the major large airlines are attempting to destroy de-regulation and replace it with their monopoly control over a large portion of the country.

I will first describe what generally has happened in the airline industry over the last twenty years. The discussion is divided into two time periods—the first and second decades following de-regulation. The designers of airline de-regulation wanted to increase competition and keep prices as low as possible. De-regulation was an unquestionable success over the first decade from 1978 to 1988. Large numbers of new airlines came into existence, the airline industry grew rapidly, and competition kept fares very low.

The second decade of de-regulation (from 1988–1998) has ushered in a new experience and the nature and structure of competition in the airline industry has changed dramatically. What fundamentally has happened is that the airline industry has developed a split personality over the last decade. Part of the U.S. remains highly competitive which is a consequence of de-regulation, but a large and growing section of the airline market is being monopolized. The big change in the structure of competition in the airline industry was associated with the four year price war in the early 1990's that cost an amazing $13 billion. Due in a large part to the massive price war 95 percent of the new entrants and many of the existing airlines were destroyed. I predict that historians will look back on this period and call it the rape of the airline industry.

The major airlines who benefited most from the huge price war developed high market share hubs in large sections of the country. Given the market power that they have developed, the major airlines have raised prices to far above the competitive level in their market hubs (as study after study has shown). Furthermore, the major airlines defend their high-price hub markets with predatory pricing. These markets are descriptively called "fortress hubs." One consequence of the destructive price wars and predatory pricing is that the major airlines are now earning record profits.

While a large part of the U.S. has been virtually monopolized over the last decade, there is still another part of the country that is benefiting from de-regulation. The Competitive Portion of the Country is the Southwest and West (approximately a third of the market) and the increasingly Monopolized Portion of the Country is the Eastern half of the country and the North-central Region (the remaining two thirds of the market). The dual personality of the airline industry (part competitive and a growing part monopolized) is confusing, but is critical to understanding this industry.

One does not have to be a genius to see the possible benefits of what could be accomplished if the competitive nature of the airline industry in the Southwest and West were introduced in the remainder of the country. In fact this is largely the position-philosophy of the Department of Transportation as explained in their May 1996 report called "The Low Cost Service Revolution." De-regulation could be rescued if the competitive nature of the airline industry in the Southwest and Western parts of the country could be introduced in the remainder of the country. However, Knowing What Needs To Be Done and Doing It Are Two Different Things. I sincerely hope that airline de-regulation can be salvaged before it becomes necessary to re-regulate the airline industry. None of us like government regulation with its inefficiency, but that is preferable to permitting airlines to monopolize large sections of the country where they charge high monopoly fares to the flying public.

I fear, however, that the Forces Of Monopoly Will Win Over The Forces Of Competition and I will try to explain why I am not optimistic regarding the outcome. We can all study the competitive portion of the country and see what has happened, and then hopefully transfer these conditions to the remainder of the country (that is where the D.O.T. is coming from). To put it simply, what we find in the Southwest and the West is that competitive entry into these markets is relatively easy. As a consequence Southwest has brought quality, low discount fares to much of this region of the United States.

Just as we are able to determine what it requires to have competitive markets, the large airlines do the same and they know the industry much better than we do. But the goal of the major airlines is to see that competition does not succeed in their markets, and they have huge resources and influence with the Federal government (Congress and Federal government agencies) to try and stop competition from spreading into the Eastern half of the country. There is no doubt in my mind that they are very displeased about this hearing and would like to stop further such hearings.

There are two things that the major airlines are doing to monopolize large segments of the country. First, they work hard to see that entry to their huge markets remains closed or difficult. Second, if a discounter enters a few of their markets they use predatory pricing to drive the discounters out of business. Senator Shelby, if you really want to strike a blow for the consumer and against monopoly forces, then do not just amend the Wright Amendment, work to have it abolished. Then you can stand back and watch what competition will do for your state of Alabama and other nearby states. Fares will fall by as much as 50 percent, and it will be a victory for the consumer and for the economy. Congress will have made a difference, and that is what it is supposed to be all about.

I would like to suggest some things that could be done immediately to help restore competition in a large section of the country.

1. It is recommended that Congress hold a series of hearings regarding how the airline industry can be made more competitive (and this hearing is a great start). The last thing that the airline industry wants to happen is for there to be a series

of hearings regarding how competition is being weakened and destroyed in large parts of the airline industry and what steps are going to be taken to reverse the situation. Please, Senators, press on!

2. The Government Accounting Office should be instructed to do a number of studies and report to Congress in 6 months about several issues of great importance to the public interest. This agency has a reputation of largely being above political influence and doing high quality studies. One such study should look at the "trend over the last decade in market concentration in large airline hubs." I have started such a study and it is eye-opening. A second study would estimate the cost of slot and other controls stopping entry into markets like Washington National, LaGuardia, Newark, O'Hare. The study would also estimate the cost of gate controls at airports like Cincinnati and Minneapolis.

3. An investigation should be conducted of whether the Department of Transportation and the Department of Justice can and will do their jobs to stop the growing monopolization of the airline industry. I believe such an investigation would show that many on the staff of these committees understand what needs to be done, but that administrators are stopping action that needs to be taken to strengthen competition. What we continue to get from the D.O.T. and D.O.J. are promises they will act to ensure that markets are competitive, but nothing happens (more about this later on). Congress should not tolerate the failure of these agencies to keep the airline industry as competitive as possible.

In conclusion, I sincerely believe that this committee and Congress can make a big difference and stop and reverse the growing monopolization of the airline industry. It is important for all Americans that you take the necessary steps to reverse the growing monopolization of the airline industry and see that competition is injected in large regions of the airline industry that are highly monopolized at this time. There is a great burden on your shoulders to take action to preserve and restore competition in the airline industry. I wish you well on the challenging task.

A SHORT EXPLANATION OF THE MONOPOLIZATION OF THE ATLANTA AIRPORT BY DELTA AIRLINES

I will commence right at home in Atlanta, Georgia and try to address the question of how serious the problem is of the growing monopolization of airports in large sections of the country. Atlanta is indicative of what has been happening in two-thirds of the United States. Delta's market share over the last decade has increased from around 50 percent to 75 percent of the passengers flying through Atlanta (Delta's market share has increased 50 percent over the last decade). Given Delta's dominance of this market, it is able to raise fares to monopoly levels in Atlanta.

Is the Atlanta airport large enough to support more airlines? It is now ranked the 2nd largest airport in the United States (1st is Chicago and 3rd is Dallas), and given the size of the market it could economically support much more competition. An Intra-market study I completed a month ago shows that Delta either monopolizes or dominates (i.e. has from three-fourths to 100 percent of the flights) almost 75 percent of the cities served from Atlanta. With little or no competition on such a high portion of the direct flights, Delta is able to charge monopoly fares on a large portion of its flights.

There are some other major, high-cost and full-service airlines that fly a few flights from their hub airports to Delta's Atlanta hub. But the major airlines have learned to "live and let live" with Delta. What "live and let live" means is I will keep prices high in your hub market if you do the same in my hub market. It is not just a question of whether there is competition, but that competition comes from low-cost discount airlines that have the cost structure to sell day in and day out for less (and not just when they are predating and temporarily lowering price to destroy competition). The composition of competition is a very important concept that this committee needs to understand. What is being discussed is the important difference between "intra-type competition" (i.e. competition between the major high-cost airlines) and "inter-type competition" (i.e. competition between the high-cost carriers and the low-cost, discount airlines).

On a practical basis, is there really a problem with high and monopoly fares from Atlanta? I think so and I believe it is huge. Studies of Federal government agencies show that fares from Atlanta are 30–50 percent higher than they are in competitive markets where market concentration is low. Are others complaining? The answer is yes. A few years ago a large company with headquarters in Atlanta was so upset with Delta's high monopoly fares that the company went public with instructions to their employees to fly any airline other than Delta Airline when at all possible. The problem is that Delta so monopolizes the Atlanta market that there are few or no significant alternatives.

I hear business people repeatedly complaining that it costs $500–$700 to fly a few hundred miles round-trip from Atlanta and a thousand dollars to book a 500–600 mile round-trip flight from Atlanta. Many in the business community wish that Delta had more competition, and in particular from low-fare competition. There is still further data suggesting that Delta charges very high prices to fly to and from Atlanta. Last week I learned that the Atlanta Chamber of Commerce has recently asked for bids from consulting firms to conduct a study of how to increase airline competition in Atlanta in order to reduce airline fares. Why would the Atlanta Chamber of Commerce sponsor such a study when Delta is such an important factor in the community? The reason is that the Chamber realizes that while high fares are good for Delta, they hurt air travel to Atlanta and hurt the local economy. Atlanta represents just one large city that is concerned about monopoly fares being charged in hub cities of the major airlines.

Consider what I found when I was making reservations to fly to Washington for these hearings. I called Delta and asked what the round-trip fare was to Washington National Airport. Delta's round-trip fare from Atlanta to Washington National Airport was $856. Washington National is one of the slot control airports so I asked what was the fare to fly to Washington Dulles Airport (which is not slot controlled) from Atlanta and the round-trip fare quoted was $352. The premium to fly to National in comparison to Dulles was 143 percent.

Given the huge difference in flying to Dulles instead of National, I decided to check fares to fly from Atlanta to New York LaGuardia (another slot controlled airport) and then to fly from Atlanta to Newark, New Jersey. The round-trip fare I was quoted to fly on Delta's monopoly route to LaGuardia was $1,106 versus $466 to fly Delta to Newark. In this case the fare premium to fly to a slot controlled airport was 137 percent. (I verified the fares quoted over the phone through Delta's electronic ticketing service. The electronic quotes were the same or close. I could provide the committee copies of the electronic fare quotes that were printed.) An interesting fact is that ValuJet flies from Atlanta to Washington Dulles and Kiwi flies from Atlanta to Newark. Before ValuJet flew to Dulles, Delta charged the same high fare to fly to Washington National and to Dulles.

REQUEST THAT THREE RELEVANT REPORTS I HAVE PREPARED BE MADE A PART OF THE RECORD

Over the last two years I have prepared three reports/studies that are relevant to the concerns of this committee regarding issues of competition in the airline industry. I request that they be made a part of the record. The reports are briefly described below.

1. The first report was my analysis of D.O.T. Report on "The Low Cost Service Revolution", April, 1996.

One of my areas of research has long been discount competition and efforts to destroy discount competition. In the introduction to "The Low Cost Service Revolution" Secretary of Transportation Federico Peña stated that the D.O.T. would remain vigilant, watching for and stopping predatory pricing. However, that very report documented that the major airlines had decreased prices by 40–60 percent in several markets that low-cost, discount airlines had entered. Subsequently many of these discounters have been driven out of business by predatory pricing. The D.O.T. did nothing but stand quietly on the sidelines and watch the discounters be destroyed as the major airlines used predatory pricing to defend their high-price "fortress hubs."

Indicative of what has happened is a recent article in Business Week entitled "Called Startups Start To Stall" (Dec. 9, 97, p. 64) that stated:

"Large carriers are now on the attack as regulators sit passively on the sidelines (emphasis added) and stormy times for the smaller airlines are not seen as abating soon. Investors and consumers alike have been hurt. In early 1995, when Midway Airlines Corp exited the Chicago-New York LaGuardia route, the most economical round-trip 7-day advance purchase fare climbed from $124 to $1,144 now offered by American Airlines and United Airlines."

The D.O.T. (with more authority than the D.O.J. to act) has stood frozen on the sidelines, while the 100 Pound Gorillas have driven many of the start-up, low-cost, discount airlines out of business using predatory pricing. The D.O.T. has made other decisions over the years that have contributed to the growing monopolization of the airline industry by a few large airlines. The D.O.T. agreed to sell airline slots to the major airlines in several large and limited capacity airports. This decision locked discounters out of these markets where the major airlines charge prices 100 percent higher than nearby competitive markets. The D.O.T. also permitted Northwest to take over Republic, a merger that the D.O.J. opposed. The merger increased

Northwest's market share of its Minneapolis hub from approximate 50 to 75 percent of the market. This gave Northwest the monopoly power to raise prices above the competitive level. This merger that the D.O.T. permitted contributed to Northwest's monopolizing 83 percent of the direct served cities from Minneapolis. What the D.O.T. did was to create one of the strongest "fortress hubs" in the country. Based on experience it is hard for me to believe that the D.O.T. will be pro-consumer today instead of pro-large airlines.

2. The second statistical study I did early this year was concerned with the "Growing Monopolization Of The United States Commercial Airline Business Through The Development And Defense Of Fortress Hubs—The Atlanta Story." Major conclusions of this study include the following:

1. Competition thrived over the years immediately following de-regulation and several new airlines were formed. A major goal of de-regulation was achieved.

2. Over the last 10 years anti-competitive conduct has destroyed many airlines and the industry has become increasingly concentrated.

3. Several large airlines have developed "fortress hubs" in large cities and have used their monopoly power to raise and maintain prices above competitive level.

4. According to American Express Travel, business fares have soared 86 percent over the last 5 years. This is due in large part to the growing monopoly power of airlines to raise prices above the competitive level.

5. Major airlines use predatory pricing to destroy discount airlines which attempt to enter their "fortress hubs" so they can continue to charge monopoly prices.

6. Slot and gate control have contributed to monopolization of other large airports and markets. High prices in such markets are used to subsidize predatory pricing.

7. The growing monopolization of the airline industry is costing the public billions of dollars a year in monopoly fare premiums and other monopoly costs. The fare premium in monopoly markets could run over ten billion a year.

8. Government intervention was necessary in the American Airline strike since American dominated some large markets and the cost of a strike was too high to society. This is just the tip of the iceberg since other airlines also dominate critically important markets.

9. Competition has been ravaged by anti-competitive conduct and the closure of markets to competition. Action is needed before monopoly powers grow beyond the point of no return.

10. Actions of the Department of Transportation have contributed to growing monopolization of airline industry. Furthermore, the D.O.T. has failed to use its authority to stop unfair and anti-competitive behavior destroying the industry.

11. The Department Of Justice also has the authority to take action to stop practices contributing to the monopolization of the airline industry.

3. The most recent study I completed a month ago was An Intra-Market Analysis Of Direct Non-stop Flight For The Major Hubs Of Delta, US Airways, and Northwest. This study was part of a report to Mr. Roger W. Fones, Chief Transportation, Energy, and Agricultural Section, Antitrust Division, U.S. Department Of Justice.

The letter to Mr. Fones encouraged the D.O.J. to enforce the antitrust laws against monopolization and predatory pricing. From studying a speech by Mr. Fones regarding predatory pricing in the airline industry, I believe that the D.O.J. knows how to proceed. However, for some reason the D.O.J., like the D.O.T., talk a good story, but does not use its authority to enforce the antitrust laws. I do not know for certain, but I get the impression that on his own Mr. Fones could lead and win a monopolization and predatory pricing suit against some of the major airline industry. The question remains whether the Administration will stand up to the large airlines and their unions. They represent large political contributions to the Administration. A further possibility is that the economists on the staff of the D.O.J. are so biased towards the naive Chicago School "Theory of Perfect Markets" that it is hard for this agency to get the support of its own industrial organization staff to bring a suit.

Data from the Intra-market study I did of direct flights from major airline hubs is presented below. This data shows the monopoly power that the major airlines have in their hub markets that permit them to increase prices far above the competitive level. Monopoly market share and prices go hand-in-glove together.

NUMBER DIRECT, NONSTOP, DOMESTIC FLIGHTS, IN 8 HUB MARKETS

Hub city	Northwest flights		Other airline flights	
	Number	Percent	Number	Percent
NORTHWEST HUBS:				
Minneapolis	480	85.3	83	14.7
Detroit	488	82.6	103	17.4
Memphis	221	82.2	48	17.8
US AIRWAYS:				
Charlotte	414	92.6	33	7.4
Pittsburgh	456	87.5	65	12.5
Philadelphia	303	67.9	143	32.1
DELTA HUBS:				
Cincinnati	481	87.5	69	12.5
Atlanta	787	76.7	239	23.3

The above data shows that Delta, US Airways, and Northwest control from 77–93 percent of the direct flights in their respective hubs. When airlines have such dominance in their hub markets, they are able to increase prices to far above the competitive level as several studies have shown (GAO, DOT, and my analysis). A 1996 GAO study of several of these markets indicates that fares have been increased from 27–88 percent above the competitive level. However, statistics about the market share of passengers (GAO and DOT) only partially explain the monopoly pricing occurring in major airline hubs. Monopoly power and the ability to charge monopoly prices depends in a large part on dominance of routes flown from hub markets as the Intra-market studies show.

AMERICAN'S SHARE OF DIRECT FLIGHT FROM THE DALLAS INTERNATIONAL AIRPORT

I did an Intra-market Analysis of direct flights that American has from the Dallas International Airport. The analysis showed that American dominates this hub airport having 72 percent of the direct flights and Delta has 19 percent of the flights. American and Delta combined fly 91 percent of the direct flights from the Dallas International Airport. Together they dominate the third largest airport in the United States. G.A.O. studies show that when one airline has 60 percent of the flights, or two have 80 percent from a market, they have monopoly power to raise prices above the competitive level. What makes the situation still worse is that both American and Delta are high-cost, full-service airlines. They practice "live and let live" when operating in each other's hub markets and keep prices high.

Senator SHELBY. I want to ask you a basic question because this came up in our deliberations on the Wright Amendment and so forth. It was argued on one side of the fence that this was a local issue and I said this is not a local issue. The Wright Amendment affects interstate commerce. Dr. Sterling, do you have a comment on that?

Dr. STERLING. That is exactly what I said in my comments as a matter of fact. This is not a Dallas or not a southeast issue. It goes to the heart of deregulation. It goes to the heart of free competition, free market entry because it is just like—this will strike a raw note I know—the tax code. Every time we simplify it, what happens? It gets more complex. Everybody is looking for a loophole. Once you get something like this, then something else comes in like the LaGuardia, et cetera.

I am just dead set against it. If we are going to have true competition, it is going to drive prices down and this protects prices basically.

Senator SHELBY. We have got to have real competition for the American consumer—all of us are consumers——

Dr. STERLING. That is correct.

Senator SHELBY. [continuing]. To benefit in an era of airline deregulation. Is that correct? All of you agree to that?

Dr. ALLVINE. No question about it.

Dr. STERLING. The same situation. You go to the trucking industry after deregulation. What happened there? The number of carriers increased from 18,000 to 36,000 in a short period of time and every one of those carriers, except one, was a low-cost truckload carrier. And what has happened to truckload rates? They have gone down significantly. Competition is fierce and intense, and there is a good example of how things can go right.

Senator SHELBY. Dr. Allvine, was your figure that all these impediments that we still have and concentration and everything that goes with it is costing the American people about $10 billion a year?

Dr. ALLVINE. I would say that that is a very conservative figure.

Senator SHELBY. Conservative figure.

Dr. ALLVINE. That the failure of competition throughout two-thirds of the country—the DOT talks about the benefits through 1995 being $6 billion. They did not look at the other two-thirds of the country where, if you had competition occurring, we could save the general public in the order of $10 billion plus a year, Senator.

Senator SHELBY. Thank you.

Dr. Morrison, in your testimony, you have advocated congestion pricing as an alternative to slots. Are there other alternatives we should consider if congestion pricing is not feasible in the current political environment?

Dr. MORRISON. Yes; the slot system, as I indicated, probably does good in the sense of reducing congestion, but even within the context of not going to congestion pricing, I think the slot system probably could be modified.

First of all, the question would be is the number of slots the right number. Could it be more?

Second, there is an issue of the partitioning of slots into general aviation air carrier, commuter carriers that basically ensures that slots go to those who do not value them the most. If it was an open market for slots, then they could go to those who value them the most.

Others have advocated—I think GAO and I do not disagree with it—moving away from the buy-sell rule where slots are more or less property in perpetuity to some kind of a leasing system where slots become available all the time for any carrier, particularly new entrant carriers.

Senator SHELBY. Dr. Sterling, you probably know off the tip of your tongue the exact figure, but I was thinking of a competitive price, say from two or three airlines, from Birmingham to Houston nonstop was in the range of $300?

Dr. STERLING. Yes; all four carriers have the same price.

Senator SHELBY. Nonstop from Birmingham to Houston.

Dr. STERLING. Well, it stops at Dallas and goes through. So, you are going to pay more to stop in Dallas than you will—three times more to stop in Dallas than you will to go on to Houston.

Senator SHELBY. Compare the figure. I believe you had a figure of $900 more or less.

Dr. STERLING. $968.

Senator SHELBY. To Dallas? Birmingham to Dallas?

Dr. STERLING. Yes; Delta, American, Continental, and Northwest is $970. This was as of last Friday. Birmingham to Houston, all four carriers, Northwest, American, US Air and Delta, were $307.

Senator SHELBY. And was one of them a shorter distance? Is Dallas closer to Birmingham than Houston?

Dr. STERLING. Yes; last time I checked the map it was.

Senator SHELBY. OK, but not the price. Right?

Dr. STERLING. No; both Habe and Intercontinental again—see, you got two airports.

Senator SHELBY. You got some competition.

Dr. STERLING. Yes; and even if I want to go to San Francisco, it is only $601 through Dallas.

Senator SHELBY. Dr. Sterling, in your view how do restrictions on air travel impact the flow of goods and services in our country, and what is the end result to our customers?

Dr. STERLING. Well, if we are talking about air freight—are we talking primarily about air freight now versus passenger transportation?

Senator SHELBY. Right, both.

Dr. STERLING. Air freight is fairly good.

Senator SHELBY. By good, you mean competitive?

Dr. STERLING. Yes; very competitive because there are a lot of freight forwarders. They basically own no assets acting like a broker.

I am on Mark VII's board of directors, one of the largest—the largest broker of transportation services in the country. We do a lot of import support, we do a lot of air freight. And the rates there are very, very competitive, both domestically and overseas, and that is because of competition again. You have got a lot of other carriers who are not also airline carriers and you have also got a lot of freight forwarders who are trying to get the best deal using different carriers. It is a great example of comparing two parts of the same industry and seeing a dichotomy.

Senator SHELBY. Dr. Morrison, I have always been taught that predatory pricing was illegal.

Dr. MORRISON. Correct.

Senator SHELBY. But we have seen a lot of predatory pricing. You have spoken of it.

Dr. MORRISON. I have not spoken of it.

Senator SHELBY. Dr. Allvine.

Dr. MORRISON. I really do not have a view on that. Predatory pricing is illegal but it is very, very difficult to prove because it is hard to separate the intent to predate from the intent to meet competitive price. A new airline enters and an incumbent airline lower its price. What should they do? Not lower their price? A new carrier exits, a carrier raises its price. To one set of eyes that looks like predation. To another set of eyes, it looks like meeting the competition.

Senator SHELBY. Dr. Allvine.

Dr. ALLVINE. Senator, I think that the head of the Transportation Division of the Department of Justice, Mr. F-o-n-e-s, Fones, just had a speech that he gave on predatory pricing in the airline industry, and he explains that there are symptoms you can look at that go on here. If the major airlines cut their prices and add capacity, the whole question of incremental costing is out of the window, and you look at what is going on.

Pressed, I think the Department of Justice in Mr. Fones' division could bring major predatory pricing suits. I keep my fingers crossed. I hope that they are talking to the Department of Transportation and that after long last the DOT in combination in consulting with the DOJ is going to do something about predatory pricing. Simply lowering prices 50 or 60 percent, driving the low-cost competitor out, and raising prices back is very contrary to the public interest. If you look below the surface, you can find the symptom.

And that is how the fortress hubs like Atlanta, GA, and others maintain their monopoly position. They only reduce the prices to Mobile, like we are hearing about, which was $700 before ValuJet started flying it, and then they reduced it to $150, and then ValuJet announced they were going to go, and the price went up to $600. And then ValuJet came back in and they lowered the prices back again. There is a big difference between competitive based pricing and predatory pricing.

Senator SHELBY. Market forces will work but they will not work unless there is competition, will they?

Dr. ALLVINE. When the 700-pound gorillas pounce on small airlines that are 1 or 2 or 3 percent—and they focus their resources—it is just not a question of if they are going out, it is a question of when they are going out of business.

The DOJ and the DOT have done nothing about predatory pricing. As I look at the new wave of discounters that they were so proud of in the 1996 report, they are all virtually destroyed at this particular point in time because of failure of the DOT and the DOJ to stop predatory pricing against true low-cost carriers. One-third of the country where it is competitive has low-cost competition. The major airlines in the large hubs are going to use predatory pricing to try to squash any new discounter that dares to enter those cities, Senator.

Senator SHELBY. Senator Bennett.

Senator BENNETT. I have no questions.

Senator SHELBY. Gentlemen, we appreciate you coming. We have got another panel. We appreciate your views.

What some of us are interested in is real competition in America. If we are going to talk about market forces working, they will not ever work unless there is real competition I believe.

Thank you.

DEPARTMENT OF TRANSPORTATION

OFFICE OF THE SECRETARY

STATEMENT OF PATRICK V. MURPHY, DEPUTY ASSISTANT SECRETARY, AVIATION AND INTERNATIONAL AFFAIRS

FEDERAL AVIATION ADMINISTRATION

STATEMENT OF JEFF GRIFFITH, PLANNING DIRECTOR, AIR TRAFFIC OPERATIONS

INTRODUCTION OF WITNESSES

Senator SHELBY. Our second panel will be Mr. Patrick Murphy, the Deputy Assistant Secretary for Aviation and International Affairs, U.S. Department of Transportation, and Mr. Jeff Griffith, Planning Director, Air Traffic Operations, Federal Aviation Administration.

Secretary Murphy, any statement that you might have written will be made part of the record and you can proceed as you wish.

STATEMENT OF PATRICK V. MURPHY

Mr. MURPHY. Thank you, Mr. Chairman, Senator. Thank you for holding this important hearing today.

In recent months there has been an increasing dialog on the economic implications for airline competition caused by restrictions at some of our Nation's commercial airports.

At the outset let me state that airline deregulation, which is now 19 years old, has been a success. Airfares are lower. Travel has increased substantially. U.S. airlines are profitable. Safety has increased. Aircraft noise is decreasing, and U.S. airlines are highly competitive in the global marketplace. U.S. travelers and communities are well served by the deregulated airlines.

RESTRICTED AIRPORTS

Nevertheless, because certain airports that serve major cities are restricted, there is a view that airport restrictions are preventing the full benefits of deregulation from being enjoyed by our citizens and our air carriers.

Discussions on this topic generally involve five airports. They are Chicago O'Hare, New York's Kennedy and LaGuardia, Washington National, and Dallas Love Field. These five airports are subject to various restrictions which generally fit into one or more of three categories. First, slot restrictions on how many operations may take place; second, perimeter restrictions on how far aircraft my fly; and third, aircraft size limitations.

The Department of Transportation has conducted studies on the high density rule and on the Wright Amendment at these airports.

In 1995, at the direction of Congress, the President, and the Airline Commission, the Department completed a study on the high density rule which affects Washington, Chicago, and New York. We concluded that a change in the high density rule would not affect safety. Eliminating the rule is likely to result in increased operations at the airports in these cities, which in turn would benefit consumers in the form of expanded air services and reduction in airfares as a consequence of increased competition. These increased operations would lead to more revenues for the airports.

As a result of these increased operations, we also forecast increased travel delay and costs due to increased peaking of demand. Furthermore, in the short term, there would be increased noise impact. However, in the longer term, the transition to quieter all stage 3 aircraft would reduce noise levels to a point even lower than experienced today.

We also concluded that since 1968, when the slot rule was issued, air traffic control has changed dramatically. Implementation over the last 30 years of sophisticated technology in traffic management initiatives has enhanced the efficiency of the air space system. It is the traffic management system today, not the high density slot rule, that ensures the safe operation of the air traffic system.

WRIGHT AMENDMENT

As for our study of the Wright Amendment, this was completed by an interdepartmental task force in July 1992. The report showed that a change in the Wright Amendment would result in more airline service and competition at Love Field. This would result in lower fares for Dallas and the south-central region of the United States. Because of the phasing in of stage 3 aircraft, noise impacts would continue to decline around Love Field regardless of any action on the Wright Amendment. We projected that the Dallas/Fort Worth airport would continue to grow under all scenarios that we could envision and would remain the dominant airport in the region. We also concluded that the amount of additional service that can be provided at Love Field would be limited by airspace interactions. Aircraft delays at Love Field would become a significant problem only if aircraft operations reached the level that we consider to be highly unlikely. In any event, we concluded that safety would be maintained by FAA-imposed air traffic procedures.

DOT POSITION ON AIRPORT RESTRICTIONS

Following the release of both of these studies, the Department made no recommendations to modify or repeal the high-density rule or the Wright Amendment. This partially reflects the Department's assessment that these decades' old airport restrictions have to some extent evolved beyond their original intent to control aircraft operations. Environmental and regional development concerns emerge each time changes in these restrictions are contemplated. We are of the view that it is up to Congress and local authorities to decide whether to modify these longstanding arrangements.

We take this position while at the same time recognizing that airline deregulation is premised on the concept of open competition and the elimination of economic restrictions on the airline industry.

Several studies done outside DOT have demonstrated that slot restrictions lead to higher fares and less competition.

While Congress, through hearings such as today's, evaluates these longstanding restrictions, the Department intends to exercise its exemption authority to a limited degree to allow some additional competition at the high-density airports in Chicago and New York.

We also intend to undertake a study as to how the existing slots are utilized at the airports in order to determine whether the existing slot rules might be modified. We will, of course, report to Congress on our findings.

With regard to Love Field, we will monitor carefully the impact of loosening the Wright Amendment to determine what benefits and difficulties might be created.

PREPARED STATEMENT

In conclusion, I would like to thank the committee for allowing us to testify today and for examining the important topic of restrictions at some of our Nation's most important airports.

[The statement follows:]

PREPARED STATEMENT OF PATRICK V. MURPHY

Thank you Mr. Chairman, and members of the subcommittee. I appreciate the opportunity to discuss the important subject of restrictions on commercial air service at airports within the United States. In recent months, there has been an increasing dialogue on the economic implications for airline competition caused by restrictions at some of our Nation's commercial airports.

At the outset, let me state that there is a nearly unanimous view that airline deregulation, which is now 19 years old, has been a success. Air fares are lower, travel has increased substantially, U.S. Airlines are profitable, safety has increased, aircraft noise is decreasing, and U.S. Airlines are highly competitive in the global marketplace. U.S. Travelers and communities are well served by a deregulated airline industry. Nevertheless, because certain airports that serve major cities are restricted, there is a view that airport restrictions are preventing the full benefits of deregulation from being enjoyed by our citizens and our air carriers.

RESTRICTED AIRPORTS

Discussions on this topic generally involve five airports. They are: Chicago O'Hare, New York's Kennedy and LaGuardia, Washington National, and Dallas Love Field. These five airports are subject to various restrictions which generally fit into one or more of three categories. First, slot restrictions on how many operations may take place. Second, perimeter restrictions on how far aircraft may fly. And third, aircraft size limitations. There are a few other airports which have been allowed to impose certain environmental restrictions, but they generally are smaller airports and are not viewed by observers of the industry as major impediments to airline competition.

Slot restrictions apply to Chicago O'Hare, New York's LaGuardia and Kennedy and Washington National. They were adopted nearly thirty years ago in November of 1968 in order to limit daily and hourly operations and thereby reduce delays at what were then the Nation's most congested airports. The rule which implements these slot restrictions is known as the high density rule, and an aircraft or a flight at these airports may be operated only if it has a slot for that time period. Beginning in 1985, the Department of Transportation has allowed airlines to buy and sell their slots in order to permit the most efficient use of these limited resources.

The most recent change affecting the high density rule occurred in 1994 when the Secretary of Transportation was given authority to grant exemptions from the slot rule at Chicago and New York. This authority allows operations above the limitations now in effect. The Secretary has used this authority very sparingly and until now has only granted 3 domestic exemption applications at O'Hare and one exemption at Kennedy. We now have pending before us 13 exemption applications. We are contemplating granting some slot exemptions in the near future in order to promote competition.

PERIMETER RULES

In addition to slot limitations, both LaGuardia and National Airport are subject to perimeter rules. The perimeter rule at Washington National Airport dates back to 1966 when airline operations were limited to 650 miles. Over time that limitation became a Federal restriction and evolved to 1,000 miles and then to 1,250 miles.[1] This rule was developed to manage air traffic at National Airport, especially since Dulles airport had been opened in 1962 and was not being fully utilized. At LaGuardia, the current perimeter rule is imposed by local authorities and dates back to 1984. It currently limits aircraft operations to 1,500 miles.[2]

WRIGHT AMENDMENT

Dallas Love Field operates under a separate set of Federal restrictions commonly referred to as the Wright Amendment. This legislation limited operations at Dallas Love Field beginning in 1980. The legislation prohibited both non-stop and through air service with large aircraft between Dallas Love Field and cities other than those located in Texas, Arkansas, Louisiana, New Mexico and Oklahoma.[3] As you know, very recently Congress has taken action to loosen this restriction to allow air service to three more states—Alabama, Mississippi, and Kansas. Like the perimeter rule at Washington National, this restriction was imposed at Dallas in order to assist the development of a newer airport. Dallas/Ft. Worth International Airport opened in 1974, and the Wright Amendment came five years later. The restriction was consistent with an agreement between the cities of Dallas and Fort Worth.

DOT STUDY OF AIRPORT RESTRICTIONS

The Department of Transportation has conducted studies on the high density rule and on the Wright Amendment. In 1995, at the direction of Congress, the President, and the Airline Commission, the Department completed a study on the high density rule. We concluded that a change in the high density rule would not affect safety. Eliminating the rule is likely to result in increased operations at these airports, which in turn would benefit consumers in the form of expanded air services and reductions in air fares as a consequence of increased competition. These increased operations would lead to more revenues for the airports. As a result of these increased operations, we also forecast increased travel delay time and costs due to increased peaking of demand. Furthermore, in the short term there would be an increased noise impact; however, in the longer term, the transition to quieter all stage 3 aircraft would reduce noise levels to a point lower than experienced today.

We also concluded that since 1968 when the slot rule was issued, air traffic control has changed dramatically. The implementation over the last 30 years of sophisticated technology in traffic management initiatives has enhanced the efficiency of the air space system. It is the traffic management system, not the high density rule, that ensures the safe operation of the air traffic control system.

As for our study of the Wright Amendment, this was completed by an interdepartmental task force in July 1992. The report showed that a change in the Wright Amendment would result in more airline service and competition at Love Field. This would result in lower fares for Dallas and the south central region of the United States. Because of the phasing in of stage 3 aircraft, noise impacts would continue to decline around Love Field regardless of any action on the Wright Amendment. We projected that Dallas/Ft. Worth airport would continue to grow under all scenarios that we could envision, and would remain the dominant airport in the region. We also concluded that the amount of additional service that can be provided at Love Field would be limited by air space interactions. Aircraft delays at Love Field would become a significant problem only if aircraft operations reached a level that can be considered unlikely. In any event, we concluded that safety would be maintained by FAA-imposed air traffic procedures.

DOT POSITION ON AIRPORT RESTRICTIONS

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[1] At National both the limit on slots and the perimeter rule were set by Congress in 1984.
[2] Both National and LaGuardia also have aircraft size limits due to their small size.
[3] Small aircraft of 56 seats or less were allowed to operate beyond these five states.

restrictions have to some extent evolved beyond their original intent to control aircraft operations. Environmental and regional development concerns emerge each time changes to these restrictions are contemplated. We are of the view that it is up to Congress and local authorities to decide whether to modify these long-standing arrangements.

We take this position while at the same time recognizing that airline deregulation is premised on the concept of open competition and the elimination of economic restrictions on the airline industry. Several studies done outside DOT have demonstrated that the slot restrictions lead to higher fares and less competition.

While Congress, through hearings such as today's, evaluates these long standing restrictions, the Department intends to exercise its exemption authority to a limited degree to allow some additional competition at the high density airports. We also intend to undertake a study as to how the existing slots are being utilized at the airports in order to determine whether the existing slot rules might be modified. We will, of course, report to Congress on our findings. With regard to Love Field, we would monitor carefully the impact of loosening of the Wright Amendment to determine what benefits and difficulties might be created.

In conclusion, I would like to thank the committee for allowing us to testify today and for examining the important topic of restrictions at some of our Nation's most important airports.

Senator SHELBY. Thank you, Mr. Secretary.

Next panelist, Mr. Jeff Griffith, Planning Director, Air Traffic Operations, Federal Aviation Administration.

Mr. GRIFFITH. Yes, sir; good afternoon, Mr. Chairman.

Senator SHELBY. We thank you for coming.

Mr. GRIFFITH. You are welcome.

Senator SHELBY. Any statement you want to make, you proceed.

Mr. GRIFFITH. Mr. Chairman, I have not prepared a statement, but I am here to answer any questions that the committee may have regarding air traffic.

Senator SHELBY. At this point I would like to recognize the senior Senator from Washington, Senator Gorton, who is the chairman of the authorizing subcommittee on aviation, but he is also a member of this committee. He comes with a lot of experience and knowledge. Senator Gorton, we appreciate you being here.

Senator GORTON. Thank you, Mr. Chairman. I appreciate your delving even more deeply into this issue because it is an issue that involves a wide range of issues of free competition, of justified or unjustified expectations. It has transportation-related issues in connection with it. It has passenger convenience and choice issues related to it that is a most important issue.

I am sorry that I am in on the middle of the hearing, so I prefer to hear what questions you have to offer and to read the testimony of the witnesses.

AIRSPACE MANAGEMENT

Senator SHELBY. Thank you, Senator.

Mr. Griffith, it is my understanding that the Federal Aviation Administration's primary mission is to provide a safe air transportation system in the United States. Do you share that view?

Mr. GRIFFITH. Yes, sir, Mr. Chairman, I do.

Senator SHELBY. Does the Federal Aviation Administration allow an unsafe airspace management situation to develop or to exist once it has been identified?

Mr. GRIFFITH. No, sir, Mr. Chairman. The Federal Aviation Administration does not.

Senator SHELBY. Is there anywhere in the United States today that unsafe airspace management exists that you know of?

Mr. GRIFFITH. No, sir.

Senator SHELBY. Which of the following airports or airspace management areas present the most complex air traffic management challenges such as Atlanta, Boston, Chicago, Dallas, Denver, San Francisco, Los Angeles, Miami, Minneapolis, New York, New Jersey, Salt Lake City, Seattle, and the Washington capital area? Do any of those areas present a more complex air traffic management challenge than others?

Mr. GRIFFITH. Mr. Chairman, all the locations that you have named are busy locations.

Senator SHELBY. Are they well managed?

Mr. GRIFFITH. Yes, sir; they are.

Senator SHELBY. Do you feel comfortable with them as far as safety is concerned?

Mr. GRIFFITH. Yes, sir; I do.

Senator SHELBY. I know you are giving this off the top of your head, but would you provide that assessment for the record and for the benefit of this committee as well as Senator Gorton's committee?

Mr. GRIFFITH. Mr. Chairman, in each one of those locations, they all have unique complexities. I have worked at three of those locations. I worked as the manager at Minneapolis and Chicago O'Hare.

For the record, it would be best for me to take that back and look at each one of those locations based on procedures and airspace alignment and then provide that information for you.

ECONOMIC IMPACT OF AIRPORT RESTRICTIONS

Senator SHELBY. Thank you. That would be very helpful to us.

Secretary Murphy, many people believe that restrictions on the capacity or operations at individual airports translate into higher fares for consumers that are utilizing these airports or competitor airports. Do you share that view?

Mr. MURPHY. Absolutely, yes, sir; we do. Our studies --

Senator SHELBY. In other words, these impediments we have been talking about and the economists talked about earlier are impediments to competition in America, are they not?

Mr. MURPHY. Yes; they are. Some of the numbers that we have found—the slot rule creates, we believe, fare premiums in the neighborhood of 20 percent at O'Hare, 35 percent at LaGuardia, and as high as 45 percent at Washington National. We also found that the Wright Amendment was costing in the neighborhood of $200 million in higher airfares in the Dallas metroplex region. So, we think that these restrictions have large impacts.

Senator SHELBY. Why are these restrictions so difficult to act on or to change if they appear, as I believe and you do, that they would be in the public interest to change?

Mr. MURPHY. Mr. Chairman, some of these restrictions go back almost 30 years. I believe that the metropolitan areas where you find these restrictions have come to rely on them for reasons of local development and noise control, and so we can talk about it today as an economic issue. But those other issues quickly come to the fore and we get involved with the local officials in those issues.

Senator SHELBY. Secretary Murphy, do you have any concerns about the impact of piecemeal restrictions on individual airports on the capacity or the integrity of the national airport system? In other words, we have deregulation per se in America. Yet, we have these impediments that we have been discussing here today.

Mr. MURPHY. Well, these impediments have economic consequences that ripple throughout the entire system. So, yes, we have a concern from a national standpoint about that.

Senator SHELBY. You have heard the testimony of the first panel. Do you agree or disagree with the thrust of the testimony of the experts that we have just heard from?

Mr. MURPHY. I do not disagree with the thrust with regard to these restrictions. I must say I think that Dr. Allvine and Dr. Sterling went further than we would at the Department with criticisms of airline deregulation. There are some problems, but we do not think there is a fundamental failure with airline deregulation as was almost suggested. We think there are problems that we need to continue to work on, however.

FARES AT AIRPORTS WITH CAPACITY OR OPERATING RESTRICTIONS

Senator SHELBY. The Department that you are involved with has done a great deal of work on comparing fares between city pairs. What conclusions would you draw about the pricing behavior at airports with capacity or operating restrictions, and what conclusions would you draw about airports where the traffic is dominated by one carrier, which we have at times?

Mr. MURPHY. We have found, when both of those are present, when you have airport restrictions or when you have domination by a single carrier, you are going to have significantly higher fares. As I mentioned earlier, GAO has some numbers for the airports that are slot controlled. We also found that at Dallas there is a premium being paid at that airport because of the domination by one or two carriers in the neighborhood of 20 percent higher fares in Dallas than we would expect to find if it were a more competitive situation.

SAFETY IN THE DFW AIRPORT METROPLEX

Senator SHELBY. Secretary Murphy, you noted in your testimony and I believe you referenced a DOT study which concluded that if the Wright Amendment was repealed, safety would be maintained by the FAA-imposed air traffic procedure in the Dallas/Fort Worth airport metroplex. Mr. Griffith is also an expert in that area.

Do you believe that there will be any problem with safety with FAA riding herd on it?

Mr. MURPHY. Absolutely none, Mr. Chairman. We ran computer models. We worked closely with the FAA when we did our study on the Wright Amendment.

Senator SHELBY. Was that study completed before the airspace in the Dallas/Forth Worth metroplex was reconfigured substantially——

Mr. MURPHY. That was completed even before the reconfigured airspace. With the reconfigured airspace, I expect the results or the benefits could be even greater from a repeal of the Wright Amendment.

DOT STUDY OF SLOT-CONTROLLED AIRPORTS

Senator SHELBY. OK.

Secretary Murphy, you also indicated in your testimony that the Department of Transportation will undertake a study to determine how the existing slots at the four slot-controlled airports are being utilized and how they should be modified, if at all. When do you expect this study will be completed? Can you give us any indication of that?

Mr. MURPHY. I really cannot, Mr. Chairman. We have just begun that.

Senator SHELBY. Just begun it.

Mr. MURPHY. I might mention, however, there are several bills that I have begun to see in the Congress that are being drafted that go to this issue as well and would have the Department redistribute some of these slots in the near term.

Senator SHELBY. OK.

Secretary Gorton. Secretary. I promoted, did I not? [Laughter.]

Senator SHELBY. Senator Gorton. Excuse me.

Senator GORTON. Thank you, Mr. Chairman. I am just here to listen.

DOT'S EFFORTS TO ENHANCE COMPETITION

Senator SHELBY. OK.

Where we have the concentration, other than dealing with slots and so forth, how do we bring competition?

Mr. MURPHY. We in the Department in the last year, Mr. Chairman, have been looking to take four actions.

One, we have begun to make available to civic officials and to the public more information on airfares. When civic officials see that the fares are substantially different in their city than in some neighboring city because there is less competition, we have found they will go right to the airlines and make an issue of this, and we think that is helpful.

Second, we have begun some rulemaking with regard to computer reservation systems. We know the large carriers can use their computers to their advantage. We want to make sure those systems remain competitive.

Third, we are looking at exemptions from the slot rule.

And fourth, we are looking to develop guidelines for what would be appropriate forms of competition so that the smaller carriers and the larger carriers will have some idea of what the ground rules are for competition, especially at these large dominated hubs.

Senator SHELBY. I want to thank all the witnesses, the first panel and the second panel, for your time and your thoughts today. This is very important. The committee appreciates your candor and the effort that went into your preparation for this hearing. You certainly have given us a great deal of food for thought, and you have helped make a very complex area of the aviation industry a little bit more clear.

ADDITIONAL COMMITTEE QUESTIONS

We realize this is just the beginning of this. As I said earlier, the other committee that Senator Gorton chairs has legislative jurisdiction of this, but we on the Transportation Appropriations Committee are very interested in competition, how it affects American people. As one of the first panelists testified—I believe Dr. Allvine—that $10 billion is conservative what it is costing the American consumers, it is time Congress stepped into this I believe to make competition a reality in America.

[The following questions were not asked at the hearing, but were submitted to the Department for response subsequent to the hearing:]

QUESTIONS SUBMITTED BY SENATOR SHELBY

AIRPORT SLOTS

Question. Carriers were grandfathered slots at LaGuardia, National, O'Hare, and Kennedy at no cost. As a result, those carriers may use the slots forever, and can sell them or lease them and keep the funds they receive for those transactions. Is that accurate? The GAO has stated that slots are not readily available for purchase in small numbers. Do you agree? Haven't most slot transactions been part of larger deals?

Answer. Carriers were initially awarded at no cost the slots they held on December 16, 1985, subject to the proviso that slots could be withdrawn based on a lottery number assigned to each slot for use in essential air service and international service and for other purposes. Also, there was a one-time withdrawal of slots for new entrants. The original slot holders were free to buy, sell, trade, or lease the remaining numbered slots to others. It is our understanding that today there are very few carriers willing to sell slots, although leases are offered, particularly at LaGuardia, and many are for terms of several years. It is also true as you note that the majority of slot transactions in the past have been part of larger transactions.

Question. In 1980, Secretary Goldschmidt withdrew slots from incumbent carriers and provided them to New York Air to start a shuttle operation. Since that date, has any Secretary taken similar steps to provide slots to new entrants? Would you agree that the Secretary has the authority to withdraw slots from incumbents and to reallocate them to new entrants?

Answer. Secretary Goldschmidt's action took place in the era of scheduling committees, before the buy/sell rules were established in 1985. During that time there were no use-or-lose rules and carriers typically held some slots that they were not using. Secretary Goldschmidt directed the committees to provide slots to New York Air. When the buy/sell rule was established in 1985, there was an initial, one-time withdrawal of slots for distribution to new entrants through a lottery. Other than that one-time withdrawal, provided for in the rule, there have been no other redistributions strictly for domestic new entrants. Slots have been taken for essential air service and international service as provided for in the buy/sell rule, although Congress has statutorily restricted this authority at Chicago O'Hare Airport. We agree that the Secretary has authority to redistribute slots, but under the existing rules he cannot do so, and a revision of the existing rules through the public rulemaking process would be necessary.

Question. What percentage of slots do new entrants hold at high density airports? Since 1988, how many new entrants have obtained high density slots? Is it true that foreign carriers hold approximately 2–3 times more slots than new entrants?

Answer. Since the start of the buy/sell rule in 1986, the following U.S. new entrant carriers obtained slots or limited incumbent carriers increased slots at the following airports:

Airline	Airport
Air Wisconsin	National.
AirCal	O'Hare.
America West	National, Kennedy, LaGuardia.
Braniff Airways	National, LaGuardia, O'Hare.
Carnival	Kennedy, LaGuardia.
Frontier Airlines (old)	LaGuardia, O'Hare.

Airline	Airport
Jet America	National.
McClain Airlines	O'Hare.
MGM Grand Air	Kennedy.
Midway/Jet Express	National, LaGuardia.
Midwest Express	National, LaGuardia, O'Hare.
Pan American (new)	Kennedy.
Presidential Airways	National, Kennedy, LaGuardia.
Private Jet/National Air	LaGuardia.
Sun Country	O'Hare.
Sunbird Airways	LaGuardia.
Tower	Kennedy.
Trump Shuttle	National, LaGuardia.
UltraAir	LaGuardia.
USAir Shuttle	National, LaGuardia.
ValuJet	LaGuardia.
Western Airlines	National, LaGuardia.
World Airways	LaGuardia.
Atlantic Coast	National, Kennedy, LaGuardia.
Colgan	LaGuardia.
Comair	LaGuardia.
Trans World Express	National, Kennedy, LaGuardia.
Trans States Airlines	National, Kennedy, O'Hare.

Data on the markets that were served by these carriers using these slots are not readily available. Certain transactions involving commuter carriers, complex slot arrangements, or situations where there was a doubt about a carrier's inclusion in the new entrant or limited incumbent category have been omitted.

Based on the above list of carriers, new entrants and limited incumbents are estimated to have operated six to eight percent of the total domestic slots at high density airports in early 1997. (If only recent low-fare new entrants were counted, this percentage would be less than one percent.)

A comparison of new entrant slots with foreign carrier slots is somewhat misleading since foreign carriers generally hold slots in a different manner than U.S. airlines. Some foreign carriers may have an arrival and a departure slot on Monday, Wednesday and Friday only while a U.S. carrier would have one arrival and one departure slot which would be effective for all seven days of the week. Moreover, there are virtually no foreign operations at LaGuardia or National.

Question. In 1997, how many requests for slots were submitted to DOT? How many have you acted upon?

Answer. During 1997 we received requests from 4 airlines for exemptions from the high density rule for O'Hare service, from 7 airlines for slot exemptions for LaGuardia, and exemption requests from one airline each at JFK and Washington National. We are within one week of acting on nearly all of the outstanding requests, including two that we received prior to 1997.

Question. For a carrier proposing to serve a high density airport from a small/medium market, what options does that carrier have to obtain slots?

Answer. There are many small and medium sized communities getting service to high density airports, but the service is invariably provided by a code sharing affiliate of a large incumbent airline at the high density airport. Currently, unaffiliated carriers have virtually no realistic opportunity to purchase slots, but leases are sometimes available.

Question. In an August 1990 report, the General Accounting Office suggested that several options could open up the slot market and promote new entry. In its October 1996 report, GAO again stated that little new entry has taken place at the high density airports. What actions has DOT taken since 1990 to implement the recommendations made by GAO that would increase competition?

Answer. Using legislative authority granted by Congress, the Department has adopted a policy to create access for new entrant carriers to slot controlled airports by granting exemptions to the slot rule. As already noted, we will act on most of the outstanding requests for slot exemptions. It is always possible to change the rules of the slot allocation system. Various concepts have been studied such as eliminating the slot rule altogether. This is an option that needs to be reviewed periodically. GAO's 1990 suggestion to convert slots to a lease system is another possibility. Every approach has drawbacks affecting carriers and communities.

Question. In the 1996 report, GAO stated that allowing carriers to buy and sell slots would reduce competition. They then stated that the large carriers have increased their control over slots. Do you agree that large carriers now control a larger percentage of slots than before the buy-sell rule was implemented?

Answer. Yes. FAA data show that the large carriers have increased their control of slots since the buy-sell rule was established.

Question. Doesn't a deregulated environment envision open markets? Can you have true deregulation when some of the nation's most important business markets are closed?

Answer. It would be far better for open competition if we did not have slot controlled airports. They exist because in the past the demand for service to important cities exceeded the capacity of specific airports to accommodate that demand without significant delays. Congress has recognized that these restrictions have evolved beyond their original intent to limit delays and any attempts to change these restrictions today invariably raise environmental and regional development issues.

UNEVEN DISTRIBUTION OF DEREGULATION'S BENEFITS

Question. In its 1996 report, GAO stated that although deregulation has spurred new entry and intense competition in many domestic markets, the full benefits of deregulation have yet to be realized because of problems with access to certain airports and the cumulative effect of certain marketing strategies employed by established airlines. Do you agree with that statement?

Answer. The GAO report recognized that some marketing strategies, such as frequent flyer programs and code sharing, have had negative effects for competing carriers that cannot use these strategies effectively. On the other hand, these practices have consumer benefits. Given this qualification, we generally agree with the GAO statement. In addition, the Department believes that more direct unfair competitive activities may be impeding the spread of deregulation's benefits, particularly in the local markets involving hub airports dominated by a major network carrier.

Question. What parts of the country have yet to realize the full benefits of deregulation?

Answer. We believe most regions of the country have received some benefits from deregulation, if not from lower average fares, then from more frequent, better-timed service. Some have benefited much more than others. The benefits from deregulation are greatest where competition has flourished. In general, markets in the west and across the south have done the best, particularly from the point of view of lower average fares. That leaves Appalachia, the northeast and upper midwest as having the least fare benefits.

TICKET PRICING PRACTICES

Question. When Mr. Hunnicutt testified before the Commence Committee, he stated that he has seen evidence of predatory behavior on the part of the large carriers. He went on to state that the Department would continue its review. What is the status of the review?

Answer. We continue to view certain actions we have seen by some major airlines as crossing the line from vigorous to unfair competition, but until recently have not felt we had an analytical framework to adequately define illegal behavior. After a thorough review of this behavior, we now believe we have developed such a framework and we are preparing a policy statement that will describe the behavior that we believe clearly crosses the line. We have analyzed instances where we now believe unfair competitive behavior has taken place including one instance where detailed company records were analyzed to gain a fuller understanding of how and why such behavior occurs. We have been receiving informal complaints for several years, but have used informal methods to try to deal with the problem. With our policy statement we hope to move to a more formal approach. We plan to apply any new policy on a prospective basis.

Question. Are you familiar with the situation that occurred in Mobile, Alabama when Valujet announced it was pulling out, and the subsequent action taken by Delta Airlines to increase prices? What actions can DOT take to ensure that other communities are not faced with pricing actions that drive competitors out, and then prices are raised?

Answer. We are familiar with the Mobile case and have received numerous other complaints from new entrant carriers of similar anticompetitive activity at other cities around the country. We believe the Department has the legal authority to deal with anticompetitive behavior and plan to issue a policy statement defining what behavior is illegal, which will give us the predicate for taking enforcement action against unfair exclusionary behavior.

Question. Do you agree that airfares have increased significantly this year? Do you agree that those hit hardest by those increases are those living in small and medium communities?

Answer. The data do not show that air fares have on average increased this year. For example, the average domestic fare per mile for the major U.S. airlines was down 0.6 percent for the 12 months ended September 1997 compared to the same period a year earlier. If adjusted for inflation, the decline would be even greater. While fares on average are going down, there are other trends behind those averages that are moving in different directions. We have read a great deal in the press about business fares going up, which we assume is accurate. Going in the opposite direction, we know in markets where low-fare new entry occurs, fares go down dramatically. However, the data needed to assess fares by city size beyond the first quarter of 1997 will not be available for some time, so we cannot confirm that small and medium communities have experienced a different trend in average fares this year than larger cities.

NEW ENTRIES AND MARKET SHARE

Question. A recent Solomon Brothers report stated that market share analysis shows that at the 50 largest U.S. airports there is "an unprecedented degree of concentration in the airline industry". Do you agree? What steps is the Department taking to address this factor?

Answer. It has been our experience that measures of national concentration do not provide a very useful tool in explaining industry pricing or service performance. For example, the Solomon Brothers study showed that industry concentration in the top 50 airports actually reached its peak in 1992 and has gone down since. Yet, thanks to fare wars, 1992 was a banner year for low fares and high traffic. Although concentration at hubs is part of the story, it can be very misleading. The most concentrated airport in the Solomon Brothers study is Dallas Love Field, which has had a single major carrier operating there since 1988. But because the carrier is Southwest Airlines, fares are very low there. In contrast, the Solomon Brothers study lists Buffalo as a relatively unconcentrated airport, yet it has some of the highest fares in the country as shown in our quarterly fare report. Why? Because, although it is served by seven different airlines, it is served almost exclusively to hub airports dominated by a single network carrier, and has service by only one low-fare carrier to one Florida market.

It is the Department's view that the growth of low fare competition holds the key to the regional high fare problem. The Department has taken a series of actions to help competition from new low fare carriers, including Computer Reservation System rule changes, the award of slot exemptions, public information activities like our Consumer Fare Report to highlight where competition is needed, and the development of a competition policy statement that will help to prevent anticompetitive actions by the large carriers against new entrants.

Question. How important is competition and new entry to holding down fares?

Answer. The Department's studies show that competition from low-fare airlines and new entry is the most important discipline on fares in today's U.S. domestic airline industry, especially in short- to medium-haul markets. For example, in a 1996 study of low fare airline service, we estimated that consumers save $6.3 billion per year due to competition from these low-fare airlines and that virtually all the domestic traffic growth in recent years is attributable to the spread of low-fare service competition. The study also found that, at network hub cities where low-cost carriers do not compete, fare premiums are quite high and are increasing.

Question. How many carriers are in the pipeline? Is the number of new carriers sufficient to foster new competition?

Answer. As of October 21, 1997, there were no applications for new scheduled jet service. Only one low fare new entrant has started operations over the past 16 months. It goes without saying that more new entry as well as the expansion of service from existing low-fare carriers is needed.

WRIGHT AMENDMENT/DALLAS-FORT WORTH METROPLEX

Question. In a number of studies, DOT has stated that consumers in the Dallas area would benefit from relaxation of the Wright Amendment. Am I correct in stating that consumers in markets added to Love Field would also benefit from the Wright Amendment's relaxation?

Answer. In our July 1992 report entitled "Analysis of the Impact of Changes to the Wright Amendment," we stated that a change to the Wright Amendment would result in more service, more competition, lower fares, and more traffic for the Dallas-Fort Worth Metroplex and the region. We also went on to say that travelers (consumers) to or from the Metroplex region would save an estimated $183 million per year in airfares. Thus, you are correct that consumers in markets added to Love Field would benefit from the Wright Amendment's relaxation in our view.

Question. Has concentration at DFW increased over the past several years? According to the Solomon Brothers report, DFW is one of the most concentrated large hubs in the U.S. Is that correct? Have fares also continued to increase at DFW?

Answer. As is shown in the Solomon Brothers report, which uses DOT data, concentration at DFW has gone up in the past several years. The Solomon Brothers report lists DFW as the 15th most concentrated airport in the top 50 U.S. airports. Our data do not show that average fares have increased significantly at DFW. However, in city-pair markets involving DFW where new low-fare competition has appeared, fares are generally down significantly.

Question. Has the Department received complaints about anti-competitive behavior on the part of American Airlines from carriers operating at DFW?

Answer. Yes. It has been our policy to investigate such complaints informally, and we have not publicly discussed the details of such allegations. Separately, we are developing a formal airline competition policy, which, when adopted, will create a formal basis for investigating such complaints and taking enforcement action.

Question. Do you consider O'Hare to be a major international gateway? Isn't there a significant number of domestic flights at Midway Airport? How close is Midway to O'Hare? As close as Love Field is to DFW? Has Southwest or any of the other carriers hurt the international growth at O'Hare? Is DFW increasing its international activity?

Answer. O'Hare is a major international gateway. Midway has over 60 thousand flights per year, a significant number. Based on the geographic centers of the airports, Dallas-Fort Worth is 10.1 nautical miles from Dallas Love Field and Chicago O'Hare is 13.5 nautical miles from Midway Airport. There is no reason to believe that Southwest or other carriers are impeding international growth at O'Hare. International flights out of DFW are growing.

Question. Won't DFW likely control over 80 percent of the traffic and passengers in the Dallas area, no matter what happens with the Wright Amendment?

Answer. Yes, DFW will likely continue to control over 80 percent of the traffic and passengers, because it is a major hub and because Love Field has many constraints on expansion. In 1992, the Department released a report titled "Analysis of the Impact of Changes to the Wright Amendment" that was prepared by an interdepartmental task force. That report showed that, assuming the Wright Amendment were repealed and then only if a carrier established a major origin and destination base or a major hub at Love Field, would DFW account for less than 80 percent of total operations at the two airports. The report also showed that landside constraints (adjacent industrial and residential development, limited road access, deed-restricted concourses, inadequate gates requiring major reconstruction) would need to be overcome before Love Field could significantly increase its share of operations and passengers.

Question. In 1996, the FAA implemented a new DFW Metroplex Air Traffic System Plan. Didn't this plan dramatically increase capacity at all DFW area airports? Will it reduce delays and improve on-time service at all DFW area airports?

Answer. Yes, the DFW Metroplex Plan has increased capacity at all DFW area airports, particularly on the airside. The Plan provides additional, more efficient arrival routes and redundant and better radar coverage. Airspace delays, which occurred about 13 times per day at DFW, have been reduced. Airspace delays that do occur are typically caused by inclement weather. Groundside delays, however, have increased slightly.

The Metroplex Plan has provided only limited increased capacity at Love Field. Love Field has parallel dependent runways—simultaneous instrument approaches are not permitted—when demand exceeds 36 VFR or 24 IFR arrivals per hour, traffic management restrictions may be implemented. During the peak times of 7–8 a.m., 11 a.m.–1 p.m., and 4–7 p.m., increased capacity at Love Field is limited because it shares the airspace with DFW.

Question. Is DFW Airport continuing to grow? Are additional runways planned? How will this growth impact airspace in the area? What type of delays are currently reported at DFW?

Answer. Yes, DFW is continuing to grow. The FAA forecasts operations to grow at an annual rate of 3.1 percent between 1997 and 2010 and enplanements to grow at an annual rate of 4.1 percent over the same period.

The current airport layout plan for DFW includes an additional runway, a north-south parallel runway located on the west side of the airport. It would be the eighth runway and allow DFW to accommodate quadruple simultaneous IFR arrivals.

The DFW Metroplex Air Traffic System Plan was brought on-line in October 1996. That plan took into consideration forecast aircraft operations at all airports in the Dallas/Fort Worth metropolitan area. The plan also assumed the construction of two new runways at DFW. One runway (17L/35R) was opened on October 1, 1996. The second runway is expected to be constructed in the future. The new Metroplex Air Traffic System was developed to accommodate the forecast increase in aircraft operations and expansion of DFW.

Estimated delays at DFW were approximately 1.06 minutes per operation for 1997. This is up slightly from 1996, when delays were 1.02 minutes per operation. This increase can be attributed to severe weather and ground delays (e.g., lack of available gates, delays in taxiing across active runways).

Question. What happens at an airport where there are too many flights scheduled? Do you just let them take off, or do you use flow control to limit the number of operations in any specific period of time? Therefore, is it fair to say that the FAA can safely handle aircraft traffic regardless of the number of operations scheduled?

Answer. No matter how many flights are scheduled at an airport, the FAA, through Air Traffic Control (ATC), limits the number of operations to those it can safely control. Techniques such as flow control, metering, adjusting arrival and departure routes (heading and altitude), and utilizing different runways are used by ATC to manage operations. Aircraft delays could occur, but under all conditions, the FAA ensures the safety of all operations.

Question. From an ATC perspective, is there a difference in handling a turboprop or small jet?

Answer. At DFW, the answer is yes, although both large commercial airplanes and smaller general aviation aircraft are provided equal access. Air traffic controllers in the DFW Metroplex System Plan separate jets, turboprops, and propeller-driven airplanes into three structures. Because of their varied operating performances, each category may be given a different runway and different routes or headings and different altitudes both for arrivals and departures. This system increases the number of aircraft that the controllers can manage.

Question. Does flight peaking at hub airports place a strain on the air traffic system?

Answer. Yes. Under the hub and spoke system, many airplanes arrive and depart at the same time, placing a strain on the air traffic system. As a result, aircraft delays could occur, but the safety of all operations is never compromised. The various elements of the DFW Metroplex Plan have reduced some of this strain.

SUBCOMMITTEE RECESS

Senator SHELBY. The subcommittee will recess until March 5, 1998 at 10 a.m.

[Whereupon, at 3:08 p.m., Tuesday, October 21, the subcommittee was recessed, to reconvene subject to the call of the Chair.]

BARRIERS TO AIRLINE COMPETITION

THURSDAY, MARCH 5, 1998

U.S. SENATE,
SUBCOMMITTEE ON TRANSPORTATION,
AND RELATED AGENCIES,
COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 10 a.m., in room SD–124, Dirksen Senate Office Building, Hon. Richard C. Shelby (chairman) presiding.

Present: Senators Shelby, Gorton, Faircloth, Lautenberg, and Reid.

PANEL 1

NONDEPARTMENTAL WITNESSES

STATEMENT OF PAUL DEMPSEY, VICE CHAIRMAN, BOARD OF DIRECTORS, UNIVERSITY OF DENVER/COLLEGE OF LAW

OPENING REMARKS

Senator SHELBY. The committee will come to order.

Good morning. I want to welcome you to the Subcommittee on Transportation Appropriations first hearing of the second session of the 105th Congress. Today, we are picking up where we left off last fall on the topic of competition in the aviation industry. At our last hearing, I indicated that we would have a series of hearings on competition and today's hearing is designed to focus on how airlines compete with one another. A day does not seem to go by without someone we know complaining about some aspect of the aviation industry. The complaints we hear most frequently are: Fares are too high; The airline schedules are all the same and are not convenient for non-business travelers; There are not enough options for the infrequent traveler; There is not enough service to mid-size communities; You cannot get anywhere without flying through a major hub; and Airline ticket prices do not make sense.

The more I look into the state of the competition in the aviation industry, the more I realize that it is not a subject area that lends itself to a fast or even to a simple analysis. The aviation industry characteristics of intensely competitive markets—intensely noncompetitive markets, all kinds of pressures, overtures of international competitiveness and a seemingly endless array of competitive and anticompetitive proposals put forth by anyone who has ever piloted, owned, flown on or seen a plane. I guess it is all of us.

To state the obvious, the aviation industry is a very complicated industry, which is why I initiated this series of hearings on competition. I hope we can make a very complicated industry a little more understandable to the people and to Congress.

Initially, I believe that deregulation of airlines has been very successful. More people can afford to fly today than could have been imagined when deregulation was enacted 20 years ago. The vast majority of Americans have a greater selection of flights, carriers, and in some cases airports than ever before. However, this does not mean that the state of competition in the aviation industry is perfect or that it does not require the continued attention of Congress, the administration, the press and consumer groups.

I believe we must continue our efforts to remove barriers to achieve an even more competitive environment in aviation transportation. Competition means lower fares, more choices and better service for all Americans. I am determined to make sure that the aviation industry is as competitive as possible. I am a firm believer that the American consumer will be the ultimate beneficiary of increased competition.

Part of my role as chairman of this subcommittee is to ensure that as the Department of Transportation carries out their programs they do so in a way that will promote competition and efficiency in the aviation industry, not to stifle competition. To meet that goal, I believe we must have a better understanding of the competitive dynamics of this industry.

At our October 1997 hearing, we touched on perimeter rules, slots and the Wright Amendment. In the future, we hope to explore the airlines' ticket pricing practices, yield management strategies, impact of regional jets on traffic patterns, current hubs and their impacts on the system, the future role of reliever airports, and the impact of the domestic aviation industry on international route negotiations and agreements. Today, I hope we can learn a little bit about one aspect of the industry—how airlines compete with one another.

To help us in this task, we have with us today the following experts: Paul Dempsey, an attorney and the vice chairman of Frontier Airlines; Mark Kahan, the executive vice president and general counsel of Spirit Airlines; Michael Boyd, an economist and aviation consultant; John Anderson, Jr., the GAO director for the Transportation Issues, Resources, Community and Economic Development; and Patrick Murphy, the deputy assistant secretary of transportation for Aviation and International Affairs.

PREPARED STATEMENT

I thank you, gentlemen, for agreeing to help us to explore these issues for the American people.

[The statement follows:]

PREPARED STATEMENT OF SENATOR SHELBY

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A day does not seem to go by without someone we know complaining about some aspect of the aviation industry. The complaints we hear most frequently are:

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—Airline ticket prices don't make sense.

The more that I look into the state of competition in the aviation industry, the more I realize that it is not a subject area that lends itself to a fast or simple analysis. The aviation industry has characteristics of intensely competitive markets, intensely non-competitive markets, oligopolistic pressures, overtures of international competitiveness, and a seemingly endless array of competitive and anti-competitive proposals put forth by anyone who has ever piloted, owned, flown on, or seen a plane. To state the obvious, the aviation industry is a very complicated industry, which is why I initiated this series of hearings on competition. I hope we can make a very complicated industry a little more understandable.

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Thank you, gentlemen, for agreeing to help us explore these issues this morning. Senator Lautenberg, do you have an opening statement?

STATEMENT OF SENATOR LAUTENBERG

Senator SELBEY. Senator Lautenberg.

Senator LAUTENBERG. Thanks very much, Mr. Chairman. My flight was late in taking off.

Senator SHELBY. We just complained about flights on time.

Senator LAUTENBERG. Yes.

Senator SHELBY. Yours was not on time.

Senator LAUTENBERG. We went from New York this morning.

Senator SHELBY. OK.

Senator LAUTENBERG. It is not easy. I thank you, Mr. Chairman, because this day we begin our first in a series of hearings for the fiscal year that is coming up. I want to commend you for dedicating two of these hearings exclusively to critical issues in the areas of aviation commerce.

Today's hearing, as I am sure you have indicated, is going to focus on the issue of barriers to competition. This is not a new issue to this Senator because prior to my arrival in the Senate I served as a commissioner of the Port Authority of New York and New Jersey, which owns and manages three major commercial airports in the New York/New Jersey region. Indeed, two of those airports are among the few slot-control airports in the Nation.

When I first came to the Senate, which was 5 years after deregulation, I served on the Commerce Committee. At that time, the committee was just beginning to assess the new landscape that deregulation brought to our national aviation system. Also, as a traveler who flies frequently back and forth from Washington to the north Jersey and New York area, it seems to me that I pay rates that are quite different depending on the airport that I travel from. I am familiar with the concerns that are voiced over price competition or the lack thereof in some aviation markets.

No one denies the extraordinary benefits that have accrued to our Nation as a result of deregulation. The traveling public is enjoying dramatically lower fares in many places, greater choices. Together, these forces have prompted the extraordinary growth we currently witness in air travel in our country, growth that is expected to continue well into the next century.

The numbers in the growth have stunned people, where there is constant shortfalls in the estimates that they had for the system necessary to carry the traffic. However, the consensus that exists over the benefits of deregulation legislation disappears when we turn to the issue of barriers to airline competition.

There is vast disagreement over whether the barriers to competition are real or perceived, whether the true entrepreneur is the new entrant to airline or the older established airline that cuts its fares to lead the competition. Some new entrant airlines have asserted that the older, established airlines have been deliberately cutting fairs in order to shut the door on new entrants into the business.

On the other hand, we have heard from Mr. Crandall, the chairman of AMR, when he stated that he sees the emergence of a double standard. He argues that "When a low-cost carrier enters a market and lowers fares, it is applauded for providing healthy competition; but when an established airline chooses to defend the market by matching the lower fares, or increasing capacity or both, it is denounced as predatory."

As in any major industry, we have seen some new entrants in the aviation business fail while others have flourished. Similarly, like other major industries, we have seen some new entrants fail largely on their own while others have failed with the aggressive help of their competitors.

Importantly, as an Appropriations Subcommittee it is our job to determine whether the Department of Transportation is fulfilling its responsibility to enforce the existing statute designed to maintain, if not to maximize competition.

I am grateful, Mr. Chairman, that you have included our Deputy Assistant Transportation Secretary Pat Murphy on our witness list today, the DOT, along with the Department of Justice. He is charged with enforcing several different statutes regarding competition in the airline industry.

We have several colleagues in the House and the Senate who have proposed additional legislation to address this competition question. As you might expect, these legislative proposals address the competition question from all sides of the debate. I am one Senator who believes that the Congress must act with caution in addressing the question regarding competition. If we are not careful, we could easily bring some harm to the situation. Our solution for one carrier or one market could mean the deterioration of another carrier and severe dislocation of the service in another market.

I do not advocate that the Congress sit idly by if we do, indeed, find that there are gross anticompetitive practices ongoing that are poisoning the marketplace, but I want to be convinced that the DOT and the Department of Justice do not currently have statutory tools necessary to address this problem and whether or not they have neglected to address it. I like to see competition.

Mr. Chairman, that is when the rates really reflect the marketplace. Once again, I say thank you for holding these hearings.

Senator SHELBY. Thank you.

Senator Gorton, before I call on you I just want to recognize that Senator Gorton, as a lot of you know, is not only a member of the Subcommittee on Appropriations, the Transportation Committee, he chairs the Authorizing Committee's Subcommittee on Aviation.

Senator, thank you.

STATEMENT OF SENATOR GORTON

Senator GORTON. Well, you just took the first 30 seconds of my opening statement, Mr. Chairman.

Senator SHELBY. You could probably articulate it better.

Senator GORTON. There is a certain degree of tension always between the Appropriations Committee members and the Authorizing Committee members. The subject matter of this hearing certainly fits more traditionally under the guise and jurisdiction of the Authorizing Committee.

On the other hand, increased knowledge on the part of Senators, increased sophistication on these issues is always extremely valuable and as a consequence of this hearing is a good idea. I can second something that Senator Lautenberg said about caution. I look at your opening statement, Mr. Chairman, and you list six most frequent complaints, none of which it seems to me is the appropriate subject of legislation because they have to do with fares and the moment that the Congress of the——

Senator SHELBY. If the Senator would yield?

They might not be the subject of legislation, they are the subject of oversight and something where we can certainly talk about.

Senator GORTON. The moment that we start passing laws on price fixing, we will have come up with a cure that is considerably worse than the disease.

Senator SHELBY. I do not think there was anything in there about that.

Senator GORTON. Yes; some of the barriers that we have already discussed and will discuss have an impact on those prices and are appropriate subjects for legislation in addition to oversight. You know, when competing airlines are frozen out of a market by the domination of a major airport by a single carrier and where a carrier can, in effect, engage in monopolistic practices, we are faced with a situation that is the appropriate subject of not only oversight, but perhaps of legislation itself.

Yet, it is interesting this morning's Washington Post, Mr. Chairman, in the business section includes a story about a number of additional gates, I think 10 additional gates, and the potential of 100 additional flights out of BWI by Southwest Airlines, an airline that has created a competitive market and has benefited the consumers by lower fares literally in ever market in which it has entered. The impact of Southwest at BWI is felt at National, or Reagan, and at Dulles as well.

The encouragement of that kind of entry without guarantees into a market is really important. You know, one of the major items that we need to understand is the degree to which airports in the same rough metropolitan area really compete with one another. You know, how well a Southwest can do even though it is not operating right out of the District of Columbia here in creating a competitive market is very, very important. Perhaps, the hardest things for members of Congress to do is to understand the large number of areas in which the best thing for them to do is to stay the hell out and let competitive forces work.

We do need to see to it that there is a structure in which competition can take place and the condition of airports, which almost without exception are owned by governmental bodies and may have in their own governing bodies interests other than competition, the way in which we regulate those Government-owned enterprises that are airports.

The way in which we try to see to it that competition is possible there or in the immediate vicinity is a vital and important consideration, but trying to tell given airlines when they should schedule planes, how they should schedule planes, and what their fares ought to be I am convinced is a cure far worst than the disease.

STATEMENT OF SENATOR FAIRCLOTH

Senator SHELBY. Senator Faircloth.

Senator FAIRCLOTH. Thank you, Mr. Chairman.

I heard only the later portion of what Senator Gorton had to say, but I agree with much of it and tend to echo it. I believe that airline deregulation has been one of the real success stories. Fares are lower and service is better than it overall has been in 20 years. There are going to be some areas that need attention, but I think deregulation has been a tremendous benefit to most, though not all, of the flying public.

Senator Gorton, I do not know whether you remember or not, but it used to be that you never saw anybody on an airplane that did not have on a blue suit, a white shirt and a red tie. Now it has become public transportation, but back then it was expensive and only a very few people were flying.

North Carolina is a high-growth State, and we have had a real increase in air travel. We are served by the major and the low-fare airlines in North Carolina. I believe that the smaller airlines are necessary since they offer a critical part of the service, and there should be room for them for competition.

I sense that there is a movement in the DOT to beat up on the larger carriers. The carriers are making some money now. Now here comes the DOT with a lot of advice on how to do it, but I did not see them coming forth with any subsidies when the airlines were losing trainloads of money in the past decade. I do not think that now that the airline business has been able to get on its feet and start working that we need to come in with new constraints and restrictions.

Thank you, Mr. Chairman.

Senator SHELBY. I just want to say again that this Senator is not ever going to be interested in price fixing ever, this Senator is not ever going to be trying to mandate what ticket fares are, but this Senator is going to be involved in making sure as much as we can by oversight hearings or other means that there is competition, real competition in the airline industry. That is what we are talking about. We are not going to stay the hell out of that, but we are going to stay the hell out of the other, that is: setting prices and routes.

If we leave what is going on now in America, I believe you are going to create monopolies more and more and you are going to have less and less competition and the consumer is going to get burned more and more. There are areas in the airline industry right now where people are getting burned because there is no real competition, and we know it.

Mr. Dempsey, Mr. Kahan, and Mr. Boyd, if you all would come forward.

Your written statements will be made part of the record in their entirety. We will give you 5 minutes, if you would, to sum up your testimony and then we will have time for questions.

Mr. Dempsey, do you want to start?

STATEMENT OF PAUL DEMPSEY

Mr. DEMPSEY. Chairman Shelby, distinguished Senators, my name is Paul Stephen Dempsey. I am a professor of law at the University of Denver and vice chairman and director of Frontier Airlines. It is an honor and a pleasure to be here with you this morning.

In the two decades of deregulation, we have never seen such a large and growing chorus of constituencies dissatisfied with the status quo in the airline industry. First, business travelers, which have experienced a 17-percent increase in business fares last year, are beginning to curtail travel. Prices are likely to rise again in 1989—1998, excuse me.

Second, mayors, airport directors, and chambers of commerce in America's medium-sized cities are also complaining about poor service and higher airfares resulting from inadequate competition. One need only visit with the community leaders of cities as diverse as Mobile, Huntsville, Chattanooga, Charleston, Allentown, Rochester, Des Moines, and Fargo to understand that the pricing practices of the megacarrier monopolists are less than benign.

Third, travel agents whose revenue has been unilaterally reduced 20 percent by the major airlines are increasingly dissatisfied by the market power that the megacarriers wield.

Fourth, the new entrant airlines are appalled by megacarrier efforts to drive them out of business. Despite record industry profitability in the last year, the number of new entrant airlines collapsing exceeded the number of new airlines entering the market. Competition is, therefore, declining.

Now, more than 150 airlines have gone belly up in the two decades of deregulation. Not all have been wounded or destroyed by predatory conduct. Many embraced a defective business plan, failed to find a market niche to satiate consumer demand, or were the victims of the downward slope of the market cycle or a spike in fuel costs.

Our Government should never protect a company from its managerial ineptitude or incompetence. While our Government should not be concerned about the survival of individual competitors, it should and must be concerned about the survival of competition.

Frontier Airlines has made its mistakes, too, but after Frontier achieved profitability, Frontier found itself in the crosshairs of the world's largest airline, United, which has been on a relentless 15-year homicidal mission to destroy competition and create a fortress hub monopoly at Denver.

The megacarriers insist that the affordable air carriers are out to reregulate the airline industry. They have it backward. Deregulation was not an end in itself; it was a means to an end. The purpose of deregulation was to enhance competition. Removing barriers to entry at slot-constrained airports and eliminating archaic perimeter rules are consistent with the goals of enhancing competition, the primary goal of deregulation.

We do not seek reregulation of the airline industry. We do ask that the competition and the antitrust laws applicable to every other industry in our economy also be applied to the airline industry. Ironically, that which might eventually lead to calls for reregulation lies within the exclusive control of the megacarriers.

The arrogance of monopolistic exploitation of business travelers in medium-sized cities, the predatory practices designed to drive small airlines out of business, the hypocrisy of demanding greater access to slot-constrained international airports while resisting competitive entry domestically, the growing concentration of the domestic market accelerated with the recent acquisition of control of Continental Airlines by Northwest, and the creation of global cartels shrouded with antitrust immunity—these are the abusive practices most likely to lead to a call for reregulation.

PREPARED STATEMENT

Paradoxically, if the affordable airlines are successful in restoring competition to the marketplace, any movement for reregulation will die stillborn. In an industry like transportation, like air transportation, so vital to the economic health of so many industries in our economy and geographic regions of our country, monopolistic exploitation cannot long be tolerated. After all, the airports and the airways belong to the public. Wherever possible competition is preferable to Government as regulator of the market. We are proponents of competition, Mr. Chairman, not regulation.

Thank you.

[The statement follows:]

PREPARED STATEMENT OF PAUL STEPHEN DEMPSEY

Chairman Shelby, distinguished Senators, my name is Paul Stephen Dempsey. I am Vice Chairman and Director of Frontier Airlines, Inc. I am also Professor of Law and Director of the Transportation Law Program at the University of Denver. Thank you for inviting me to testify here today on a matter of profound public importance—barriers to airline competition.

The new Frontier Airlines is a carrier born in the Summer of 1994. Today, it serves 14 cities with 14 Boeing 737 jet aircraft from a base in Denver, Colorado. Denver is a concentrated hub airport dominated by the world's largest airline, United Airlines. Several studies by the U.S. General Accounting Office and the U.S. Department of Transportation reveal that a fortress hub monopolist charges origin-and-destination consumers between 19 percent and 27 percent more than consumers are charged in competitive markets.

Frontier is a founding member of the Air Carriers Association of America. The Air Carriers Association was initially formed to deal with the effort of the major airlines to shift the tax burden away from the largest airlines and onto the smaller, affordable airlines. But as we came together, we learned we had something else in common. The major airlines appeared to be on a homicidal mission to destroy the low-fare airlines, and thereby, suppress competition.

The window of opportunity appeared after the ValuJet catastrophe in the Everglades, on May 11, 1996. The Department of Transportation had been a champion of the competition brought to bear by the new entrant airlines, praising their annual $6 billion contribution to consumer savings as a clear success of deregulation. But the Everglades crash occurred in an election year, and for political reasons, DOT soon found itself neutralized. ValuJet's 53 aircraft were grounded. The question in the industry became, "Why did Delta allow ValuJet to grow so large? Why didn't Delta kill off ValuJet when it had the chance?"

That mind-set put a number of relatively smaller airlines in the cross-hairs of the majors. It was open season on the upstart airlines. For example, the world's largest airline, United, targeted Frontier and Western Pacific Airlines. American allegedly targeted Vanguard and Sun Jet International. Delta allegedly targeted ValuJet (now AirTran). Northwest allegedly targeted Reno and Spirit Airlines.

Capacity dumping and below-cost pricing were the essential ingredients of this campaign to eradicate competition. In each situation, the tactics differed somewhat, but the purpose was the same—destroy the affordable airlines so as to raise consumer prices.

The major airlines have falsely claimed that the economic problems which confronted the affordable fare airlines is that consumers shied away from them after the Everglades crash. In Frontier's case, bookings took a modest dip in May 1996, coinciding with that unfortunate disaster in Florida, but then were restored relatively quickly. A far more significant hit in bookings occurred for Frontier in the Summer of 1996, coincident with Frontier's announcement of its first and second consecutive quarterly profits. It was at that point that United began a surreptitious campaign to destroy Frontier Airlines, engaging in the following practices:

—Adding seat capacity and flight frequency to deny competitors of realistic or achievable break-even load factors (in the Denver-Los Angeles market, for example, United added 8,600 seats per week);
—Dropping prices to below-cost levels (United dropped its prices in Frontier's markets by about 30 percent below United's costs, while raising prices sharply in its monopoly markets) while opening up low-fare "buckets" to flood the market with low-fare seats;
—Refusing competitors non-discriminatory access to its network (through discriminatory ticketing-and-baggage, joint-fare, frequent-flyer program, and code-sharing agreements);
—Biasing its computer reservations system against more convenient competitive offerings (by adding the equivalent of 1,440 minutes to interline flights in order to dominate the connecting market through its dominant hub);
—Paying travel agents commission overrides to steer business toward United and away from competitors; and
—Entering into "exclusive dealing" arrangements with corporate purchasers and regional turboprop carriers.

I have published a study entitled "Unfriendly Skies Over Colorado: United Airlines' Fortress Hub Monopoly At Denver," which chronicles United Airlines' activities over a 15-year period designed to establish and maintain a monopoly hub at Denver.

Frontier initially sought to restore nonstop jet service to a number of city-pairs which formerly enjoyed jet service prior to the elimination of the Continental Airlines' hub at Denver. Because United Airlines monopolizes the feed traffic necessary to provide adequate load factors in those "thin" markets, Frontier has been forced to amend its route strategy to focus on large city-pair markets radiating from Denver.

Since inaugurating service in July 1994, Frontier has withdrawn from the following city-pairs:

Denver-Bismarck, N.D.; Denver-Fargo, N.D.; Denver-Minot, N.D.; Denver-Grand Forks, N.D.; Denver-Billings, Mont.; Denver-Great Falls, Mont.; Denver-Bozeman, Mont.; Denver-Missoula, Mont.; Denver-Tuscon, Ariz.; Denver-Las Vegas, Nev.; Denver-St. Louis, Mo.; and Denver-San Diego, Cal.

Again, Frontier Airlines' original route strategy was to restore jet service to markets which previously enjoyed it, prior to Continental Airlines elimination of its Denver hub. Frontier began service between Denver and four cities in North Dakota, and Denver and four cities in Montana. These were markets which had sufficient local and connecting traffic to support jet service, particularly at a cost structure of a new low-cost airline like Frontier. Because the competing service in most of these nonstop markets was in high-cost, slow turboprop aircraft (flying as United Express), Frontier would dominate the local origin-and-destination market, for Frontier offered superior jet service at a competitive price. But United would monopolize the connecting market at the Denver hub, denying Frontier reasonable access to connecting passengers who might prefer to connect to a Frontier jet to a United Express turboprop aircraft. The means by which United would deny Frontier connecting traffic were as follows:

1. United refused to enter into a ticketing-and-baggage agreement with Frontier, though most other major airlines did enter into such an agreement with Frontier. This meant that passengers seeking to connect at Denver between United and Frontier flights would have to collect their bags from the incoming flight in the main terminal at Denver International Airport, then check them again onto their outgoing flight. Such an inconvenience would dissuade passengers from making the connection. It was not until the Department of Transportation "jaw boned" United into giving Frontier a ticketing-and-baggage agreement that United reluctantly did so.

2. United refused to enter into a joint-fare agreement with Frontier. Typically, carriers interlining passengers agree on a discounted combination of the A–B fare and the B–C fare, so that the passenger pays an overall A–C fare lower than the sum of the two undiscounted fares. United has joint-fare arrangements with its United Express affiliates. United (connecting at Denver with United Express) could therefore offer consumers a lower price between, for example, Los Angeles and Fargo, N.D., than could Frontier.

3. United refused to enter into a code-sharing agreement with Frontier. Code-sharing is a means whereby an airline falsely sells an interline connection as if it were an on-line connection. Thus, a United Airlines Los Angeles-Denver connection with a Great Lakes Aviation flight on a Beech 1900 turboprop flight between Denver-Fargo, N.D., is falsely portrayed as a United flight connected to a United flight both on the computer reservations systems [CRS's] and the ticket issued to the passenger. Most tickets are sold via CRS's, the retail distribution center for the overwhelming majority of flights. United owns a controlling interest in the Apollo CRS, which is strongly biased against non code-sharing interline flights. By using a CRS algorithm prejudiced against the United-Frontier (and all other interline connections which do not enjoy a code-share), United assures that such connections will not be displayed on the first page of the CRS screen, where travel agents sell 85 percent of all flights. This allows United to monopolize the connecting traffic at Denver.

4. United biases its computer reservations system against competitive connecting service. The overwhelming number of airline tickets are sold by travel agents. Travel agents sell 85 percent of tickets from the first page of their computer reservations screen. The computer reservations systems are owned by the major airlines, and are strongly biased against independent carrier connections. Although many (perhaps most) consumers would prefer to connect to a jet rather than a turboprop airplane, many at Denver have been funneled onto small turboprop aircraft operated by companies like Great Lakes Aviation, Mesa Airlines and Air Wisconsin, all operating at Denver as "United Express." Ironically, jet aircraft have lower available seat mile costs than do turboprop aircraft. The Apollo computer reservations system, which

United controls, adds the equivalent of 1,440 minutes (24 hours) to United's connections with Frontier at Denver, while adding zero additional time to its connections with Great Lakes, Mesa and Air Wisconsin. Adding such a severe penalty to independent carrier connections assures that they are not displayed on the first page of the CRS screens, and therefore, are rarely sold, even if consumers would prefer them.

5. United prohibits its code-sharing affiliates from code-sharing with Frontier. United has several code-sharing partners which feed its Denver hub—Air Wisconsin, Mesa Airlines and Great Lakes Aviation—all operating as "United Express." United prohibits these companies from entering into commercial relations with Frontier, so as to deny Frontier connecting traffic at Denver. Recently, Air Wisconsin (a company over which United Airlines exercises considerable influence) purchased Mountain Air Express [Max], a Denver-based code-sharing partner of Frontier, which provided new traffic to Frontier from such cities as Kansas City, Tulsa, Oklahoma City, Colorado Springs and Hayden/Steamboat Springs, and Montrose, Colorado. Because of Air Wisconsin's exclusive contractual relationship with United, Max has announced its intention to cancel its code-sharing agreement with Frontier. Connecting service from these cities will be lost to Frontier, and gained by United.

These reasons made it necessary for Frontier to withdraw from the four cities in North Dakota and the four cities in Montana, and contributed to its decision to withdraw from the Tucson market as well. These city-pair markets are simply too "thin" to be served by a competitive low-cost jet carrier where the dominant hub carrier monopolizes the connecting traffic. Frontier believes that United's hub network is an "essential facility," in the same way that AT&T's telecommunications network was deemed an "essential facility" for antitrust purposes, leading to its divestiture of local operating telephone companies in the 1980's.

Frontier's withdrawals from Denver-Las Vegas, Denver-St. Louis and Denver-San Diego were also influenced by United's monopolization of connecting traffic, but since they are significantly larger markets, it was less of a factor. However, Denver-Las Vegas is a market where United flooded the route with a significant increase in flight frequencies with its competitive "weapon", Shuttle by United, and significantly dropped fares (then, of course, raised them sharply after Frontier left the market). Shuttle has also appeared in the Denver-Phoenix and Denver-Salt Lake City markets, which may have caused the departure therefrom of another low-fare carrier, Vanguard Airlines. Though United portrays Shuttle as a consumer-friendly low-cost/low-fare alternative. The facts suggest otherwise. Though United still offers low fares in the Denver-Phoenix market (where it competes with Frontier and America West), United Shuttle raised fares sharply after Frontier withdrew from the Denver-Las Vegas market:

A TALE OF TWO CITIES: UNITED'S LOWEST REGULAR FARES (EACH WAY)

	Before shuttle	Feb. 11, 1997 introductory fare	Feb. 11, 1998
Denver-Phoenix (608 miles)	$49	$49	$84
Denver-Las Vegas (649 miles)	69	49	112

Additional predatory practices of United which have driven Frontier from markets, or caused it financial injury so that it could not expand its operations, include the following:

1. *United engaged in below-cost pricing until Frontier was driven out of the markets*.—Average fare data produced by the U.S. Department of Transportation reveals that United typically lowered its average fares to Frontier's levels until Frontier exited the market, then increased fares to levels above those which preceded Frontier's entry. Since, in some markets, United offers a first-class product, an average fare which appears to match Frontier's actually undercuts Frontier's single-class coach product, for the DOT's average fare data includes all tickets sold, first and coach class. United also refused to raise fares in Frontier's markets after Congress re-imposed the 10 percent ticket tax in August 1996, though United raised its prices in all non-Frontier markets radiating from Denver to account for those increased costs. Frontier's research revealed that United was pricing its product about 30 percent below its costs in the Fall of 1996. We believe Northwest Airlines may also be engaging in below-cost pricing in the Minneapolis-Denver market, but we do not have specific evidence to substantiate our belief at this time.

2. *United has dumped excessive capacity into markets Frontier has entered.*—For example, after Frontier entered the Denver-Los Angeles market, United added 8,600 seats per week in the Summer 1996 vis-à-vis average levels a year earlier. In this period, United increased its average capacity, year-over-year, as follows:

	Percent
Denver—Salt Lake City	+28
Denver—Phoenix	+30
Denver—Las Vegas	+32
Denver—Omaha	+35
Denver—Los Angeles	+24

3. *United entered into "exclusive dealing" contracts with corporate purchasers.*—Frontier has attempted to sell its product to corporations in Denver and other major cities it serves, only to learn that United has contractually prohibited companies to which it gives a corporate discount from enjoying a discount from a competitor. United is not alone in such behavior, as Frontier also has encountered corporate purchasers in Minneapolis who are tied to Northwest Airlines' exclusive dealing contracts. In essence, these megacarriers are saying to corporations, "We'll give you a discount only if you don't fly Frontier."

4. *United bribes travel agents to book flights on United.*—A "bribe" is defined by Webster's as "money or favor bestowed on or promised to a person in a position of trust to pervert his judgment or corrupt his conduct," or "something that serves to induce or influence." The overwhelming majority of airline tickets are sold by travel agents. Travel agent commission overrides have become increasingly important to agents now that major airlines have rolled back and capped commissions, reducing agent revenue by 20 percent or more. Overrides are earned where travel agents exceed prescribed quotas on United's flights well in excess of United's capacity in those markets. In order to meet those quotas, agents must sell more of United's product and less of a competitor like Frontier. To do so, they must somehow steer purchasers to United's product, even if it is higher priced or offered at a less convenient departure time. An airline like Frontier which offers only a few frequencies per market can never provide sufficient capacity to compete with those override quotas. Northwest Airlines uses the same tactics in Minneapolis. In essence, these megacarriers are saying, "We'll give you a commission override check only if you don't book too many flights on Frontier."

5. *United refuses to sell Frontier access to its Mileage Plus frequent flyer program.*—Although United Airlines sells Mileage Plus frequent flyer miles to its code-sharing partner airlines, car rental agencies, hotels, florists, mortgage companies, clothiers, credit card companies, and a plethora of other businesses, United steadfastly refuses to sell Mileage Plus miles to Frontier. An overwhelming number of Denver's regular air passengers belong to United's Mileage Plus program. Because they cannot earn Mileage Plus miles on Frontier, they are thereby dissuaded from purchasing Frontier's product. Frontier does offer its passengers Continental Airlines' One Pass miles (for Continental does not have such an exclusionary policy), but far fewer of Denver's frequent flyers belong to the One Pass mileage program.

More recently, United Airlines has taken yet another blatantly anticompetitive move to further monopolize the Denver hub. On February 2, 1998, Frontier Airlines proposed to the Western Pacific Airlines [WestPac] Chapter 11 bankruptcy estate that, if Western Pacific shut down, Frontier be allowed to fly off WestPac's air traffic liability (tickets sold but not yet flown) on a non-exclusive basis. Frontier would wet lease between 2 and 4 of WestPac's Boeing 737–300 aircraft to restore low-fare service between Denver—Dallas and Denver—San Diego, markets in which Western Pacific provided the only low-fare nonstop alternative to United Airlines.

To digress for a moment, all three carriers—United, Western Pacific and Frontier—hubbed at Denver International Airport [DIA]. In the latest month for which we have data (December), United and its code-sharing affiliates operating as United Express controlled 70.9 percent of the passenger traffic at DIA (of which United had 64.7 percent and United Express had 6.2 percent), Western Pacific had 5.5 percent, and Frontier had 3.5 percent.[1]

On Wednesday morning, February 4, United made a preemptive strike against Frontier, cutting an exclusive deal with the bankruptcy estate to fly all the air traffic liability. Without this source of tickets to accelerate the ramp-up of demand, Frontier cannot take on WestPac's aircraft to open new service to Dallas and San Diego. With Western Pacific's grounding on February 4, this results in a situation where no low-fare competitor operates in either market. With the demise of Western

[1] Data: Denver International Airport.

Pacific, and the preemptive strike against Frontier's entry, United now has a full monopoly in the Denver-San Diego nonstop market, faces only two high-cost competitors (American and Delta) in the Denver-Dallas nonstop market, and effectively takes WestPac's 5.5 percent market share.

Given United's relatively high load factors in Denver, it will be difficult for United to accommodate many Western Pacific customers. By the agreement, they are precluded from using their Western Pacific tickets on Frontier. Also, given the low average fares at which the Western Pacific tickets were sold (because WestPac was having difficulty filling seats while it was in Chapter 11 bankruptcy), and the fact that United agreed to fly the tickets for 50 percent of their face value, the revenue potential of these tickets cannot be a realistic motivation for United.

The only reason this makes sense for United is that it causes competitive harm to Frontier, effectively prohibits Frontier from immediately entering the Denver-Dallas and Denver-San Diego markets, prohibits these Western Pacific customers from being introduced to the Frontier product, allows United to control another 5.5 percent of the Denver market, limits Frontier's ability to acquire new aircraft, and exacerbates Frontier's Stage 3 aircraft compliance obligations by December 31, 1998.

Frontier flys only 14 aircraft to 14 cities from Denver and, again, accounts for only 3.5 percent of the Denver market. United is the largest airline in the world. United has been on a 15-year quest to suppress competition and monopolize the Denver market via a plethora of means—capacity dumping, below-cost pricing, exclusive dealing contracts with regional feeder airlines and corporate purchasers, travel agent commission overrides, computer reservation systems bias, and discriminatory ticketing-and-baggage, joint-fare, and code-sharing agreements. If it is free from the competition laws, as it perceives itself to be, it can destroy low-fare competition in Denver.

MONOPOLIZATION UNDER THE ANTITRUST LAWS

On February 11, 1997, Frontier Airlines filed a complaint with the U.S. Department of Justice alleging unlawful monopolization by United Airlines of Denver International Airport [DIA] and city-pair markets radiating therefrom. Frontier identified eight antitrust doctrines that United appears to have violated: Dumping excess capacity into competitors' markets; Pricing discrimination; Predatory pricing; Monopoly leveraging; Refusal to deal; Refusal to share an essential facility; Raising rivals' costs; and Exclusive dealing arrangements.

Section 2 of the Sherman Act provides that "every person who shall monopolize, or attempt to monopolize * * * any part of the trade or commerce * * * is guilty of a felony."[2] A Section 2 claim can be brought against the use of monopoly power "to foreclose competition, to gain a competitive advantage, or to destroy a competitor."[3] Frontier believes United Airlines' activities over the past 15 years have been aimed at destroying competitors, controlling prices, and foreclosing competition at Denver, Colorado. One who effectively controls a market may not lawfully use any exclusionary practice against a competitor, even though it is not technically a restraint of trade in violation of section 1 of the Sherman Act.[4] A monopolist may not legitimately deter potential competitors from entering its market or existing rivals from increasing their output.[5]

POLICIES OF THE AIRLINE DEREGULATION ACT

The Airline Deregulation Act of 1978 specifically provides that deregulation was not designed to condone unfair methods of competition, or deceptive, anticompetitive and monopolistic practices. Specifically, the Airline Deregulation Act provides:

"[T]he Secretary of Transportation shall consider the following matters, among others, as being in the public interest:

"(4) the availability of a variety of adequate, economic, efficient, and low-priced services without unreasonable discrimination or unfair or deceptive practices * * *.

"(9) preventing unfair, deceptive, predatory, or anticompetitive practices in air transportation.

"(10) avoiding unreasonable industry concentration, excessive market domination, monopoly powers, and other conditions that would tend to allow at least one air car-

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[2] Section 2 has two elements: (1) the possession of monopoly power in the relevant market, and (2) the willful acquisition or maintenance of that power, as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident.

[3] *United States* v. *Griffith*, 334 U.S. 100 (1948).

[4] Herbert Hovencamp, Economics and Federal Antitrust Law 136–37 (1984).

[5] Id at 138.

rier * * * unreasonably to increase prices, reduce service, or exclude competition in air transportation.

"(11) maintaining a complete and convenient system of continuous scheduled interstate air transportation for small communities * * *

"(13) encouraging entry into air transportation markets by new and existing air carriers and the continued strengthening of small air carriers to ensure a more effective and competitive airline industry." [6]

Each of these policies has been thwarted by United Airlines' predatory and anticompetitive activities at Denver, and in city-pair markets radiating therefrom. Over the past decade, several studies performed by the U.S. General Accounting Office have chronicled the plethora of predatory weapons used by major airlines to thwart these Congressional goals. In its most recent report, the GAO concluded:

"[W]e identified a number of policy options 6 years ago that DOT could consider to lower these barriers [to entry] and increase competition. Since then, there has been little progress toward reducing these barriers, and some * * * have grown worse. Therefore, we believe that DOT must now take positive steps to address several of the most serious barriers." [7]

In its 1996 report on new entrant airlines, DOT expressed concern that hub dominant airlines have an incentive to discourage competitive entry by engaging in predatory behavior and unfair competitive practices:

"[W]e will not be indifferent to attempts to exclude or preclude new entry through predatory activity * * *. [T]he beneficial impact of low cost new entry—especially in disciplining fares and filling service voids—is simply too important to permit predation to undermine it. Anticompetitive activity can take myriad forms, from sudden and targeted service increases and sharp and highly selective fare cuts to * * * other doing business problems. The Department will continue to evaluate which actions cross the line from tough competition to anticompetitive predation and react accordingly." [8]

It is for these reasons that Frontier has asked the U.S. Department of Transportation to investigate United Airlines' predatory and anticompetitive practices at Denver and routes radiating therefrom.

UNFAIR COMPETITION UNDER THE FEDERAL AVIATION ACT

Section 41712 (formerly section 411) of the Federal Aviation Act provides:

"On the initiative of the Secretary of Transportation or the complaint of an air carrier * * * and if the Secretary considers it is in the public interest, the Secretary may investigate and decide whether an air carrier * * * has been or is engaged in an unfair or deceptive practice or an unfair method of competition in air transportation * * *. If the Secretary, after notice and an opportunity for a hearing, finds that an air carrier * * * is engaged in an unfair or deceptive practice or unfair method of competition, the Secretary shall order the air carrier * * * to stop the practice or method." [9]

This statutory provision is modeled after section 5 of the Federal Trade Commission Act. [10] Both the Federal Trade Commission and the DOT may forbid anticompetitive practices before they become sufficiently serious to violate the Sherman Act. [11] The DOT has acknowledged that its authority under this provision "allows us to define practices that do not violate the antitrust laws as unfair methods of competition, if they violate the spirit of the antitrust laws." [12] United Airlines' predatory and anticompetitive activities at Denver violate not only the spirit of the antitrust laws, but arguably the letter of those laws as well.

We hope DOT will take forceful action to preserve competition, which was among deregulation's principal objectives.

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[6] 49 U.S.C. § 40101.

[7] U.S. General Accounting Office, Airline Deregulation: Barriers to Entry Continue to Limit Competition in Several Key Domestic Markets 22 (Oct. 1996).

[8] U.S. Dept. of Transportation, The Low Cost Airline Service Revolution 32–33 (l996).

[9] 49 U.S.C. § 41712.

[10] 15 U.S.C. § 45. *United Air Lines* v. *Civil Aeronautics Board*, 766 F.2d 1107 (7th Cir. 1985).

[11] *Pan American World Airways, Inc.,* v. *United States*, 371 U.S. 296 (1963); *Atlantic Refining Co.* v. *FTC*, 381 U.S. 367 (1965).

[12] 61 Fed. Reg. 42,208, 42,215.

ANTITRUST ENFORCEMENT IS NOT THE EQUIVALENT OF RE-REGULATING THE AIRLINE INDUSTRY

United Airlines falsely claims that Frontier advocates re-regulation of the airline industry.[13] That allegation is patently absurd. Frontier is an airline born of deregulation, and has never requested re-regulation in any form. Frontier merely asks that the existing competition laws, applicable to every other industry in the United States, also be made applicable to the world's largest airline, United Airlines. One must recall the admonitions of Alfred Kahn, the father of deregulation, who repeatedly insisted, "When we deregulated the airlines, we certainly did not intend to exempt them from the antitrust laws."[14] Yet the antitrust laws have not been applied with full force to the airline industry. Until 1985, the Civil Aeronautics Board provided antitrust oversight. With the sunset of that agency, it is now time for the Justice Department to fill the void.

Re-regulation ot the airline industry would require a substantial legislative overhaul of the Federal Aviation Act. We do not believe that will be necessary if the Airline Deregulation Act and Sherman Antitrust Act are applied as citizen (though perhaps, as explained below, it may be useful for Congress to clarify what constitutes unfair and deceptive practices and unlawfull monopolization under these statutes).

To the extent we do perceive a need for legislative change, we see it in the arena of farther deregulation in order to enhance competition—deregulating the buy-sell slot rule, deregulating the airport perimeter rules, deregulating exclusive airport gate agreements and majority-in-interest clauses, and stripping major airlines of the ability to regulate computer reservations systems in a manner which distorts competition, or to bias travel agents with consumer overrides. That's not re-regulation. That's eliminating anticompetitive barriers to entry which suppress competition. Eliminating barriers to entry was among the fundamental purposes of the Airline Deregulation Act of 1978. Allowing the largest airlines to monopolize gates, slots, and the computerized distribution system is nowhere listed among deregulation's objectives.

Ironically, the major airlines have been vigorous proponents of competitive access in foreign markets. Testifying before a Senate Judiciary Subcommittee on April 22, United Airlines' Vice President Cyril Murphy said, "It would be irresponsible for governments not to protect their citizens against the possibility of [cartelization and monopoly pricing]."[15] In opposing the proposed American Airlines/British Airways alliance (which, incidentally, would compete with the United/Lufthansa alliance, which had been conferred immunity from the application of the antitrust laws) United's Murphy said, "Governmental bodies have as their dual goals freeing the industry in terms of the elements of competition and protecting their citizens from the potential for anti-competitive abuse of that new, open environment. This means * * * developing anti-monopoly policies that provide strict scrutiny of the 'superhubs' so as to maintain the opportunity for meaningful intrahub competition."[16] Among the remedies proposed by United was the surrender, by American Airlines and British Airways, without compensation, of slots at Heathrow, JFK and Chicago O'Hare Airports, a restriction on the acquisition of new slots, and the termination of code-sharing agreements with British Midland. Though United had received free slots at O'Hare and LaGuardia Airports in the 1980's, United objected when new entrant airlines like Frontier recently asked for access to these slot-constrained airports.[17] Because of slot regulation, United has been able to capture a monopoly premium associated with monopolization of a finite public resource. Frontier believes that deregulation of slots would open a clogged monopoly bottleneck.

Though United advocates "open skies" in international markets, United takes a different view when addressing competition issues in the superhubs it dominates.

Though United Airlines advocates vigorous governmental intervention to prevent monopoly abuse at London's Heathrow Airport, on April 10, United Airlines CEO Gerald Greenwald said, "Try to get the government to come in and solve [Denver's] competitive issues, and we will all regret it."[18] Apparently, developing anti-monop-

[13] See Roger Gibson, Controls Could Turn Clock Back 20 Years, Denver Post, May 4, 1997, at El.

[14] Melanie Pickett, The Air Fare Puzzle, Los Angeles Times, Nov. 19, 1989, at D3.

[15] Statement of Cyril Murphy Before the U.S. Senate Judiciary Antitrust, Monopolies and Business Rights Airline Subcommittee (April 22, 1997).

[16] Id.

[17] United Airlines Press Release. May 8, 1997.

[18] Richard Williamson, United Slaps Back At Frontier, Rocky Mountain News, April 10, 1997, at 1B.

oly policies for strict scrutiny is appropriate only at superhubs United Airlines does not monopolize.

LEGISLATIVE PROPOSAL

It would remiss of me to come before you and not offer a model remedy to the problems I have discussed here, and their pernicious impact on consumers and disadvantaged regions of our nation. I have suggested that the Justice and Transportation Departments have significant statutory means of addressing these problems. Certainly, the Appropriations Committee can assure that these agencies have sufficient resources to address anticompetitive issues in the airline industry. But to clear up some of the case law which, for example, has unduly narrowed the concept of predatory pricing under the Sherman Act, and to apply the competition laws more precisely to the specific problems which emerge in the airline industry, I would respectfully suggest consideration of proposed legislation along these lines:

AIRLINE COMPETITION ACT OF 1998

Preamble

The Congress hereby recognizes that the competition unleashed by airline deregulation has been beneficial to large segments of the consuming public, but that competition should be further advanced so that a larger universe of Americans can enjoy the benefits of airline deregulation. In the Airline Deregulation Act of 1978, Congress explicitly affirmed its commitment to preventing unfair, deceptive, predatory or anticompetitive practices in air transportation, avoiding unreasonable industry concentration, excessive market domination, monopoly power and other conditions that would allow a carrier unreasonably to increase prices, reduce service or exclude competition in air transportation. Congress is concerned that prices are not fully competitive for travel to or from airports dominated by a single airline, and for travel to and from small communities. Congress is also concerned that market dominant airlines are using their domination of public resources in a manner to suppress competition. Because airports and the airways are public resources, they should be used for public benefit, and airline competition is a major public benefit.

1. Definitions: (a) A "market dominant airline" is an airline which transports more than 60 percent of the passengers, leases more than 60 percent of the gates, or flys more than 60 percent of the flights, to or from any major U.S. airport. It shall be considered a market dominant airline only at the airport it so dominates.

(b) A "market dominant airport" is an airport at which a single airline transports more than 60 percent of the passengers, leases more than 60 percent of the gates, or flys more than 60 percent of the flights.

(c) An "exclusive dealing contract" is a contract which prohibits a contracting party from entering into a like or similar contract with another airline.

(d) A "travel agent commission override" is any supplementary economic or other compensation paid to a travel agency based on its sales of the market dominant airline's product, above that paid to all other travel agencies.

(e) A "code-sharing arrangement" is a marketing relationship by which two airlines agree to use each other's two-letter codes for display in computer reservations systems and other sales outlets.

(f) A "joint-fare arrangement" is an agreement between two carriers to provide interline air travel at an agreed-upon division of joint fares.

(g) A "ticketing-and-baggage arrangement" is an agreement between carriers to honor each other's tickets issued by the Airline Reporting Corporation and transfer baggage between them.

2. A market dominant airline may not enter into exclusive code-sharing, joint-fare or ticketing-and-baggage arrangements at any airport it dominates. Any such code-sharing and joint-fare relationship must be offered to all carriers seeking such relationships on a non-discriminatory basis for travel to and from the market dominant airport.

3. A market dominant airline may not lawfully enter into an exclusive dealing contract with a connecting airline for service to or from an airport it dominates. Any such exclusive dealing contract is null and void.

4. A market dominant airline may not lawfully enter into an exclusive dealing contract with a corporate purchaser of air travel at any city located within 50 miles of an airport which the airline dominates. Any such exclusive dealing contract is null and void.

5. A market dominant airline may not lawfully offer or pay any commission overrides to any travel agency or travel agent at any city located within 50 miles of an airport which the airline dominates.

6. A market dominant airline may not lawfully refuse to sell frequent flyer mileage to its airline competitors for travel to or from a market dominant airport at a price higher than the lowest available price offered to any purchaser.

7. Any violation of these provision shall constitute an unfair and deceptive practice under 49 U.S.C § 41712 and unlawful monopolization under 15 U.S.C. § 2.

This is only a suggested model of what might be appropriate legislation. I leave it to the Honorable Senators and their capable staff to draft a bill which better accomplishes the competition enhancement goals we share.

CONCLUSION

The arsenal of anticompetitive activities used by major airlines against new entrants is not new, though these tactical weapons have been used with increasingly better precision and effectiveness by the major airlines. Several low-cost/low-fare airlines now find themselves in the cross-hairs of the major airlines. It is also apparent that a failure of government agencies to impose sanctions against such practices has led to a widespread belief among the major airlines that our nation's competition laws do not apply to them. It would therefore be helpful if the U.S. Department of Justice and the U.S. Department of Transportation take such enforcement action as is necessary to preserve competition, while there is still competition to preserve.

Despite record profits earned by the major airlines, the number of low-cost low-fare airlines is declining. Within the last year, new entrant airlines like Air South, Sun Jet International, Western Pacific and Pan American World Airways have disappeared from the competitive landscape. That environment would change profoundly if the Transportation Department and Justice Department took formal action against a major hub-dominant airline for blatantly anticompetitive activities such as those described herein.

Neither the Department of Transportation nor the Department of Justice need protect an individual competitor from the rigors of the marketplace. They should, however, protect competition. Without application of the competition laws, predation runs riot, and competition is jeopardizes. Because of the profound economic externalities airlines impose upon communities and businesses across America, monopolization in the airline industry cannot be tolerated. After all, the American people own the airways and the airports. These are public resources to be used in the public interest. Therefore, it is reasonable to insist that air carriers serve the public interest. Monopolistic exploitation is antithetical to that duty.

Thank you.

BIOGRAPHICAL SKETCH

PAUL STEPHEN DEMPSEY

Paul Stephen Dempsey is Vice Chairman & Director of Frontier Airlines. He is also Professor of Law and Director of the Transportation Law Program at the University of Denver. He formerly served as an attorney with the Civil Aeronautics Board and the Interstate Commerce Commission in Washington, D.C. Professor Dempsey has written more than fifty law review and professional journal articles, scores of newspaper and news magazine editorials, and several books:

Airline Management: Strategies for the 21 st Century (Coast Aire 1997).

Air Transportation: Foundations for the 21st Century (Coast Aire 1997).

Denver International Airport: Lessons Learned (McGraw-Hill 1997).

Aviation Law & Regulation (two volumes, Butterworth 1993).

Airline Deregulation & Laissez-Faire Mythology (Quorum Books 1992).

Flying Blind: The Failure of Airline Deregulation (Economic Policy Institute, 1990).

The Social & Economic Consequences of Deregulation (Quorum Books 1989).

Law & Foreign Policy in International Aviation (Transnational 1987).

Law & Economic Regulation in Transportation (Quorum Books 1986).

Professor Dempsey was a Fulbright Scholar, was awarded the Transportation Lawyers Association Distinguished Service Award, and was designated the University of Denver's Outstanding Scholar. He was the first individual designated the University of Denver's Hughes Research Professor and DePaul University's Distinguished Visiting Professor of Law. He was inducted into the Colorado Aviation Hall of Fame. Since 1979, he has been faculty editor of the "Transportation Law Journal." He also serves on the Editorial Boards of the "Denver Business Journal," and "The Aviation Quarterly."

Since 1986, he has been the host of KWGN–TV's weekly talk show, "Your Right To Say It." Professor Dempsey has appeared on the ABC Evening News with Peter

Jennings, the NBC evening news with Tom Brokaw, the MacNeil-Lehrer News Hour, ABC World Business Report, NBC Today, ABC Good Morning America, CNN Crossfire, National Public Radio, CBS Radio, NBC Mutual Radio, and other news broadcasting networks in the United States and abroad. His editorials have been published numerous newspapers and news magazines, including Newsweek, the New York Times, and the Wall Street Journal.

Professor Dempsey has served as President of Americans for Sound Aviation Policy. He has also been a consultant to U.S. and foreign airlines, railroads, motor carriers, transportation labor organizations, travel agents, telecommunications companies and governmental agencies. Dr. Dempsey holds the following degrees: A.B.J., J.D., University of Georgia; LL.M., George Washington University; D.C.L., McGill University. He is admitted to practice law in Colorado, Georgia and the District of Columbia.

Major Airline Hubs

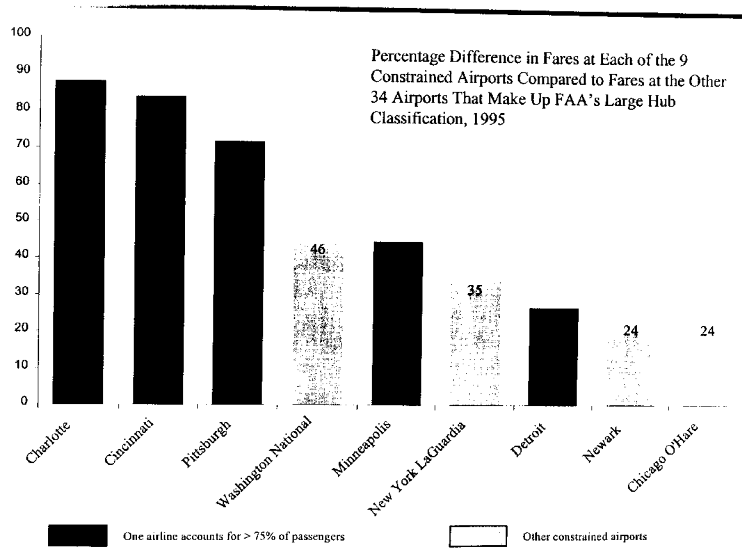
More Than 75% of Domestic Service Involves a Major Airline Hub

Top U. S. Airports - 1st Half, 1998 (Domestic Hubs)

Airport	No. 1 Airline	Share %	No. 2 Airline	Share %
Chicago O'Hare	United	47%	American	34%
Atlanta*	Delta	80%	ValuJet	4%
Dallas/Ft. Worth	American	67%	Delta	19%
Los Angeles	United	31%	Delta	15%
San Francisco	United	61%	American	7%
Denver*	United	71%	Frontier	5%
Phoenix	America West	40%	Southwest	26%
Detroit	Northwest	80%	Southwest	3%
Miami*	American	66%	United	8%
St. Louis	TWA	71%	Southwest	12%
Newark	Continental	59%	United	10%
Minneapolis	Northwest	85%	United	4%
Houston	Continental	84%	American	5%
Seattle	Alaska	38%	United	19%
Average		63%		12%

*Airports that have changed from a two-hub airport to a one-hub airport during this period.
Source: Department of Transportation, GKMG Consulting Services, and Aviation Daily

Percent average fare was higher at Concentrated Hubs



Source: GAO's analysis of DOT's data.

U.S. AIRLINE INDUSTRY—MARKET SHARE BASED ON ENPLANEMENTS—DENVER STAPLETON INTERNATIONAL AIRPORT

[Units in thousands]

	Percentage						
	1987	1990	1991	1992	1993	1994	1995
United	43.02	48.44	46.76	48.54	52.57	62.94	69.94
Delta	2.67	4.21	4.46	4.54	4.32	4.48	5.08
American	2.02	3.23	3.59	4.07	3.61	4.20	4.83
Continental	43.51	34.26	36.83	35.45	31.34	16.97	3.39

Airfare Index

Reflects Average One-Way Fares from Denver to 10 Cities*

Full Coach

June 1994	$519
August 1994	$519
December 1994	$534
March 1995	$549
June 1995	$571
One-year change	10%

Typical Business**

June 1994	$315
August 1994	$355
December 1994	$435
March 1995	$419
June 1995	$458
One-year change	45%

Lowest Discount

June 1994	$175
August 1994	$123
December 1994	$136
March 1995	$149
June 1995	$168
One-year change	4%

Average Fare Paid

June 1994	$224
August 1994	$245
December 1994	$260
June 1995	$308
One-year change	37.5%

Composite Fare***

	June 1995	One-Year Change
Full coach	$411	3%
Typical business	$335	7%
Lowest discount	$123	-7%
Average fare (June '95)	$254	13%

* Atlanta, Chicago, Dallas, Newark, Omaha, Salt Lake City, San Francisco, San Jose, Seattle and Washington, D.C.
** Discount economy-class ticket that is reasonably unrestricted.
*** Average airfare nationwide, based on 215 routes between U.S. Cities. Source: The American Express Airfare Index

Denver, CO—10 City Pairs

[Year-over-year percent change (Q3 1997 vs. Q3 1996)]

Full Coach	30
Typical Business	35

Source: The American Express® Airfare Index, American Express Consulting

TYPICAL BUSINESS FARE SAMPLING

	Fare	Percent
1998 [1]	$448	+5
1997	426	+16
1996	366	+9
1995	335	+3
1994	326	−6
1993	282	+22

[1] Projected

Note: Average Yearly Increase + 8 percent.

Denver International Airport—The Big Prize

—A $5 billion air market
—6th Largest market in the United States
—73 percent of Total Traffic Controlled by UAL
—97 percent of Connecting Traffic Controlled by UAL

UAL Combines Tactics to Create Monopoly Power

—Prices below its cost [19]
—Dumps seat capacity [19]
—Refuses Economic Connections to their System
—Precludes feed traffic from UAL affiliates
—Pays Override Commissions to Travel Agents [19]
—Denies competitive shelf space in CRS displays
—Enters exclusive contracts with large corporations [19]

Flights Arriving On Time
August 1996 - September 1997

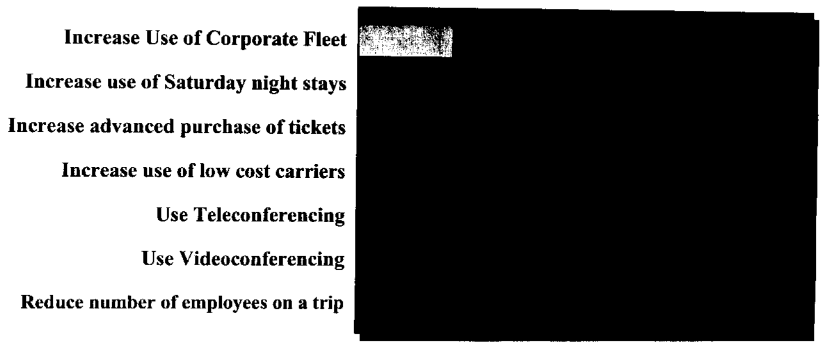
DOLLAR SAVINGS COMPARISON

Denver to:	Frontier Corporate fare BNR	United Walk-up fare BUA	Dollar savings	Percent savings
Albuquerque	$174	$423	$249	59
Baltimore/Washington	282	732	450	61
Bloominton-Normal	237	N/A	N/A	N/A
Boston	324	878	554	63
Chicago (Midway)	216	584	368	63
El Paso	209	N/A	N/A	N/A
Los Angeles	189	622	433	70
Minneapolis-St.Paul	248	498	250	50
New York LGA	399	843	444	53
Omaha	219	523	304	58
Phoenix	195	273	78	29
Salt Lake City	198	260	62	24
San Francisco	219	682	463	68
Seattle/Tacoma	230	673	443	66

[19] This reverses direction once competition is eliminated.

Corporations Strike Back at Record Business Air Fares

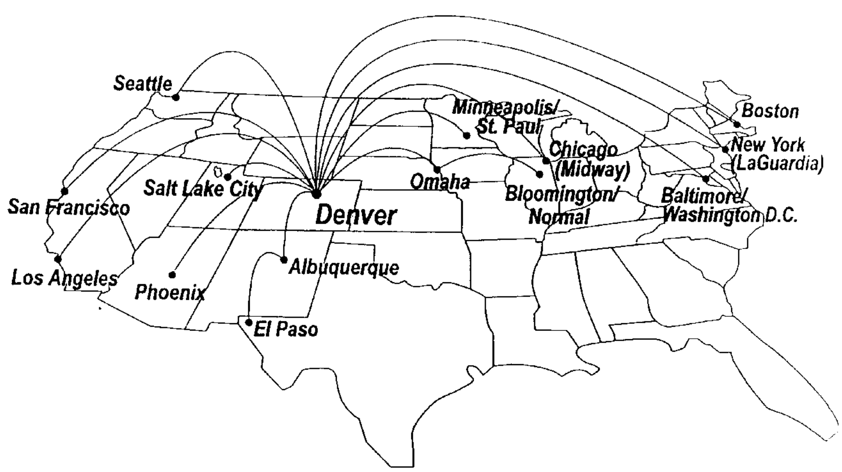
What steps do you expect to take to offset increasing air fares in the near future?



NBTA

DOMESTIC MARKET SHARE—DENVER INTERNATIONAL AIRPORT— DECEMBER 1997

Airlines	*Percent*
United	64.7
United Express	6.2
Frontier Airlines	3.5
Delta	4.7
Continental	2.6
American	4.5
Western Pacific	5.5
Other	6.1
Northwest	2.2

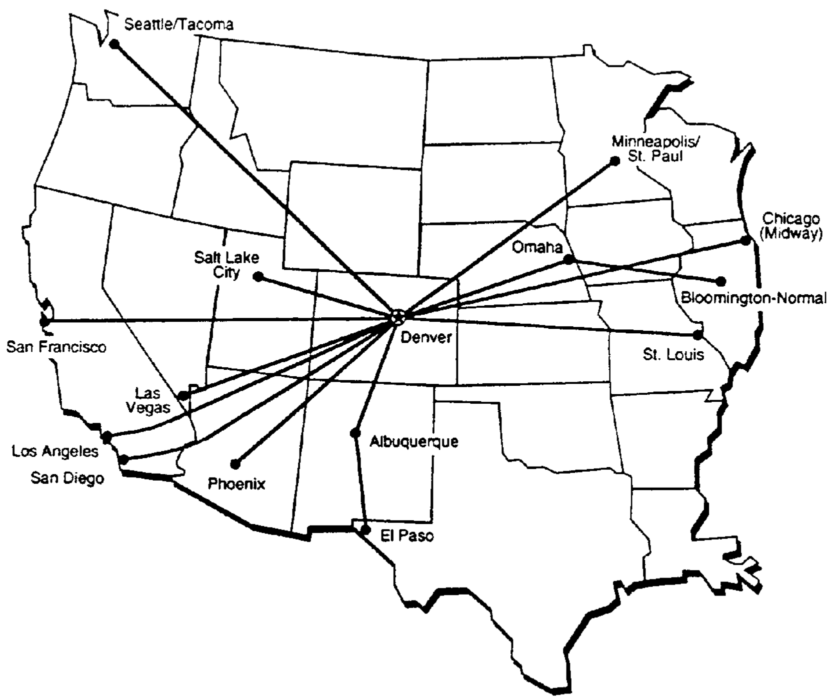


UNFRIENDLY SKIES OVER COLORADO: UNITED AIRLINES' FORTRESS HUB MONOPOLY AT DENVER

(By Paul Stephen Dempsey)

FOREWORD

This study documents the predatory practices used by United Airlines to monopolize the air transportation market at Denver. Having used such tactics to drive two major hub competitors out of Denver—the original Frontier Airlines and Continental Airlines—United is now focusing its gun sights on new, low-cost entrants to the Denver marketplace, principally the "new" Frontier Airlines. Frontier is attempting to counter United's actions through a number of major new marketing programs. At the same time, Frontier is seeking public and governmental understanding of the need to reestablish a level playing field at Denver. Frontier does not believe that United's tenacious determination to maintain a monopoly at Denver can withstand the light of day.



EXECUTIVE SUMMARY

UNITED AIRLINES' MONOPOLIZATION OF THE DENVER HUB

Introduction: United Airlines' Determination to Establish and Maintain a Monopoly Hub at Denver

United Airlines is the largest airline in the world. In 1996, United and its code-sharing affiliates controlled nearly 80 percent of the Denver passenger market, and more than 95 percent of the connecting passenger market flowing through its Denver Fortress Hub. United's dominance of the Denver hub was accomplished by several predatory practices designed to eliminate or subdue competitors: (1) add seat capacity and flight frequency to deny competitors realistic or achievable break-even load factors; (2) drop prices to below-cost levels; (3) refuse competitors nondiscriminatory access to its network; (4) bias its computer reservations system against more convenient competitive offerings; (5) paying travel agents commission overrides to steer business toward United and away from competitors; and (6) enter into "exclusive dealing" arrangements with corporate purchasers. Once a competitor has been driven from the Denver market, United has behaved like a rational wealth-maximizing monopolist—raising fares to monopoly levels. Chronologically, these unfair and deceptive practices have manifested themselves in the following order:

ELIMINATE THE ORIGINAL FRONTIER AIRLINES AS A COMPETITOR TO CREATE A UNITED & CONTINENTAL DUOPOLY AT DENVER

In 1982, United Airlines launched a plan to drive the original Frontier Airlines (then, along with United and Continental Airlines, one of Denver's three dominant airlines) from the Denver market. By increasing its capacity at Denver by a third, cross-subsidizing losses on deeply discounted fares in the Denver market with profits earned elsewhere in its vast route network, and biasing its computer reservations system to mislead travel agents, United was able to force Frontier to suffer its first losses in a decade. As its losses mounted, Frontier was forced to sell most of its assets to United Airlines, in 1985. After its sale to People Express, Frontier collapsed into bankruptcy, in 1986.

DRIVE CONTINENTAL OUT OF DENVER TO CREATE A FORTRESS HUB MONOPOLY

After Frontier's departure, United continued to engage in below-cost pricing. At first, United opposed the construction of a new airport at Denver, fearing that new competitors might enter the market. Once Continental Airlines signed up for Concourse A at the new Denver International Airport [DIA], United signed up for Concourse B, though insisting on a contractual provision that the new airport would not open until it was satisfied with the performance of the automated baggage system it had insisted be installed. In 1992, United designated Denver its "major domestic initiative." Using a variety of predatory practices, United turned up the heat on Continental, which began to lose $10 million a month at Denver, and half a billion dollars over three years. Although DIA could have opened in 1993, United delayed its opening until Continental downsized its hub at Denver. By 1995, when United finally allowed DIA to open, Continental flew only 13 flights a day to Denver from three cities. To ensure that no other airline would emerge as a significant competitor at Denver, United insisted that it be allowed to take over the Concourse C automated baggage system, that rents on Concourse A would disproportionately be assessed for its baggage system (which has never worked), and that United's maintenance hangar would be built on the site of a future concourse.

EXTRACT MONOPOLY FARES AT THE DENVER HUB

After Continental's departure, United raised fares sharply. Though it blamed DIA's high costs, United had begun to raise fares to monopoly levels well before DIA opened, as Continental downsized its operations. Moreover, United's belated and massive construction scope changes were the single most important factor in driving up DIA's costs.

MONOPOLIZE THE CONNECTING PASSENGER MARKET FLOWING OVER THE DENVER HUB AND, AS A BY-PRODUCT, DENY JET SERVICE TO SMALL COMMUNITIES THROUGHOUT THE ROCKY MOUNTAIN AND GREAT PLAINS REGION

United enters into discriminatory and monopolistic interline arrangements with select carriers at Denver. By refusing to enter into joint-fare and code-sharing agreements with unaffiliated domestic jet carriers, and adding the equivalent of 1,440 minutes (24 hours) to the elapsed flight time in their displays in its Apollo computer reservations system [CRS], United ensures that competing jet carriers' flights often will be shoved off the first page of the CRS display, where 85 percent of all flights are sold. United's competitors are thereby denied sufficient connecting traffic to attain break-even load factors in thin markets. By monopolizing the connecting passenger market at the Denver hub, United dictates that small communities throughout the Rocky Mountain and Great Plains region will be served only by high-cost, high-price monopoly "United Express" affiliates from Denver, most of which fly only small turboprop aircraft.

DRIVE NEW LOW-COST COMPETITORS FROM THE DENVER FORTRESS HUB AND THE NEARBY COLORADO SPRINGS AIRPORT

As a few small low-cost competitors emerged at DIA and Colorado Springs to offer prices lower than United's monopoly fares, United responded aggressively, by dumping additional aircraft capacity in their markets, lowering fares to levels below costs, paying travel agents commission overrides to steer business toward United and away from competitors, entering into "exclusive dealing" contracts with business purchasers, and in February 1997, launching its competitive weapon—Shuttle by

United—to markets in which low-cost entrants have emerged. The mission of the Shuttle is not to lower prices (though low prices it will initially bring); it is to drive low-price competition out of Denver.

EXTRACT MONOPOLY FARES AT THE DENVER HUB: ROUND TWO

If United is successful in driving the new Frontier Airlines from Denver, and Western Pacific Airlines from Colorado Springs, it will extract monopoly fares from passengers who begin or end their trips there. This will result in a wealth transfer of several hundred million dollars from consumers to the monopolist, United Airlines. Monopoly fares will have an adverse impact on Colorado's $6 billion a year tourism industry, and dissuade new business investment in Colorado.

In December 1996, when asked how much of the Denver market United wanted, United Airlines Vice President Roger Gibson said, "I'd like it all." That, of course, includes the 3 percent market share of Frontier Airlines. United's mission is to drive competitors from Denver so that it can charge Colorado's Consumers whatever the market will bear. Monopoly is the Name of the Game.

INTRODUCTION: UNITED AIRLINES' DETERMINATION TO ESTABLISH AND MAINTAIN A MONOPOLY FORTRESS HUB AT DENVER

United Airlines is the largest airline in the world. Beginning in 1982, United launched a plan to monopolize the Denver non-stop and connecting passenger market. Virtually every step United has taken with respect to competitors at Denver has been consistent with that goal.

The monopolization of the Denver hub has been achieved with several careful and deliberative steps. Step one was to eliminate the original Frontier Airlines as a competitor, which it did in 1986. Step two was to drive Continental Airlines out of Denver as a hub competitor, which it did in 1994. Steps three and four are to eliminate the new Frontier Airlines as a low-cost Denver competitor, and to drive Western Pacific [WestPac] out of Colorado Springs.

The means by which United accomplishes these goals have been consistent: (1) add seat capacity and flight frequency in competitors' city-pairs in order to drive its competitors' load factors to below break-even levels; (2) drop prices to levels at or below those of any competitor which dares to enter its market, even if the price is below United's costs; (3) refuse any competitor access to its dominant passenger network; (4) bias its computer reservations system to dissuade travel agents from selling its competitors' services; (5) bribe travel agents with commission overrides to steer passenger business toward United; and (6) enter into exclusive dealing arrangements with corporate purchasers. After a competitor is eliminated, United's conduct as a monopolist has also been strikingly consistent—raise prices in its monopoly city-pairs to whatever the market will bear. This gives it the economic resources to repeat the cycle whenever a new entrant attempts to invade its fortress hub.

This study documents the anticompetitive behavior of United Airlines toward its competitors chronologically, beginning shortly after airline deregulation.

ELIMINATE THE ORIGINAL FRONTIER AIRLINES AS A COMPETITOR TO CREATE A UNITED AND CONTINENTAL DUOPOLY AT DENVER

The original Frontier airlines began service as a "local service carrier" in 1946. By the beginning of 1982, Frontier Airlines had more flights at Denver than any other carrier, serving a total of 85 cities from its Denver hub. Frontier had been consistently profitable during the previous ten years.[1] Although the industry as a whole lost money in 1981, Frontier earned $32 million of profit on revenue of $577 million.[2] It was to be Frontier Airlines' last good year.

According to Aviation Daily, in 1982, "United, a major competitor at Denver Stapleton, launched a massive campaign to capture a bigger share of the Denver market and to become the dominant carrier at the airport."[3] The 1981 air traffic controllers' strike had led the FAA to impose a cap on landing slots. In 1982, as it began its buildup at Denver, United was buying slots from anyone who would sell them, moving acres of seats to Denver.[4] (See Appendix B). United increased its flights out of Denver by a third, predominantly adding capacity in Frontier's mar-

[1] H. Laws & R. Lossee, Frontier (monograph Dec. 2,1986). at 2.
[2] History of the Former Frontier Airlines: 1946–1986.
[3] Aviation Daily (Sept. 2, 1986), at 348.
[4] Dee Mosteller & Danna Henderson, Denver's Stapleton Airport: A Good Place To Watch Deregulation, Air Transport World (Nov. 1986), at 64.

kets.[5] In its "United's High On Denver" plan, United Airlines executives explicitly identified Frontier Airlines as its principal target.[6] From May to July of 1982, United increased its flights from 96 to 133 daily departures, becoming Denver's largest carrier, versus 120 daily departures by Frontier and 110 by Continental.[7] This author's study of the airline industry (published in 1992) discussed this period as follows:

"United, the nation's largest airline, was determined to dominate Denver. With a deep pocket that could cross-subsidize losses in competitive markets, a powerful computer reservations system that could discriminate against competitors, and an attractive frequent-flyer program that could lure business travelers (the most lucrative segment of the passenger market), United, the nation's largest airline, began to turn up the heat on Frontier." [8]

1982 marked the first time United Airlines was described by the press as "the 800-pound gorilla." [9] It is a metaphor that has since been almost universally embraced by observers of the airline industry.[10]

By 1983, United had added over 100,000 seats per week at Denver since deregulation, and increased its frequencies to 174 departures per day at Denver's Stapleton International Airport. Frontier had 138 daily departures and 24.3 percent of the market, while Continental had 18.5 percent.[11] Frontier was being squeezed by a determined United Airlines. That year, despite a significant cost-saving labor agreement, an 11.2 percent increase in passenger boardings, and an improvement in revenue, Frontier posted a net loss of $13.8 million, the first in more than a decade.[12] (See appendices C and D). By the end of 1983, Continental Airlines collapsed into Chapter 11 bankruptcy.

By 1984, average fares in Denver were the lowest in the United States. In 1985, they dropped another 8.3 percent.[13] Frontier was forced to begin liquidating assets, and United seized the opportunity. In early 1985, Frontier sold five McDonnell-Douglas aircraft to United Airlines for $95 million, and in May of 1985, was forced to sell half its remaining fleet (25 of 51 of its Boeing 737's) to United for $265 million. By purchasing more than half of Frontier, United was able to gradually downsize its competitor.[14] The rest of Frontier was sold to Newark-based new entrant airline People Express in November 1985.[15]

By 1986, United controlled nearly 40 percent of the Denver market, followed by Continental at 28 percent and People-owned Frontier at 18 percent.[16] (See Appendix A). Fares at Denver fell another 4.6 percent in that year.[17] Denver was being described as the "fare wars capital of the world," with the lowest unrestricted fares of any major hub in the United States. Yields (the amount of revenue charged per seat) were as low as 5 cents a mile, while Frontier's seat-mile costs were north of 8 cents.[18]

Below-cost pricing began to take its toll on smaller carriers the Denver market. In May 1986, Pioneer Airlines, a long-time Denver commuter carrier, ceased operations.[19] In addition to below-cost pricing, United launched a program offering a

[5] Id.

[6] United is Biggest, Best at Denver, Friendly Times (Oct. 1982).

[7] Id.

[8] Paul Dempsey & Andrew Goetz, Airline Deregulation & Laissez-Faire Mythology 70 (1992).

[9] Frank Lorenzo Lures a Co-Pilot, Bus. Week (Dec. 6. 1982). at 42.

[10] See e.g., Steven Lolford. Carriers Moves On Labor Costs Are Viewed As Bold Decisions, Travel Weekly (Sept. 12. 1983), at 1; Douglas Feaver, Airline Charts New Course After Best Year, Washington Post, Feb. 24. 1985, at G1; Joan Feldman, Is There Any Justice in Reagan's Airline Merger Policy? Air Transport World (May 1986), at 18; Mark Hornway, Ferris Loads Up On Debt To Thwart Allegis Buyout, Crains Chicago Bus., June 1, 1987, at 2; MacNeil/Lehrer NewsHour, Nov. 4, 1987; Robert Rose, Taking Off: United Airlines Begins To Pick up Altitude, Wall St. J., July 28. 1988, at 1; Stanley Ziemba, Sleeping Giant United Wakes Up, Chicago Tribune, Feb. 9, 1992, at C1; Paul Betts. Grounded After a Bumpy Flight, Financial Times, Jan. 10, 1994, at 14; Gene Amole, Blame Romer, Peña for DIA Fare Hike, Rocky Mountain News, Jan. 31, 1995, at 5A; Colorado Business Strategy, Rocky Mountain News, Feb. 12, 1995, at 98A; James Ott, Domicile Issue Divides UAL, Cabin Crews, Av. Week & Space Tech. (Nov. 20, 1995), at 52; Chuck Green, Supporting DIA Tests a Person's Endurance, Denver Post, Jan. 14, 1996, at B1; and Robert Moorman, The "New" New Frontier, Air Transport World (Aug. 1996), at 86.

[11] Texas Air Makes Bid for Frontier, Aviation Daily, Apr. 5, 1985. at 201.

[12] Frontier Airlines, Annual Report (1983).

[13] Stapleton International Airport, Average Airline Fares for Selected U.S. Airpons (1988).

[14] Certain aircraft were leased back to Frontier for short periods of time.

[15] Frontier Begins Downsizing Operations, Aviation Daily (May 15, 1985), at 83.

[16] Stapleton Int'l Airport, Domestic Market Shares (July 1986).

[17] Stapleton Int'l Airport, Average Airline Fares for Selected U.S. Airports (1988).

[18] Dee Mosteller & Danna Henderson, Denver's Stapleton Airport: A Good Place To Watch Deregulation, Air Transport World (Nov. 1986), at 64.

[19] Id.

$100 reward to Denver travel agents every time they told a customer "it's just as easy and just as cheap to fly United." [20]

In July 1986, with Frontier still losing money, People Express agreed to sell Frontier to United, and transferred many of Frontier's most important assets to United while the deal was pending. United was able to acquire $43.2 million worth of assets from Frontier, including some of its most valuable properties—five takeoff and landing slots at Chicago O'Hare, three gates at Dallas/Ft. Worth, contracts to acquire two MD–80 aircraft, and two hangars and six gates at Denver.[21] By now, United had spent more than $400 million directly on Frontier's assets, and hundreds of millions of dollars more in below-cost pricing, in an effort to eliminate Frontier as a competitor at Denver. Continental filed a lawsuit objecting to the monopoly Frontier's acquisition by United would create.[22]

Once it had acquired several of Frontier's prized assets, United began to take a hard line stance in its negotiations over the acquisition of the rest of Frontier. Although United had agreed to purchase Frontier, and agreed to "use its best efforts" to resolve potential labor problems, United balked at consummating the acquisition as its pilots refused to accede to United's insistence that Frontier's pilots be integrated into United's labor force at their existing wage levels (in effect, a "C" scale, with wages 40 percent below those of United's pilots). Some speculated that United failed to exercise good faith in the negotiations (for example, United never negotiated with the other union groups), because it knew that Frontier's deteriorating cash position would soon cause it to collapse in bankruptcy. By walking away, United could eliminate Frontier without having to conclude the purchase agreement with People Express.

Meanwhile, People Express continued to lose money, and was forced to shut down Frontier on August 24, 1986.[23] Frontier entered bankruptcy two days later. A United Airlines' publication revealed, "United will benefit from eliminating the instability of Denver's three-carrier hub. This will translate into higherfares and better returns and will ensure that another carrier does not attempt to build a presence in Denver." [24]

But United did not anticipate that Continental would pick up the pieces of a grounded Frontier. Only a month after People put Frontier into bankruptcy, Frank Lorenzo's Texas Air offered to purchase both People Express and Frontier, and by February 1987, they were both folded into Continental (along with New York Air).[25] After a settlement with United over the transfer of assets from Frontier,[26] Continental came away with most of Frontier's aircraft, in addition to three hangars and two concourses (C and D) at Denver's Stapleton Airport.[27] With the acquisition of Frontier, Continental surpassed United with 236 daily departures compared to United's 218, and briefly held the dominant position at Denver from June 1987 to May 1988.[28] The era of three hubbing airlines in Denver was over.

Subsequently, an antitrust action was filed against United by a large number of former Frontier pilots, flight attendants, and ticket, reservations and station agents against United Airlines. In that case, plaintiffs alleged that United engaged in various anticompetitive activities designed to destroy Frontier. Among the more prominent allegations was that United: (1) exerted monopoly power in the computer reservations system [CRS] market in Denver and also with respect to its Apollo CRS; (2) overcharged Frontier for its participation in the Apollo system; (3) caused Apollo to operate unfairly in ticket sales; and (4) purposefully did not go forward with the stock purchase agreement it had concluded with Frontier, leaving Frontier so weakened financially that it failed.[29] Unfortunately, the court held that employees lack

[20] Henry Dubroff, Touters of United Rewarded, Denver Post, Mar. 8, 1986.

[21] In re Frontier Airlines, Inc. (memorandum opinion and order on motion to approve settlement, Case No. 85 B 8021 E, Mar. 23, 1987) at 4.

[22] Dee Mosteller & Danna Henderson, Denver's Stapleton Airport: A Good Place To Watch Deregulation, Air Transport World (Nov. 1986), at 64.

[23] Agis Salpukas, Frontier Files for Bankruptcy, N.Y. Times, Aug. 29, 1986, at D1.

[24] Reporters, Analysts Applaud United's Frontier Purchase, Friendly Times (Aug. 1986), at 2 [emphasis supplied].

[25] Paul Dempsey & Andrew Goetz, Airline Daregulation & Laissez-Faire Mythology (Quorum 1992), at 87.

[26] See In re Frontier Airlines, Inc., 74 Bankr. 973 (1987).

[27] Paul Dempsey & Andrew Goetz, Airline Deregulation & Laissez-Faire Mythology (Quorum 1992), at 88.

[28] Continental Expects To Operate 250 Daily Denver Departures By Yearend, Aviation Daily (Nov. 3, 1986), at 182.

[29] *Sharp* v. *United Airlines*, 967 F.2d 404 (10th Cir. 1992).

standing to bring an antitrust claim, and never reached the merits of the complaint.[30]

Another lawsuit brought in 1985 by Continental Airlines objected to the manipulation and display bias, and suppression of competitors' fares and schedules imposed by United and American Airlines in their computer reservations systems.[31] In the mid-1980's, United's Apollo CRS was used by between 70 percent and 80 percent of Denver-area travel agencies.[32] A federal district court "found sufficient evidence that United and American committed mail fraud and wire fraud in connection with their CRS's to allow Continental to proceed with a jury trial on its $1 billion RICO (Racketeering Influenced and Corrupt Organizations Act) claim against the carriers," to allow the case to proceed to a jury.[33] Continental claimed United had programmed its CRS to favor United's flights over those of its competitors, even when a competitors' flight was more convenient for a customer. Continental also alleged that United overcharged it and other carriers for participation in its CRS. The court found that United and American "had specific intent to defraud" when they "deceitfully concealed material facts concerning the manipulation of the Continental plaintiffs flight information in Sabre and Apollo."[34] After 10 weeks of trial, on the eve of jury deliberations, United settled the suit for about $70 million.[35]

With Frontier and People Express gone, the Denver market became a duopoly for Continental and United. For a short while (until United decided to force Continental out of Denver), it resembled more of a "shared monopoly," as each carrier attempted to recoup some of the losses incurred in the battle with Frontier.[36] Accordingly, airline ticket prices at Denver rose by 17.6 percent in 1987 and a record 39.2 percent in 1988.[37] Without Frontier, passenger enplanements at Denver declined sharply, exacerbated by the fare increases.

DRIVE CONTINENTAL OUT OF DENVER TO CREATE A FORTRESS HUB MONOPOLY

With Frontier out of business, United's market share at Denver climed to 50 percent. But half the market wasn't enough for United. United wanted all of it.

Founded as Varney Speed Lines in 1934, Continental Airlines' first route was from El Paso to Denver. From 1937 to 1963, Continental was headquartered in Denver.[38] After Frontier and People Express went out of business, and Frontier's gates and aircraft folded into Continental, for a short while Continental became Denver's leading carrier. In 1987, Continental accounted for 42 percent of total enplaned passengers at Denver.[39] The status was short-lived, however, as United quickly regained the lead in May 1988, a position it never again relinquished. (See Appendix A). By 1990, Continental was in bankruptcy for the second time in a decade.

Former United Airlines' CEO Stephen Wolf said, "I never fought anything so hard in my life" as the new Denver International Airport [DLA].[40] Opposition was predicated on cost, and (though never said by United publicly), the possibility that a large new airport might have sufficient capacity to attract new competition. But once Continental jumped on the DIA bandwagon, United had little choice but to jump aboard too.

Among the last things Frank Lorenzo did as CEO of Continental was to sign a lease with the city of Denver in the summer of 1990 for 20 gates at the new Denver International Airport. Because Continental became DIA's first hub carrier, it was able to reserve the closest (and therefore most desirable) concourse (A) to the main terminal building, and the city agreed to build a pedestrian bridge linking the terminal directly to that concourse. When United subsequently signed up for Concourse B (which had no pedestrian bridge to the main terminal), it insisted the city make the glass on Continental's Concourse A bridge opaque, so that no passenger could see the splendid view of the Colorado Rocky Mountains from it, for United believed

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[30] Id.

[31] American, Continental Spar As CRS Suit Heads To Court, Aviation Daily, Feb. 27, 1989, at 295.

[32] Dee Mosteller & Danna Henderson, Denver's Stapleton Airport: A Good Place To Watch Deregulation, Air Transport World (Nov. 1986), at 64.

[33] American, Continental Spar As CRS Suit Heads To Court, Aviation Daily, Feb. 27, 1989, at 295.

[34] Continental Lawsuit Going To Trial, Denver Post, Feb. 24, 1989.

[35] Continental Settles Lawsuit, N.Y. Times, Mar. 30, 1990, at D13.

[36] Paul Dempsey & Andrew Goetz, Airline Deregulation & Laissez—Faire Mythology (Quorum 1992), at 89.

[37] Stapleton Int'l Airport, Average Airline Fares for Selected U.S. Airports (1988).

[38] Jeffrey Leib, Continental's Denver Departure, Oct. 23, 1994, at H1.

[39] Leigh Fisher Associates Analysis Prepared for the City and County of Denver (1994).

[40] Don Phillips, $3.1 Billion Airport At Denver Preparing for Rough Takeoff, Washington Post, Feb. 13, 1994, at A10.

the bridge offered Continental a competitive advantage. Mercifully, DIA engineer Ginger Evans refused, and the city breached its contractual agreement.[41] United chose not to press its case, undoubtedly fearing the public relations fallout once the new airport opened.

United took several actions to pressure Continental to depart. For example, United refused to allow DIA to open until its automated baggage system could deliver 225 bags a minute. DIA's chief engineer, Ginger Evans, contends DIA could have opened early in 1994 with the baggage system operating at 40 bags per minute, adequate to allow United to meet its connect times.[42] "Virtually every design and construction professional [who] was involved directly or as a consultant * * * believed at that time the project, including the BAE automated baggage system, could have been completed by October 21, 1993 [the originally scheduled opening date]."[43] If an allegedly malfunctioning baggage system was not the fundamental cause of the delay, what was? One plausible and widely accepted explanation has been proffered by former Denver airport director George Doughty in testimony before the U.S. Congress:

United Airlines did not want to go to DIA. United could have cooperated with the City to work out options for manual bag handling, but they did not * * *. As to exactly what United's rationale [was] one can only speculate, but a few things are clear. United had no incentive to move in 1994. They had just increased their operations at Denver in order to capture an even greater market share that would eventually force Continental to dismantle its hub. It was to their advantage not to move until that was assured * * *.[44]

In 1992, Continental reached its last high water mark of 285 flights per day (including Continental Express) at Denver. With 38 percent of the market, Continental was still second to United's 40 percent. United designated Denver its "major domestic initiative," and increased its capacity by 30 percent over the next several years in what appeared to be a deliberate move to oust Continental once and for all.[45] UAL's 1992 Annual Report spoke of "an aggressive plan for expansion" at Denver: "At Denver, United phased in a dramatic increase in departures during the year, moving from 180 flights last spring to 217 during the summer and, by March of this year, to 247 departures [plus 105 by United Express carriers]."[46] Its 1993 Annual Report stated, "An aggressive buildup has made a significant contribution to revenue improvement at [the Denver] hub. United ended 1993 with 257 daily departures in Denver, up from 212 a year earlier * * *. Already the number one carrier in the Mile High City, United had increased its capacity over the last two years by nearly 30 percent."[47] United's aggressive behavior at Denver was clearly targeted at Continental. United pulled away and never looked back as it steadily increased market share, leading to Continental's decision to pull out.

Toward the end, Continental was losing $10 million a month at its Denver hub, and could not face the prospect of continuing hub operations at the more expensive new airport. Denver airport director Jim DeLong described it as a "fierce battle for dominance of the Denver market."[48] Continental's Annual Report revealed that the company had lost $130 million at Denver in 1993, and lost $500 million at Denver from 1990–1993.[49] According to Continental's CEO Robert Ferguson, "Continental's losses are at unacceptably high levels in Denver, even with our reduced flying."[50] Continental's Annual Report said, "Although the new facilities [at DIA] will be greatly superior to those presently serving Continental's Denver passengers, they

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[41] Woman of the Year Ginger S. Evans, Engineering News-Record (Feb. 11, 1994), at 34.

[42] See Paul Dempsey, Andrew Goetz & Joseph Szyliowicz, Denver International Airport: Lessons Learned (McGraw Hill 1997).

[43] Greiner Says SEC Staff Case Against Denver Consultants Not Legitimate, Airports, Dec. 19, 1993.

[44] George Doughty, Testimony Before the U.S. House Transportation Subcommittee on Aviation (May 11, 1995).

[45] "United Airlines, the dominant carrier in the Denver market, has been increasing its service to pressure Continental," Bill Mintz, Denver A Victim of Continental's Fare Strategy, Houston Chronicle, July 8, 1994, at 2. See also Paul Dempsey, "Rip United Airline's Hold from DIA," Denver Business Journal, August 25–31, 1995.

[46] UAL Corp., 1992 Annual Report 7 (1993) [emphasis supplied].

[47] Id. at 6 [emphasis supplied].

[48] Jeffrey Leib, GAO Study Encouraging for DIA's Financing, Denver Post, Feb. 14, 1995, at C3.

[49] Continental Airlines, 1994 Annual Report 19 (1995).

[50] Michelle Mahoney, Denver Exit Costly One for Continental Airlines, Denver Post, July 10, 1994, at 2D; Continental To Close Denver Crew Bases This Fall, Aviation Daily, July 8, 1994, at 38.

also will be much more expensive." [51] It was estimated that increased landing fees required to pay off bonds issued to finance DIA would have added another $50 million to Continental's costs.[52]

The advantages Continental gained from signing the first lease at DIA were never fully realized because Continental ultimately was forced to cry "uncle," in March 1994, and announced its decision to abandon its Denver hub operations and relinquish the market to United. Continental had already downsized its presence in Denver from a high of 285 flights a day in February 1992, to 165 flights in August 1993, to 148 flights in January 1994, to 107 flights in March 1994. Continental's Denver operations dropped to 86 flights in July 1994, 59 in September 1994, and 19 in March 1995.[53] Meanwhile, United increased its flights to 280.[54]

Following Continental's announcement that it was scaling back its Denver hub beginning in the fall of 1993, the withdrawal proceeded throughout the following year. Continental dropped 26 routes through August 1994, and an additional 23 on October 31, 1994. By the time DIA opened, Continental was down to 13 flights a day to three cities.

Passenger traffic, which was increasing since 1990, began to decline after Continental's pullout. In 1995, only 31 million total passengers were flown to, from or through Denver, down from 33 million in 1994. A contributing factor in this decline is the fare increase strategy that United enacted as it realized more monopoly opportunities.

United's goal of becoming the dominant carrier in Denver has been fully realized, as United and its code-sharing affiliates now control nearly 80 percent of the total passenger market at Denver. By September 1996, United flew to 55 cities from Denver and Colorado Springs.[55] In 1994, United's CEO, Gerald Greenwald, confessed that United's strategy to dominate the Denver market had paid off in increased market share and profitability.

Outgoing United CEO Stephen Wolf called Denver the "major domestic initiative" for the airline over the preceding two years. According to Greenwald, "United has done a fantastic job of building strength in Denver and we'd like to take advantage of that, if anything, and build it stronger." [56]

As noted above, United may have purposely delayed opening of DIA in order to encourage Continental to abandon its Denver hub. Along the way, United also cut several additional deals with the city to disadvantage its competitors. United insisted it be allowed to take over the Concourse C automated baggage system loop, so that only United would have a high-speed baggage system. Ironically, the Concourse C automated system was the only one operating well before United occupied it. Other airlines were relegated to traditional tug-and-cart technology.

Further, United insisted that carriers using Concourse A pay a disproportionate share of the costs of that concourse's automated baggage system, though the system has never been functional. (On a per-passenger basis, Continental Airlines pays the highest costs of any carrier at DIA; it absorbs a portion of the additional costs of its two sub-lessees on Concourse A; but because of this agreement, half of Concourse A's domestic gates remain empty.) United's insistence assures that the high cost of Concourse A's gates will dissuade new carrier entry on that concourse for years to come, despite its superior location. Unfortunately, DIA's costs have dissuaded many low-fare airlines (including Southwest Airlines) from entering the market, and driven low-cost airlines (e.g., Midway and Morris Air) from it. Finally, United insisted the city build it a hangar directly north of Concourse C, on land a future concourse is supposed to occupy. No such future concourse can be built without tearing down United's hangar.

In summary, though unable to stop construction of a new airport at Denver, United Airlines was able to ensure its Fortress Hub dominance of DIA by driving up its costs, withholding permission to open DIA until Continental Airlines had succumbed to United's below-cost pricing and fully committed itself to eliminating its Denver hub, by ensuring Concourse C carriers would be deprived use of an automated baggage system and that Concourse A carriers would pay an exorbitant price for its automated baggage system (though a back-up baggage system was welded on

[51] Michelle Mahoney, Denver Costly for Continental, Denver Post, June 18, 1994, at A23.

[52] Bill Mintz, Denver A Victim of Continental Fare Strategy, Houston Chronicle, July 8, 1994, at 2; Michelle Mahoney, Airline's Memo Jolts Morale, Denver Post, Mar. 31, 1994, at C1.

[53] City and County of Denver, Airport System Revenue Bonds, Series 1994 (Sept. 1, 1994); Michelle Mahoney, Airline Changes Buffet Denver, Denver Post (Feb. 13, 1994).

[54] Leigh Fisher Associates Analysis Prepared for the City and County of Denver (1994).

[55] Jeffrey Leib, United Joins Fare War, Denver Post, Sept. 19, 1996, at A1.

[56] Michelle Mahoney & Jeffrey Leib, UAL's Success Key To Denver, Denver Post, July 13, 1994, at C1.

top of it, thereby denying Concourse A carriers the automated system whose costs they must pay).

EXTRACT MONOPOLY FARES AT THE DENVER FORTRESS HUB

As Continental departed, an airline executive observed, "Denver residents will know the true definition of high fares." [57] By mid-1995, United enjoyed about 70 percent of Denver's passenger traffic, and even a higher percentage of DIA's $5 billion travel market.[58] Continental Airlines, once an airline as large in Denver as United, accounted for less than 3 percent of DIA's traffic. Without a major airline to discipline the monopolist, United could extract whatever the market would bear.

United raised fares to monopoly levels in virtually every market Continental abandoned. For example, United Airlines quadrupled its unrestricted coach fare from Denver to San Francisco (from $238 to $954), and tripled its fare from Denver to Los Angeles (from $298 to $892).[59] United would boast that nearly 60 percent of its seats at DIA are discounted, with approximately 55 percent discounted up to 35 percent or more of the full fare.[60] That makes United sound like a benign monopolist until you compare these statistics with industry-wide data compiled by the Air Transport Association of America [ATA]. According to ATA, more than 90 percent of passengers fly at a discount, and the average discount is more than 60 percent of the full fare, and has been for nearly a decade.[61] In 1996, 93 percent of U.S. travelers were flying on a discounted ticket (compared with 60 percent on United at Denver), and the average discount was 67.5 percent off the full fare (compared with only 55 percent of Denver's United travelers enjoying a 35 percent discount off the full fare).[62] It is remarkable that United would insist that Denver passengers should be grateful for its pricing when its Denver discounting was so miserly.

In a study of Denver International Airport, the U.S. General Accounting Office reported to Congress that United Airlines raised prices at Denver 38 percent from June 1994–95, while the average ticket price nationally increased only 7 percent over the same period.[63] In August 1995, American Express Travel said its Denver customers were paying 46 percent more.[64] However, in September 1995, United insisted average fares were only up 16 percent, but included free frequent-flyer tickets in this calculation.[65] Moreover, it is unclear whether United was calculating fares for all Denver passengers, or only origin and destination [O&D] passengers (passengers who begin or end their trips in Denver). One would expect that connecting ticket prices would be priced competitively, for a consumer traveling east-to-west (or vice versa) has a multitude of airlines from which to choose and hubs through which to connect, while local O&D passengers are subject to the monopolist's whim on pricing.

United contended it also had to raise prices to cover the $210 million in increased costs attributable to Denver International Airport over the airport it replaced, Stapleton.[66] Earlier, United had estimated that its costs of operations at the new airport would increase by only $100 million.[67] But most of United's fare increases were imposed as Continental downsized its Denver hub, months before DIA opened. With DIA opening, and blaming DIA's high costs, United announced it was adding another $40 round trip to the prices of tickets beginning or ending at Denver.

But because of DIA's efficient runway configuration, terminal spacing, and triple Cat. III simultaneous landing capability, United's operating costs at DIA (excluding airport fees) would be significantly lower than those at Stapleton Airport. Stapleton had been plagued by congestion and delays (particularly during periods of inclement weather), which mutilate efficient aircraft and labor utilization. Thus, DIA's efficiencies offset a portion of United's facility fees and landing costs at DIA.

[57] Alex Berenson, Continental Fading Away, Denver Post, July 29, 1994, at A1.

[58] Jeffrey Leib, DIA Floats Bid for Southwest, Denver Post, June 26, 1995, at E1.

[59] Jeffrey Leib, United Forging 'Fortress Hub,' Denver Post, Aug. 24, 1994, at C1.

[60] United Airlines, 3 The Plane Fax (Apr. 1996) (newsletter by UAL Vice President Roger Gibson).

[61] Air Transport Ass'n, 1996 Annual Report 8 (1996).

[62] Julius Maldutis, Airline Update—November 1996 (Dec. 10, 1996), at 11.

[63] U.S. General Accounting Office, Denver Airport: Operating Results and Financial Risks 6 (1996); Jeffrey Leib, GAO Study Encouraging for DIA's Financing, Denver Post, Feb. 14, 1996, at C3.

[64] Ann Imse, United Disputes Air Fare Reports, Rocky Mountain News, Aug. 18, 1995, at 53A.

[65] Ann Imse, United Targets Fare Gripes, Rocky Mountain News, Sept. 2, 1995, at 74A. United would later claim its fares were up only 15 percent. See Roger Gibson, United Airlines Decries Guest Editorial, Denver Bus. J., Oct. 6, 1996.

[66] United To Raise Fares To Pay for New Denver Airport, Orlando Sentinel, Jan. 29, 1995, at A26.

[67] News In Brief, Airline Financial News, Apr. 18, 1994.

Because of United's poor credit rating, the city had financed many major facilities for United at DIA—including a hangar with six aircraft maintenance bays, an 18-bay ground equipment maintenance building, an air freight facility, kitchens, and a baggage system—many of which are traditionally tenant-financed facilities, and at other airports would not be included in fees paid to the airport authority.

Moreover, in Congressional testimony, Denver aviation director Jim DeLong identified United Airlines' belated and massive scope changes as the most significant cause of increased construction costs at DIA.[68] "It is clear that your airline is a significant contributor to what you describe as the high cost of DIA,"[69] Denver mayor Wellington Webb told United. "It is no secret that when one air carrier becomes dominant in a market, that they develop as a fortress hub, and as a result, fares have always increased."[70] Webb was right. United's massive scope changes negotiated after construction on the main terminal was well under way, coupled with its insistence on delaying the airport opening, contributed to hundreds of millions of dollars in additional construction and interest expenses at DIA. In order to avoid DIA's high costs, other airlines were flying over DIA to reach Colorado ski resorts like Vail and Aspen directly.[71] Low-cost/low-fare carriers like Midway Airlines and Morris Air departed Denver, MarkAir collapsed into bankruptcy, and Southwest Airlines announced DIA's costs made that airport prohibitively expensive to enter.

United's market dominance has also been a significant factor dissuading other new airline entrants at DIA. The city of Denver launched a campaign to try to recruit new entrants to fill the competitive void left by the departure of Continental Airlines. Denver mayor Wellington Webb observed, "every carrier we have spoken with is concerned with United's dominance of the market."[72] A letter to the editor of the Denver Post put it well: "Since Continental's withdrawal from this market, United's behavior has been that of a monopolist * * *. The only serious question with regard to United Airlines is why the antitrust regulators have been so quiescent."[73]

Then there's the hypocrisy. While United relishes the role of monopolist at Denver, it objected to a proposed agreement between British Airways and American Airlines on grounds that the alliance would create a monopoly, with the two airlines controlling the majority of routes between the United States and London.[74] United officials also complained about "predatory pricing" by smaller rivals in Denver and Chicago.[75] United was the only major carrier to support promulgation of the Airline Deregulation Act of 1978, whose principal purposes included the following:

—The availability of a variety of adequate, economic, efficient, and low-priced services without unreasonable discrimination or unfair or deceptive practices.

—Preventing unfair, deceptive, predatory, or anticompetitive practices in air transportation.

—Avoiding unreasonable industry concentration, excessive market domination, monopoly powers, and other conditions that would tend to allow at least one air carrier * * * unreasonably to increase prices, reduce services, or exclude competition in air transportation.

—Maintaining a complete and convenient system of continuous scheduled interstate air transportation for small communities and isolated areas.

—Encouraging entry into air transportation markets by new and existing air carriers and the continued strengthening of small air carriers to ensure a more effective and competitive airline industry.[76]

Though the only major airline to support airline deregulation in the 1970's, United Airlines has thwarted each and every one of these policies embraced by the legislation.

[68] James DeLong, Testimony Before the U.S. House of Representatives Aviation Subcommittee (May 11, 1995).

[69] Patrick O'Driscoll, Webb Blasts United, Denver Post, Jan. 29, 1995, at A1.

[70] Kevin Flynn & Burt Hubbard, Webb Berated United for $40 Fare Increase, Rocky Mountain News, Jan. 29, 1995, at 4A.

[71] See Ann Imse, Vail Gains Link to World With 3 Big Air Routes, Rocky Mountain News, June 16, 1995, at 68A.

[72] Jeffrey Leib, Additional Carriers Among Webb's DIA Goals for '96, Denver Post, Dec. 31, 1995, at H1.

[73] Letter to the Editor from Virginia Anne Housum, Denver Post, Oct. 6, 1995, at B6.

[74] United Requests Inquiry Into American-British Air Alliance, Dallas Morning News, Oct. 10, 1996, at 4D.

[75] Jeffrey Keyes, Minneapolis Star Tribune, June 22, 1992, at 3D.

[76] 49 U.S.C. § 40101.

MONOPOLIZE THE CONNECTING PASSENGER MARKET FLOWING OVER THE DENVER HUB, AND AS A BY-PRODUCT, DENY LOW-COST JET SERVICE TO SMALL COMMUNITIES IN THE ROCKY MOUNTAIN AND GREAT PLAINS REGION

The new Frontier Airlines, Inc., inaugurated service in the Summer of 1994. Its strategic plan was to restore jet service from Denver markets which had recently been abandoned by Continental Airlines, which was in the process of sharply downsizing its Denver hub. Although a high-cost carrier like United Airlines (which dominates the Denver market) might not be able to break-even with jet service in thin markets, Frontier, with its significantly lower cost structure, believed it could. In July 1994, Frontier inaugurated jet service between Denver and four cities in North Dakota (Bismarck, Fargo, Grand Forks, and Minot). In August and September 1994, Frontier launched jet service to four cities in Montana (Billings, Bozeman, Great Falls and Missoula). As late as 1993 (before Continental's departure) most of these cities enjoyed two round-trip jet flights a day from Denver; half still had turboprop service.[77] In October 1994, Frontier began service to Albuquerque, El Paso and Tucson.[78] (See Appendix E).

Most of these markets previously were served by another airline by the same name (Frontier), which, as noted above, was acquired by Continental Airlines in 1986. Many of the new Frontier Airlines' executives and employees served the old Frontier Airlines, and understood that sufficient traffic flows existed to support jet service (provided by a low-cost carrier) from Denver to many medium and small-size cities across the Great Plains and Rocky Mountain regions. Both the original Frontier, and Continental, had proven that many of these thin markets had sufficient traffic to provide adequate load factors to support jet service from Denver. The new Frontier's marketing studies confirmed the existence of ample traffic to support two round-trip Boeing 737's a day. Again, while a large, established major carrier, with its high cost structure, may be unable to provide jet service to such markets, a new entrant carrier, with its relatively lower cost structure, should be able to. Frontier believed that passengers in these communities prefer the speed and comfort of jet service over flying relatively slower turboprop planes without in-flight amenities (such as lavatories or galleys).

Because Frontier flew the only jets in several of these markets, Frontier enjoyed a disproportionately large share of local origin-and-destination traffic (e.g., Denver-Bozeman, Denver-Bismarck). But United refused to allow Frontier to connect passengers with it. As a consequence, Frontier was deprived of sufficient connecting traffic to make these flights viable.

From the outset, Frontier began to try to tap the feed traffic off the huge networks of the dominant hub carriers at Denver—United Airlines and Continental Airlines. Since cooperative code-sharing and related arrangements were the only means by which Frontier could tap sufficient connecting traffic to make thin routes viable, Frontier asked each company for cooperative joint-fare and code-sharing agreements. United repeatedly refused.

Continental promptly entered into joint-fare and code-sharing relationships with Frontier. Unfortunately, Continental no longer maintains a hub at Denver, and has reduced service there to 13 flights a day from but three cities (Houston, Cleveland, and Newark). The passenger and cargo feed from Continental's network is welcomed traffic. But unfortunately, it is insufficient to provide adequate incremental traffic to sustain break-even load factors on Frontier's flights to Montana and North Dakota.

It may not be immediately apparent why discriminatory joint-fares and code-sharing, and the related impact of discriminatory display bias in computer reservations systems, adversely affect competition and small community service, so let us digress a moment to explain how these relationships affect connecting traffic. Under deregulation, most of the traffic which moves today connects between aircraft, usually at a hub, like Denver, Salt Lake City, St. Louis, Chicago, Dallas/Ft. Worth, or Minneapolis. A passenger flying from Grand Forks or Bismarck, North Dakota, to Tucson or San Jose might connect over Denver or Minneapolis. Without a joint-fare and code-sharing relationship with United, it is very difficult for any carrier providing service from Denver to attract that passenger, even though the routing and connection over Minneapolis might involve a more circuitous and time-consuming journey. Alternatively, a passenger can take a direct code-sharing routing on a slow, noisy turboprop aircraft to Denver to connect to a jet headed for Tucson or San Jose.

Joint fares.—Typically, the longer the distance flown, the lower the price per mile. Part of this is a reflection of cost considerations, and part is a reflection of competi-

[77] Frontier Airlines, Inc., Prospectus (Apr. 21, 1994).
[78] Frontier Airlines, Inc., Annual Report 2 (1996).

tive considerations. A passenger flying from A to C via B will usually be given a lower through fare from A to C than the sum of adding the A to B fare with the B to C fare. A joint-fare agreement between two carriers allows a passenger to take advantage of a lower through rate (prorated on a discount basis between the connecting carriers), as opposed to the higher sum of two point-to-point fares. But in the absence of a joint-fare agreement between the connecting carders, a passenger is charged the individual A to B fare, plus the individual B to C fare. Without a joint fare agreement between United and Frontier, many passengers attempting to fly from, say, Bozeman, Montana, to Kansas City, Kansas, found the more circuitous Delta Air Lines connection over Salt Lake City or Northwest Airlines connections over Minneapolis to be the lower ticket price. While several major airlines (including Continental, TWA and USAir) have entered into joint fare agreements with Frontier, United refuses.[79] It was not until the U.S. Department of Transportation intervened that United consented to entering into a bilateral ticketing-and-baggage agreement with Frontier.

Code-sharing.—Code-sharing is a means whereby two carriers agree to be displayed in the airline computer reservations systems as an "on-line" (Carrier X to Carrier X) connection, rather than an interline (Carrier X to Carrier Y) connection. At Denver, United has marketing and code-sharing agreements with Mesa Airlines, Great Lakes Aviation and Air Wisconsin, flying mostly turboprop aircraft throughout the Rocky Mountain and Great Plains region.[80] United's connections with Mesa, Great Lakes and Air Wisconsin are falsely displayed in the CRS as on-line connections between United and "United Express." Without a code-sharing agreement with United, the United-Frontier connection is shown as what it truly is—an interline connection between United and Frontier. Unfortunately, the CRS system of which United is principal owner saddles the displays of all interline connecting flights with the equivalent of an artificial and astounding 1,440 minutes (24 hours), which is added to the true elapsed time of the flight. Zero minutes are added to the United-Great Lakes, United-Air Wisconsin or United-Mesa Airline interline connections, for they are falsely treated as "on-line" connections, as if it were a United jet connecting to a United jet.

Eighty-five percent of flights are sold by travel agents off the first page of the computer reservations system screen. By adding the equivalent of an artificial 1,440 minutes to Frontier's connecting flights, they are often shoved off the first page of the screen, and hence, rarely sold. In other words, a United jet connecting to a Great Lakes Beech 1900, 19-seat aircraft, gets superior retail shelf space to a United jet connecting to a Frontier jet, even though consumer preferences for speed, convenience and safety may favor jet-to-jet connections rather than jet-to-turboprop connections. This is fundamentally unfair to small airlines like Frontier, to small communities seeking competitive jet service, and to consumers.

For example, Frontier flew from Denver to Bismarck and Fargo, North Dakota, in 108-seat Boeing 737 jets. Great Lakes Aviation (United Express) flew Beech–1900 19-seat turboprop aircraft, without a lavatory or in-flight amenities, requiring flight times that took nearly an hour longer than the Frontier flight. The Wall Street Journal described the United Express flight from Denver to Bismarck as among the longest commercial commuter-flights in the United States.[81] Now most passengers, if given a choice, would prefer to fly a jet rather than a turboprop aircraft. But with code-sharing (combined with the CRS bias described above), most of United's connecting passengers were funneled aboard the Beech–1900's.

Let's pose an analogy. Suppose Frontier was in the bean business, and made the best beans money could buy. Suppose also, that the major supermarket chains in Denver (i.e., Safeway, Albertson's, and King Soopers) were owned by the major bean companies (i.e., Green Giant, Campbell's, and Libby's). Frontier asks for shelf space to sell its product, and each of its competitors refuses. Frontier would have the option of either opening its own supermarket chain (impossible), or hawking their wares from carts on the street. United Airlines owns the majority interest in the Apollo CRS. In fact, the major airlines variously control the four major CRS's, and each of them discriminate against non-code-sharing connecting flights.

United Airlines and its code-sharing affiliates control nearly 80 percent of the traffic at Denver. Without a joint-fare or code-sharing agreement with United, Frontier cannot attract sufficient traffic to make thin routes viable. Frontier cannot profitably restore jet service to communities which have lost it, though, in fact, that was precisely its original intent.

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[79] Id. at 3.
[80] Leigh Fisher Associates Analysis Prepared for the City and County of Denver (1994).
[81] Lisa Miller, Odds & Ends, Wall St. J., July 28, 1995, at 9.

Frontier urged United to enter into joint-fare and code-sharing relationships with it for sound business reasons. Convenient interline connections are a two-way street; they allow passengers to flow conveniently over the networks of both carriers. Frontier pointed out to United that it can provide United's passengers superior and more convenient jet service vis-a-vis the turboprop connections which now exist. Frontier emphasized to United that a large volume of the traffic that now flows over the Salt Lake City and Minneapolis hubs could be funneled by Frontier over Denver to feed the United Airlines network. Frontier believes it makes sound business sense for United to do business with Frontier. But at a meeting with Frontier's executives at United's Elk Grove Township, Illinois, headquarters, United's then-Senior Vice President Rakesh Gangwal responded, "Frontier is a low-cost provider. United can never be a low-cost provider. Therefore we think of you as the enemy." [82] No enemy will be given either a joint-fare or a code-sharing agreement.

United Airlines is a $15 billion corporation, more than 200 times the size of Frontier.[83] United perceives Frontier to be the enemy.

Frontier informed United Airlines that it believed that its refusal to allow Frontier nondiscriminatory access to United's network potentially poses a serious potential antitrust problem for them. An analogous problem arose in the 1970's and 1980's in the telecommunications industry with AT&T's refusal to permit MCI nondiscriminatory access to its network. It took years, but ultimately MCI won a multimillion dollar verdict against AT&T, and the U.S. Justice Department forced divestiture of AT&T into seven regional holding companies, and one long-distance carrier. Today, federal regulatory authorities require that all telecommunications companies be given nondiscriminatory access to the networks of their competitors. USWest would never be allowed to enter into preferential connections and rates with, say, Sprint, depriving or dissuading consumers who preferred AT&T of access. Just as AT&T was the largest telephone company in the world, United is the largest airline in the world. Frontier can no more be expected to replicate the vast United Airlines route network than could MCI have been expected to replicate the vast AT&T network.

If such a rule (requiring nondiscriminatory connections between telecommunications networks) existed with respect to the transportation networks, Frontier's Montana and North Dakota service likely would have been profitable, and as a consequence, Frontier would not have been forced to terminate service to Montana in September 1995, and to two North Dakota markets in January 1995, and the final two in September 1996. Frontier has re-deployed those Boeing 737's to markets which already had frequent jet service, such as Denver-Los Angeles, Denver-Chicago, Denver-San Francisco, and Denver-Phoenix, where sufficient nonstop origin-and-destination passenger traffic exists to provide break-even load factors. (See Appendix E). As a result of the shift in its route structure, Frontier enjoyed two profitable quarters in 1996, despite its considerable losses in serving these remaining small communities, and the cost of shifting its route structure toward dense markets.

Of course, passengers in those dense markets to which Frontier has re-deployed its aircraft benefit from new competition. Fares have fallen dramatically (but as we shall see below, this has put Frontier in United's cross hairs). Nevertheless, large sections of the nation are wholly excluded from jet service because of discriminatory joint-fare and code-sharing arrangements, as well as computer reservations systems bias which shoves non-code-sharing interline arrangements off the first page of the CRS screen. That is not to suggest that all small communities have sufficient traffic to support jet service. But many small communities which could support jet service from a low-cost carrier are denied it because of these pernicious code-sharing practices.

United's refusal to enter into joint fare and code-sharing relationships with domestic jet airlines results in relegating small communities to inferior and high-cost monopoly turboprop aircraft. Code-sharing is a way of defrauding consumers into believing they will be flying a megacarrier's jets, when on most occasions they are funneled onto a smaller carrier's turboprop aircraft at the hub, all in a deliberate attempt to steer feed traffic away from jet competitors.[84]

Even competing turboprop carriers are injured by these discriminatory arrangements. GP Express (formerly Continental Connection) also suffered from an inabil-

[82] The meeting was held between United Airlines Senior Vice President Rakesh Gangwal and Frontier Airlines CEO Sam Addoms and Frontier Vice President Dan Love.

[83] Comparison of gross revenues of the two companies. UAL Corporation 1995 Annual Report (1996); Frontier Airlines, 1996 Annual Report (1996).

[84] United does maintain code-sharing with Air Wisconsin on a carefully limited number of smaller jets.

ity to tap the United Airlines network. United entered into preferential joint-fare and code-sharing agreements with select carriers (one per city-pair market) which gave their interline connections preferred space on the computer reservations systems. For example, United code-shared with Mesa Airlines out of Denver to Rocky Mountain cities like Telluride and Grand Junction. United's interline with Mesa is falsely shown on the CRS as an "on-line" connection from United to United Express. As a pseudo-on-line connection, it enjoys a higher display on the CRS screens. The United-GP Express interline would be shown as an interline (in this instance, no deceit), and often shoved off the first page of the CRS screen. With Continental's departure from Denver, and unable to tap United's feed at the Denver hub, GP Express collapsed into bankruptcy in 1995. The net result of these discriminatory and anticompetitive practices is poorer and more expensive air service to many small communities across America.

The U.S. Department of Transportation [DOT] has found that 34 small communities have lost all service since promulgation of the Airline Deregulation Act of 1978; many communities which had jet service lost it to turboprop aircraft; out of 320 small communities, the number served by major carriers declined from 213 in 1978 to 33 in 1995; the number of small communities served by multiple carriers has decreased from 135 in 1978, to 122 in 1995.

The DOT studies severely understate the problem. Of the 514 non-hub communities receiving air service in 1978, by 1987 (a decade after deregulation began) 313 (60.8 percent) had suffered declines in flight frequency, and 144 (28 percent) had lost all service; only 32 (6.2 percent) enjoyed the inauguration of new service.[85] By 1995, things were even worse. Of the 514 non-hub communities receiving air service in 1978, by 1995 167 (32.5 percent) had been terminated, while only 26 (5.1 percent) gained new service.[86]

The DOT's studies were unable to comment meaningfully about pricing of air service to small communities, for commuter carriers generally do not report pricing data. But the U.S. General Accounting Office has found that passengers flying from small-city airports to major airports paid 34 percent more if the major airport was concentrated and 42 percent more if both the small-city and major airport were concentrated.

For those small community city-pair markets with sufficient volume to support jet service by a low-cost carrier, the code-sharing phenomenon insures that they will instead be relegated to relatively higher-cost/higher-priced turboprop service. For example, one of the nation's largest connecting turboprop carriers, Mesa Airlines (which in some parts of the country operates as a United Airlines code-sharing affiliate—"United Express"), charges yields of nearly 35 cents per mile, compared with about 12 cents a mile by United Airlines. Even USAir, which operates short-haul high-cost jet service, charges only about 18 cents a mile—about half that charged by a turboprop carrier.[87] A low-cost jet entrant typically charges consumers significantly less than do the major airlines.

For most Colorado communities (and many small communities throughout the Rocky Mountain and Great Plains region), the result of United's discriminatory and anti-competitive practices is that they are served from Denver only by a United Express affiliate flying turboprop aircraft and charging sky high air fares, even in those markets which have sufficient traffic to sustain jet service.

In 1995, United Airlines controlled 95 percent of the connecting passenger tropic at Denver International Airports.[88] Projections are that United will control 97 percent of that market in 1996.[89] But United wants all of it. United's overwhelming dominance of DIA (and the city-pair markets radiating from it) is attributable to its ability to fill seats by flowing connecting passengers over the Denver hub, and to deprive any other competitor of the ability to do that.

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[85] Andrew Goetz & Paul Dempsey, Airline Deregulation Ten Years After: Something Foul in the Air, 54 J. Air L. & Com. 927, 947 (1989). See also, Paul Dempsey & Andrew Goetz, Airline Deregulation & Laissez-Faire Mythology (1991).

[86] Unpublished study by Dr. Andrew Goetz, University of Denver.

[87] 1996 data from Julius Maldutis, Airline Update-August 1996 (Sept. 8, 1996).

[88] Leigh Fisher Associates, Year End Settlement of 1995 Rental Fees and Charges at DIA, Tab 4, table 1 (June 28, 1996) [data are for the 10 months of 1995 during which DIA was open].

[89] Leigh Fisher Associates, Midyear Adjustments to 1996 Rentals, Fees and Charges at DIA, Table 1, (Aug. 8, 1996).

DRIVE NEW LOW-COST COMPETITORS FROM THE DENVER FORTRESS HUB AND THE NEARBY COLORADO SPRINGS AIRPORT

With Continental's departure from Denver in 1994, United's market share at Denver climbed to 60 percent. But 60 percent of the market wasn't enough for United. United wanted all of it.

As Continental downsized its hub at Denver, United raised prices sharply in the city-pair markets Continental exited. In many cases, fares became so high that some Denver travelers chose to fly out of the Colorado Springs airport located 65 miles south of downtown Denver. A new low-cost airline, Western Pacific, started hub operations in Colorado Springs in 1995, and attracted a sizable number of Denver travelers who prefer driving the extra distance to avoid the high fares at Denver. In summer 1995, regular shuttle van service to Colorado Springs from Denver was inaugurated to tap into the growing exodus. As we shall see below, diversion of some of Denver's traffic to Colorado Springs put Western Pacific in United's crosshairs.

After Continental folded its hub at Denver, a few (very few) low-cost, low-fare airlines emerged to serve Denver—MarkAir (which moved its operations in Chapter 11 to Denver from Alaska, then collapsed entirely in late-1995), Vanguard (headquartered in Kansas City), Reno Air (serving Denver through Reno, Nevada), and Frontier (a new airline with many of the same officers as the original airline by the same name). Most found United engaging in various types of predatory behavior—pricing at fares at or below those of competitors, dumping excess capacity in competitors' markets, and paying travel agents commission overrides to steer business toward United.

MarkAir moved the base of its operations from Anchorage to Denver in 1993. In 1994, MarkAir provided 17 daily nonstops to 10 cities from Denver.[90] The question was whether MarkAir could stay off United's radar screen. MarkAir CEO Neil Bergt described his strategy as "bottom fishing," trying to expand the market with low fares without upsetting competitors.[91] One airline analyst predicted that "as soon as the industry hits a bump, Denver's resident giant, United Airlines, will force MarkAir out of Denver."[92] Another accurately predicted, "As soon as United decides that they've had enough, then it's all over for MarkAir."[93] In markets where it had a monopoly, United charged monopolistic prices ($1,064 round-trip for a walk-up ticket from Denver to San Francisco, for example). But where MarkAir competed with United, United met its fares on a capacity-controlled basis (both United and MarkAir charged $160 round-trip for a walk-up ticket from Denver to Los Angeles) on flights in close proximity to MarkAir's.[94] United's employee-owner pilots took credit for derailing a deal which would have allowed the city of Denver to guarantee $30 million of MarkAir's debt to retain MarkAir's competitive presence at Denver.[95] After MarkAir moved its headquarters from Alaska to Denver, United also launched a promotion to wound MarkAir in Alaska, matching its promotion "ticket-for-ticket" to trade books of travel coupons for Alaska residents' "permanent fund" $980 dividend.[96]

MarkAir collapsed into bankruptcy and liquidation in 1995. MarkAir's demise resulted in "dramatically higher prices for unrestricted, or walk up, tickets to certain cities" including Atlanta (United's $1,066 compared to MarkAir's $376), Seattle (United's $1,296 compared to MarkAir's $342), and San Diego (United's $1,002 compared to MarkAir's $304).[97]

After MarkAir's demise, Frontier announced it would fill some of the void of the MarkAir departure (and the earlier Continental departure) by inaugurating service to several of the most popular travel destinations from Denver, beginning with Chicago and Phoenix.[98] As noted above, without joint fares and code-sharing with the dominant hub carrier at Denver, Frontier could not hope to fill sufficient seats in thin markets to break even. In 1995, Frontier terminated service to four cities in Montana, two in North Dakota, and one in Arizona, and began service from Denver

[90] Leigh Fisher Associates Analysis Prepared for the City and County of Denver (1994).
[91] Aldo Svaldi, Can MarkAir Stay Aloft?, Denver Bus. J., Oct. 22, 1993, at 1A.
[92] Helen Jung, MarkAir Red Ink Runs Deep, Anchorage Daily News, May 20, 1995, al C1.
[93] Helen Jung, MarkAir Cuts Anchorage Lower 48 Link, Anchorage Daily News, Apr. 20, 1995, at A1.
[94] Ann Imse, Frontier Will Fly To West Coast, Rocky Mountain News, Sept. 22, 1995, at 58A.
[95] Alex Berenson, UAL Pilots Fought MarkAir, Denver Post, Nov. 24, 1994, at D1.
[96] United, MarkAir War Heats Up, Denver Post, Oct. 11, 1994, at C1. The "permanent fund" dividend is paid by the state of Alaska annually to each state resident based on oil royalties earned by the state from oil production at Prudhoe Bay.
[97] Ann Imse, MarkAir Demise costly for DIA, Rocky Mountain News, Nov. 1, 1995, at 42A.
[98] Steve Caul, Frontier Steps Up Expansion, Rocky Mountain News, Aug. 3, 1995, at 50A.

to Omaha, Las Vegas, Phoenix, Chicago (Midway), Los Angeles, Minneapolis, Salt Lake City, and San Francisco. In 1996, Frontier terminated service at Bismarck and Fargo, North Dakota, and began service to Seattle, St. Louis, and San Diego. By the end of 1996, Frontier flew 10 Boeing 737 aircraft to 13 cities from Denver, accounting for slightly more than three percent of the Denver passenger market. Each of these markets had undergone significant capacity constriction with Continental and MarkAir's departures, many of which had become a United nonstop monopoly.

Going head-to-head with United was a risky strategy, for as the world's largest airline, United had the power to crush an airline as small as Frontier. But Frontier had little choice but to make a "midcourse correction" in its route strategy. (See Appendix E). Without an ability to connect with the United network, Frontier could do nothing but lose money serving small communities. It needed to serve markets with sufficient origin-and-destination traffic to provide adequate load factors. Frontier hoped that by offering no more than two or perhaps three round trips per market, the "800-pound gorilla"[99] would sleep. The gorilla slept soundly until Frontier posted its first two quarterly profits in Jan.-Mar. and Apr.-June 1996. Then the gorilla awoke in a foul mood.

Meanwhile, there had been a profound change in Washington. As DOT Secretary, Federico Peña had championed the cause of new entrant airlines. Early in the Clinton Administration, the DOT and Justice Department "jaw-boned" Northwest Airlines into backing off its predatory capacity dumping and pricing practices targeted at Reno Air, which had just opened a route from Reno, Nevada, to Minneapolis (Northwest's hub).

The facts were these. In February 1993, Reno Air announced plans to serve Minneapolis with three daily flights beginning April 1. Northwest countered by announcing it would serve the Reno-Minneapolis market, for the first time, also with three daily flights beginning April 1, as well as new flights from Reno to Los Angeles, San Diego and Seattle, three of Reno Air's most important markets. Northwest also matched Reno Air's fares in these markets. Nevada Senators Richard Bryan and Harry Reid urged the U.S. Department of Justice to investigate Northwest's alleged antitrust violations. Northwest succumbed to the pressure, and withdrew from the Reno markets.

A 1996 report of the U.S. Department of Transportation reached the following conclusions:

> The high fares hub dominant carriers have enjoyed at their hub cities clearly provides the incentive for those carriers to discourage competitive entry. And allegations of predatory behavior have increased as a result of the recent emergence and growth of a number of low cost, low fare new entrant airlines. Given the incentives and the reality of very high prices for local passengers at certain network hubs, we have to be concerned about possible predatory behavior or unfair competitive practices * * *.
>
> [W]e will not be indifferent to attempts to exclude or preclude new entry through predatory activity * * *. [T]he beneficial consumer impact of low cost new entry—especially in disciplining fares and filling service voids—is simply too important to permit predation to undermine it. Anticompetitive activity can take myriad forms, from sudden and targeted service increases and sharp and highly selective fare cuts, to hoarding unneeded gate space or slots, as well as other "doing business" problems. The Department will continue to evaluate which actions cross the line from tough competition to anticompetitive predation and react accordingly.[100]

In 1996, Peña announced, "In the past year, American consumers have saved an estimated $6.3 billion in airline fares because of the competition brought about by the new low cost, low fare airlines."[101] But by the end of President Clinton's first term, it was clear that Peña would not be DOT Secretary in his second term. This political vacuum gave United the freedom to move brazenly against competitors in the city he once served as mayor. At this writing, it is unclear whether DOT will be as vigorous in protecting new entrants against unfair and deceptive practices in President Clinton's second term.

The Denver market is estimated to be about a $5 billion revenue prize. With approximately 300 daily departures and service to 62 cities, United has the market power to influence passenger choices through its schedule frequency and frequent flyer program. United also controls the regional distribution channels through the

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[99] See e.g., Gene Amole, Frontier Airlines Needs Your Business, Rocky Mountain News, Nov. 14, 1996.

[100] U.S. Dept. of Transportation, The Low Cost Airline Service Revolution 32–33 (1996).

[101] Id.

use of a large corporate discount program and the payment of commission overrides to key travel agencies.

However, United is a relatively high-cost airline when measured in industry terms of Cost per Available Seat Mile [CASM].[102] Airlines enjoy a significant cost taper over distance. Using second quarter 1995 data (the most recent data we could find) produced independently by Roberts Roach & Associates, when adjusted for stage length (the length of the flight), United's system-wide operating costs are as follows:

Table 1.—United Airlines Domestic Boeing 737–300 Available Seat

[Mile Costs[103]]

Stage Length (miles)	*United ASM Costs (cents)*
200	19.35
250	16.95
300	15.35
350	14.21
400	13.35
450	12.68
500	12.15
550	11.71
600	11.35
650	11.04
700	10.78
750	10.55
800	10.35
850	10.17
900	10.02
950	9.88
1000	9.75
1050	9.64
1100	9.53
1150	9.44
1200	9.35

[103] Roberts Roach & Associates, Scorecard: Airline Industry Cost Management 51 (3rd ed. 1996). The costs in this study have not been adjusted for specific Denver operating costs. They are based on system-wide costs. Some upward adjustment should be made to reflect the higher operating costs of Denver International Airport to more accurately reflect United's true cost of operation at the Denver hub.

The data above reflect break-even seat mile costs and assume that all seats on a flight are filled (that is, the flight has a 100 percent load factor). But because of hourly, daily, seasonal and directional cycles in demand, no carrier fills all of the seats on its flights all of the time (most major airlines achieve annual average load factors of between 65 percent and 70 percent). Thus, these data understate, by about a third, United's actual break-even seat mile costs. In other words, United's average prices must be about a third higher than these ASM costs in order for it to break-even. For this reason, the following analysis errs on the side of conservatism.

Comparing Frontier's ASM costs to United's requires an apples-to-apples comparison of stage-lengths. In the second quarter of 1995, Frontier's average stage length was 407 miles; Frontier's ASM costs were 9.29 cents per mile. As Table I reveals, United's ASM costs at a 400 mile stage length were 13.35 cents per mile. Thus, Frontier's costs are about 30 percent lower than United's. Operating costs at Denver are likely higher than United's system-wide averages revealed in Table 1, somewhere in the neighborhood of an additional one cent per ASM. This suggests the difference in Frontier's vis-a-vis United's costs is even greater than 30 percent.

Despite the fact that United's costs are significantly higher than Frontier's, United is pricing not only below its costs, but below Frontier's as well. In several instances, United has lowered prices below Frontier's lowest price. United is pricing significantly below its true operating costs in order to disrupt, disable or destroy its low-fare competitors.

As Table 2 below reveals, the sale fares announced by United Airlines in December 1996 averaged 99.47 percent of United's unit costs. But in city-pair markets radiating from Denver in which Frontier competed, United's prices were only 68.85

[102] See Roberts Roach & Associates, Scorecard: Airline Industry Cost Management (3rd ed. 1996).

percent of cost, and in markets where Frontier does not compete, United's prices were 109.04 percent of costs. Stated differently, in markets in which Frontier competes, United prices its product an average of 31 percent below its costs. United cross-subsidizes these losses with revenue derived from non-competitive and international markets.

TABLE 2. COMPARISON OF UNITED AIRLINES' COSTS VS. PRICES[104] (December 9, 1996)										*Cities Served*	
City Pair	Miles	Aircraft type (ASM costs in cents per mile) Boeing 737-300	Boeing 757	Cost per seat $	Excise Tax $	Total UAL Cost per seat $	UAL Actual Fare $	UAL Fare as % of Cost	Frontier markets	Non-Frontier markets
DEN/LNK	442	x12.68		=56.05	+6.23	=62.27	81.00	130.07		130.07
DEN/OKC	500	12.15		60.75	6.75	67.50	69.00	102.22		102.22
DEN/DSM	602	11.04		66.46	7.38	73.85	93.00	125.94		125.94
DEN/GEG		10.02		83.37	9.26	92.63	80.00	86.37		86.37
DEN/IND	987	9.75		96.23	10.96	106.93	99.00	92.59		92.59
DEN/WAS	1473		7.43	109.44	12.16	121.60	130.00	106.90		106.90
DEN/BWI	1500		7.43	111.45	12.38	123.83	163.00	131.63		131.63
DEN/NYC	1626		7.28	118.37	13.15	131.53	197.00	149.78		149.78
DEN/EWR	1626		7.28	118.37	13.15	131.53	81.00	61.59		61.59
DEN/BDL	1680		7.24	121.63	13.51	135.15	193.00	142.81		142.81
DEN/BOS	1763		7.15	126.05	14.01	140.06	166.00	118.52		118.52
CHI/TPA	1006	9.64		96.96	10.78	107.75	80.00	74.24		74.24
CHI/PDX	1745		7.19	125.47	13.94	139.41	149.00	106.88		106.88
CHI/LAX	1746		7.19	125.54	13.95	139.49	183.00	131.20		131.20
SEA/WAS	2318		6.87	158.83	17.65	176.48	197.00	111.63		111.63
DEN/OMA	485	12.15		58.93	6.55	65.48	63.00	96.22	96.22	
DEN/PHX	983	9.75		95.84	10.65	106.49	77.00	72.31	72.31	
DEN/LAX	845	10.17		85.94	9.55	95.49	63.00	65.98	65.98	
DEN/CHI	907	9.88		89.61	9.96	99.57	63.00	63.27	63.27	
DEN/SFO	954	9.75		93.02	10.34	103.35	63.00	60.96	60.96	
DEN/SEA	1017	9.64		98.04	10.89	108.93	63.00	57.83	57.83	
	AVERAGE FARE AS PERCENTAGE OF COSTS							**99.47**	**68.85**	**109.04**

The city codes are as follows:

BDL = HARTFORD	GEG = SPOKANE	PDX = PORTLAND
BOS = BOSTON	IND = INDIANAPOLIS	PHX = PHOENIX
BWI = BALTIMORE	LNK = LINCOLN	SEA = SEATTLE
CHI = CHICAGO	LAX = LOS ANGELES	SFO = SAN FRANCISCO
DEN = DENVER	NYC = NEW YORK	TPA = TAMPA
DSM = DES MOINES	OKC = OKLAHOMA CITY	WAS = WASHINGTON, D.C.
EWR = NEWARK	OMA = OMAHA	

104 This analysis was prepared by Frontier Airlines CEO Sam Addoms. Cost data are based on Roberts Roach & Associates, Scorecard: Airline Industry Cost Management (3rd ed. 1996).

(The above findings are displayed graphically in Appendices F and G).

For three reasons, these data understate the differential between United's costs and prices by a significant margin. First, given that most major airlines fill only about 65 percent to 70 percent of their seats annually, these data understate United's break-even revenue requirements by about one-third. Second, the significant increase in the cost of aviation fuel has not been included. Fuel cost between 52–54 cents a gallon in the second quarter of 1995; by the fourth quarter of 1996, it had increased 23 percent, to more than 70 cents per gallon.[105] Third, the above calculations are based on United's system-wide costs which are lower than operations from DIA, for Denver International Airport's fees account for about one cent per ASM higher than other airports. In other words, the difference between United's costs and its prices is significantly greater than these calculations. Finally, these prices are United's lowest. Frontier does not have the proprietary data to determine the size of the inventory over which these seats have been spread. However, Frontier's booking and sales data suggest that United's low-fare seat buckets were opened wide after Frontier announced quarterly profits.

Even before entering Denver's largest air passenger markets, Frontier had already brought down United's fares here and there. For example, before Frontier's entry into the Denver-Omaha market, United's lowest walk-up fare was $460 roundtrip. Frontier entered with a $140 fare, which United promptly matched. According to U.S. Department of Transportation data, in the first quarter of 1994, United's average one-way fare in the Denver-Albuquerque market was $187; in the fourth quar-

105 Julius Maldutis, Airline Update—November 1996 (Dec. 10, 1996), at 11.

ter of 1994, as Frontier entered the market, United's average one-way fare dropped to $87. In the Denver-Bismarck market, United dropped its average $310 fare to $104 after Frontier entered. (See Appendices H through J).

Beginning in 1995, Frontier began entering Denver's largest nonstop markets. In the Denver-Los Angeles market, United's average one-way fare dropped from $163 in the third quarter of 1995, to $122 as Frontier entered in the fourth quarter of 1995. In the Denver-Phoenix market, United dropped its average one-way fare from $147 in the second quarter of 1995, to $89 in the fourth quarter of that year. (See Appendices J through L).

American Express reported that Denver's cheapest fares fell 44 percent in November 1996 (compared to a year earlier) for 10 routes out of Denver in which Frontier competed. In contrast, United's business fares increased 21 percent.[106] The unrestricted business fare also becomes a revenue source with which to cross-subsidize below-cost pricing against competitors. In a letter to the editor of the Denver Post, one consumer summarized what more and more Colorado residents are experiencing:

> "I travel extensively on business, and it is my experience that United is deliberately manipulating prices to put its competitors out of business.
>
> "A recent round trip to Boston on United cost $1,667. The following week, I flew to Minneapolis, again on United, at a cost of $146. The difference is because Frontier flies to Minneapolis. United is charging excessive fares on some routes and using the profits to undercut competition where it exists.
>
> "This unethical behavior would be bad enough on its own. But United is using the taxpayer-supported airports, and the taxpayer-funded air traffic control system in its anti-competitive efforts."[107]

United's pricing in markets Frontier has been forced to abandon is even more remarkable. In the Denver-Billings market, United's average one-way fare was $168 before Frontier entered (in the third quarter of 1994); United dropped it to $92 after Frontier entered (in the first quarter of 1995), then increased it to $208 after Frontier departed. United's average one-way fare in the Denver-Tucson market was $178 in the second quarter of 1994, dropped to $104 after Frontier entered, then rose to as high as $186 after Frontier departed (see Appendices M and N). United offers high prices before and after low-fare competitors enter its markets, but not while it is trying to drive them out of its markets. Indeed, United uses the high prices it extracts from its monopoly markets to cross-subsidize below-cost predatory pricing in markets in which low-cost carriers dare to enter. (See Appendix O).

All airlines suffered higher costs in the second half of 1996. Fuel costs increased between 18 percent and 25 percent. Congress re-imposed a 10 percent excise tax in late August. Frontier attempted to raise its prices modestly to recover these costs on six different occasions. United matched only one of those price increases in markets in which Frontier offers service, but raised prices significantly in many markets in which Frontier does not. Of course, Frontier has no choice but to reduce its prices to United's level even though United has set them at levels below Frontier's costs, and well below United's.

Taking advantage of this unique intersection of two potentially unfavorable events (the double whammy of sharply higher taxes and fuel costs), United appears to have initiated a deliberate effort to suppress prices at the lowest end of their pricing scale. Simultaneously, year over year, coinciding with the end of Frontier's first two profitable quarters, United dramatically expanded seat and flight capacity available at these lower prices so that Frontier's profitability would turn south.[108] (See Appendix P).

This had the effects of eroding Frontier's market share, causing a decline in Frontier's load factors, eroding Frontier's yield, and creating a higher break-even load factor requirement for Frontier precipitated both by lower average fares and higher unit costs. (See Appendix Q and R). Frontier's seven consecutive months of profitable operations have turned into significant monthly losses.

This appears to be a deliberate effort to cause Frontier to hemorrhage revenue. United knows that only a fool enters a bleeding contest against a blood bank. While consumers enjoy a short-term benefit in below-cost pricing, they will again enjoy the monopoly pricing of United if it is successful in driving Frontier from the market.

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[106] Rocky Mountain News, Dec. 23, 1996.

[107] Letter to the Editor by Michael Reilly, Denver Post, Dec. 26, 1996, at 10B.

[108] Unfortunately, while the actual fare data is public, only United Airlines knows the actual number of seats it offers at the lowest price. Moreover, actual cost data and actual fare data for the last quarter of 1996 will not be known until about mid-April of 1997.

Until May 1996, United matched Frontier's lowest fares only on flights in close departure proximity to Frontier's flights.[109] That month, United matched Frontier's fares on all flights, spreading its lowest fares across square miles of seats. To add insult to injury, by the fall of 1996, United was under-pricing Frontier on many routes in which they competed, despite United's significantly higher cost structure.[110] United then began to add flight frequencies in several of the markets in which Frontier competed.

For example, United increased its frequencies in the nonstop Denver-Los Angeles market from 14 daily round-trips in August 1994, and 15 in August 1995, to 20 in August 1996. That increased United's share to more than 90 percent of the flights in that city-pair market. The Denver-Los Angeles market is the sixth biggest market in United's system,[111] and United was determined to increase its monopoly position in the market. Comparing August 1995 to August 1996, United also added a new daily round-trip flight in the Denver-San Francisco market and the Denver-Salt Lake City market, and two in the Denver-Las Vegas market. Again, flights were added in these markets after Frontier entered.

For example, comparing 1996 with 1995, in the Denver-Las Vegas Market, United increased its seat capacity up to 71 percent and flights 37 percent; in the Denver-Los Angeles market, United increased seats up to 34 percent and flights 33 percent; in the Denver-Phoenix market, United increased seats up to 38 percent and flights 27 percent; and in the Denver-San Francisco market, United increased seats up to 19 percent and flights 16 percent. (See Appendices S through V). At cities Frontier departed, United tended to reduce seat capacity and flights, year over year. For example, in the Denver-Billings market, United reduced seats and flights by as much as a third. (See Appendix W).

In late 1996, United announced it was adding capacity from Denver to 12 cities, 11 of which were cities in which either Frontier or Western Pacific competed. Even though United had confessed that it was losing money in the Denver-Las Vegas and Denver-Phoenix markets (in both of which Frontier competes), United announced sharp increases in frequencies in these markets with Shuttle by United to operate low-fare high-frequency service.[112] According to one source, "The Shuttle is United's weapon against a growing swarm of low-cost airlines that are winning fliers with low fares."[113] A United spokesman describes United's Shuttle in these terms, "Shuttle by United was created by the employees to be a competitive tool against low-fare, short-haul carriers."[114] Whether a "tool" or a "weapon," Shuttle by United is designed to subdue, punish and destroy low-fare competitors.

Originally launched in West Coast markets to discipline Southwest (an airline which, United learned, was too large to destroy), United was now turning the Shuttle toward Frontier and Western Pacific. Beginning February 11, 1997, United would fly 13 round trips in the Denver-Phoenix market (up from 9), and 12 round-trips in the Denver-Las Vegas market (up from 7). Vanguard Airlines announced it was exiting the Denver-Phoenix market.[115] United insisted that one of the reasons it was losing money in these markets was the equipment—its DC–10's would be replaced by the Shuttle's 737's.[116] Anyone who understands anything about airline economics knows the Available Seat Mile [ASM] costs of a wide-bodied aircraft like a DC–10 are typically lower than the ASM costs of a narrow-body aircraft like a 737, even though the pilots in the cockpit of a wide-bodied aircraft are paid significantly more than those of a narrow-body aircraft. United refuses to reveal the Shuttle's costs (perhaps to obfuscate them in an attempt to repel allegations that it is engaging in predatory pricing, an antitrust violation). But operating from Denver, any legitimate accounting methodology would likely place United's Shuttle costs significantly higher than Frontier's.[117] Even with the Shuttle, United's system-wide 737 costs rose 4 percent, year-over-year. Shuttle by United accounts for 45 percent of United's total Boeing 737–300 operations.[118] Thus, the above chart revealing

[109] Jeffrey Leib, Frontier Joins Discount Fray, Denver Post, Aug. 15, 1995, at C1.

[110] Ann Imse, Fronter Exec Calls United Predatory, Rocky Mountain News, Nov. 9, 1996, at 1B.

[111] Aviation Daily, Dec. 9, 1996, at 392.

[112] Ann Imse, Frontier Exec Calls United Predatory, Rocky Mountain News, Nov. 9, 1996, at 1B.

[113] Julie Schmit, West Coast Showdown, USA Today, Sept. 30, 1994, at 1B.

[114] Penny Parker, United Taps Low Fares To Launch Its Shuttle, Denver Post, Nov. 20, 1996, at C3.

[115] Jeffrey Leib, Vanguard Cancels Flight Before Shuttle Debuts, Denver Post, Nov. 9, 1996, at 3D.

[116] Jeffrey Leib, Low-Fare United Shuttle DIA-Bound, Denver Post, Nov. 7, 1996, at 1C.

[117] Roberts Roach & Associates, Scorecard: Airline Industry Cost Management (3rd ed. 1996).

[118] Id. at 18.

United's 737–300 system-wide domestic cost structure probably reflects costs which approximate those of the Shuttle, particularly given that DIA's fees and charges add about one cent per mile to carrier costs.

Why, then, is United bringing the Shuttle to Denver? Former Denver airport director George Doughty offered this explanation:

"[I]t is clear that United is not doing this because it wants to provide a low-fare product at its fortress hub. You can bet if there were no low-fare competitors, there would be no shuttle. It goes counter to its pricing philosophy, which is to maximize fares. You need only compare fares available in markets where United has a monopoly or competes only with another Big Seven carrier to markets where there is a competing low-fare carrier." [119]

The reason United is bringing its Shuttle to Denver is not to lower fares at its Denver fortress hub. It is to drive the low-fare competitors at Denver out.

United also offers major travel agencies commission overrides in various city-pairs radiating from Denver, several in which Frontier competes. With agent commissions capped at $50 by the major airlines in 1994, overrides have become a far more important, if not essential stream of revenue for agents. Agencies only earn overrides if they book an extremely high percentage (e.g., 90 percent) of flights on the carrier which offers them. Thus, agents are incentivized to book their customers on United even when Frontier (or any other competitor) has a more desirable schedule or better service.

Agents also rely on computer reservations systems which, as we have seen, are biased against non code-share connections.

United Airlines also includes a contractual provision in its corporate discount contracts with Denver businesses prohibiting them from entering into similar agreements with other carriers. Typically, it provides: "During the Term of this Agreement, Customer will not enter into any similar agreement with any other airline under which air transportation is provided to Customer in return for any incentive on the air routes serviced by United."

The combination of United's strategy of (1) dumping excess capacity in Frontier's markets, (2) lowering prices to or below Frontier's, (3) paying agents commission overrides to steer business toward United, and away from Frontier, (4) refusing to enter into joint-fare or code-sharing agreements with low-cost jet competitors, (5) biasing its CRS against interline flights, and (6) imposing "exclusive dealing" requirements with corporate accounts, began to take its toll. Although Frontier was profitable in the first two calendar quarters of 1996, it lost money in the third (at this writing, fourth quarter returns are not out). By October and November 1996, Frontier was filling only 50.7 percent and 52.7 percent of its seats, respectively (compared with 58.4 percent and 61.1 percent, respectively, a year earlier).[120]

Western Pacific began serving Colorado Springs Airport (about 75 miles south of Denver) in 1993. In September 1995, United "counterattacked an upstart Colorado Springs airline * * * and sharply cut ticket prices on tickets from Denver to 16 cities [in 13 of which Western Pacific competed]." [121] Despite its significantly higher cost structure, United began matching or beating WestPac's fares.

By late 1996, WestPac was serving 20 cities with fifteen 138-seat Boeing 737–300 aircraft.[122] WestPac's lowest walk-up fare to San Francisco was $417, while United's was $1,080.[123] United's management described WestPac as a "nuisance," taking several actions to clip its wings.[124] First, United began matching WestPac's fares on a capacity controlled basis. For example, United dropped its Colorado Springs-Washington (Dulles) round-trip fare to $228, though flying the same aircraft out of Denver cost consumers $1,138.[125] Then United began matching WestPac's fares from

[119] George Doughty, Smart Business Travelers Can Invest In Fare Competition, Denver Business Journal, Nov. 29, 1996, at 27A.

[120] Jeffrey Leib, Frontier's Passenger Traffic Dips, Denver Post, November, 1996, at C1; Frontier Fills Fewer Seats, Denver Post, Dec. 12, 1996, at 2C.

[121] Jeffrey Leib, United Cuts Fares To Meet, Beat Springs Deals, Denver Post, Sept. 22, 1995, at A1.

[122] Carriers Suffer With Rising Fuel Prices, Reduced Traffic and Taxes, Airline Financial News (Oct. 14, 1996).

[123] Ann Gottlieb & Jeffrey Leib, Competition Would Cut Fares, Denver Post, July 16, 1996, at A10.

[124] United Airlines Chief: WestPac's a Nuisance, Colorado Springs Gazette Telegraph, Jan. 10, 1006, at D1.

[125] Ann Imse, Computer Helps You Find Lowest of the Low Fares, Rocky Mountain News, Mar. 24, 1996.

Colorado Springs on a "seat-for-seat" basis.[126] By replacing 737 service from Colorado Springs to Chicago with DC–10's, United increased its capacity by 20 percent.[127] Pricing below cost and dumping capacity are two of the consistent tactics United has used to drive competitors from markets it seeks to dominate.

A December 1996 cover story of the Wall Street Journal summarized the predatory behavior targeted at small airlines like Western Pacific and Frontier by megacarriers like United:

"[After the ValuJet crash in the Everglades caused a temporary drop in new entrant airlines' bookings] [b]ig carriers, sensing vulnerability, aggressively matched fares and added flights on routes flown by small airlines * * *.[128]

"[B]ig carriers such as United * * * were increasing pressure on Western Pacific and other start-ups. Trying to win back customers, UAL Corp.'s United, for example, increased its flights between Denver and Colorado Springs and even added a DC–10 on the short hop. The carrier more aggressively matched the fares of Western Pacific and Frontier, and announced plans to bring its low-fare Shuttle by United from the West Coast into Denver."[129]

Both Frontier and Western Pacific are in United's cross hairs, and United appears to be firing at its targets with impunity.

As we have seen, United engages in a multitude of unfair, deceptive, anticompetitive and predatory practices designed to establish and preserve a Fortress Hub monopoly at Denver:

—United Airlines is willing and able to dump low-priced capacity in any market in which a competitor appears.

—United Airlines is willing and able to engage in predatory pricing to maintain and increase its monopoly at Denver. Where United faces competition at Denver, it has priced as much as 42 percent below cost.

—International and monopoly markets provide United with ample revenue to cross-subsidize losses incurred because of its below-cost pricing in its competitive markets.

EXTRACT MONOPOLY FARES FROM THE DENVER FORTRESS HUB: ROUND TWO

As it has driven competitors out of markets, United has raised prices sharply. For example, before Frontier entered the Denver-Billings market, United's lowest roundtrip fare was $384. After Frontier entered, United lowered its fare to $198. After Frontier departed, United raised its fares to $345.[130]

The Denver-Boulder metropolitan area is the largest center of business activity in the Rocky Mountain Region. Unfortunately, Denver is an oasis of population isolated from other business centers in North America. For example, the distance from Denver to Phoenix is nearly 600 miles, to Dallas nearly 650 miles, to Minneapolis 700 miles, to Los Angeles 850 miles, to Chicago 900 miles, and to Seattle 1,000 miles.[131] Amtrak rail service exists to some of these cities, but it is extremely slow. Interstate highways make these cities accessible by automobile, but the distances and driving times are vast. These features make Denver and Colorado more reliant on air transportation than most other American cities. As a consequence, an unusually high proportion (58 percent) of passengers at Denver International Airport are origin-and-destination [O&D] passengers.[132] It is these passengers upon whom a monopoly fare can be placed by a dominant airline.

A 1990 study by the U.S. General Accounting Office comparing pricing between concentrated and unconcentrated hub airports found that O&D fares were 27 percent higher at the concentrated hubs.[133] A separate study performed that year by the U.S. Department of Transportation found that average yields were 18.7 percent

[126] United Airlines Chief: WestPac's a Nuisance, Colorado Springs Gazette Telegraph, Jan. 10, 1006, at D1.

[127] Bill Vogrin, United Makes Denver Flights a Big Deal, Colorado Springs Gazette Telegraph, Mar. 5, 1996, at A1.

[128] Scott McCartney, Start-Ups Still Suffer From ValuJet Crash and FAA's Missteps, Wall St. J., Dec. 9, 1996, at 1.

[129] Id. at A10.

[130] Ann Imse, Frontier Exec Calls United Predatory, Rocky Mountain News, Nov. 9, 1996, at 1B.

[131] Leigh Fisher Associates Analysis Prepared for the City and County of Denver (1994).

[132] U.S. General Accounting Office, Denver Airport: Operating Results and Financial Risks 18 (1996).

[133] U.S. General Accounting Office, Airline Competition: Industry Operating and Marketing Practices Limit Market Entry (1990).

higher at single-carrier hubs.[134] A 1996 study by DOT concluded that the presence of low-cost competitors produce a 40 percent fare savings to consumers at dominated network hubs.[135]

A 1994 study of airline pricing at Denver prepared for the city estimated 16.5 million enplaned passengers, of whom 8.25 million were O&D. Average airfares of $362 multiplied times 8.25 million O&D passengers produced $3 billion in gross revenue. Assuming a 15 percent increase in air fares attributable to the hub monopoly of United Airlines, the annual cost to Denver consumers from monopolization of the Denver hub was $450 million. Assuming a 27 percent increase, the annual consumer cost of monopolization was $810 million in 1994 terms. (See Appendix X). The airport itself loses $10 million in revenue because higher prices translates into fewer passengers. (See Appendix Y). Thus, in a relatively short time frame, United could recover the losses it incurred in its below-cost fare wars with its competitors at Denver.

These are highly conservative estimates. By 1996, the consensus was that DIA produced $5 billion in gross revenue for the airlines which serve it, that 58 percent of the traffic was O&D, and that a monopoly airline could charge fares 42 percent higher than in competitive markets. This suggests a potential direct negative impact on Colorado consumers in excess of a billion dollars a year. Much of that increase is attributable to United Airlines' dominance of virtually all spokes radiating from Denver.

These are the minimum costs imposed on the Colorado economy by monopolization of DLA. They do not account for the ripple effect on business, particularly travel-related business, such as hotel, convention and tourism. In Colorado, the ski industry does nearly $2 billion in retail activity, while tourism is a $6 billion industry. The success and well being of both industries is directly tied to the reasonableness of air fares to Colorado. A perception that Colorado is an expensive tourism destination will send tourists elsewhere. United's monopoly will siphon tens of billions of dollars of revenue out of the Colorado economy over the long term, significantly dampening discretionary traffic in an economy strongly dependent on tourism.

It has been proven statistically that a 15 percent increase in air fares results in a 4.5 percent decrease in passenger traffic; a 27 percent increase in fares results in about an 8 percent decrease in passenger traffic.[136] In 1994, it was estimated that the tourism economic impact of Stapleton International Airport was $892 million (comprised of $622 million in winter tourism, $222 in summer tourism, and $48.4 million in business travel and conventions). A decline in passenger traffic of between 4 percent and 8 percent attributable to monopoly air fares translates directly into a loss of tens of millions of dollars in lost income for these industries. The aggregate impact of higher ticket prices imposed by United Airlines upon O&D passengers, plus the loss of revenue sustained by the Colorado tourism industry and Colorado business more generally, plus declining DIA revenue attributable to dampened passenger demand, may be well over $1 billion annually.

The only thing that stands between a consumer's wallet and a wealth-maximizing monopolist is a competitor. United Airlines is determined to see to it that there will be no low-fare competitor at Denver or Colorado Springs.

Like a colonial government, the Elk Grove Township, Illinois-based megacarrier is determined to control its Colorado territorial economy to maximize United's wealth, irrespective of the impact of the indigenous inhabitants who rely on the Fortress hub it dominates. United forgets that taxation without representation is what led to the American Revolution.

Many industry observers have described United Airlines as Denver's "800-pound gorilla."[137] United Airlines recently announced it was inaugurating a new public relations campaign to improve its image. One travel expert believed United was trying to combat its 800-pound gorilla image at DIA.[138] Whether splashing money on public relations in Denver can put the beast in lamb's clothes or not, it will still walk, and talk, and growl like a gorilla, and crush any small animal that dares enter its cage. A gorilla clad in lamb's wool is nonetheless a gorilla.

As 1996 drew to a close, United Airlines and its code-sharing affiliates controlled nearly more than 95 percent of the connecting traffic, and nearly 80 percent of the total passenger traffic at the Denver hub. (See Appendix Z). In December 1996,

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[134] U.S. Dept. of Transportation, Secretary's Task Force on Competition in the U.S. Domestic Airline Industry: Airports, Air Traffic Control, and Related Concerns (1990).

[135] U.S. Dept. of Transportation, The Low Cost Airline Service Revolution 9 (1996).

[136] Julius Maldutis, Airline Update-August 1996 (Sept. 9, 1996), at 2.

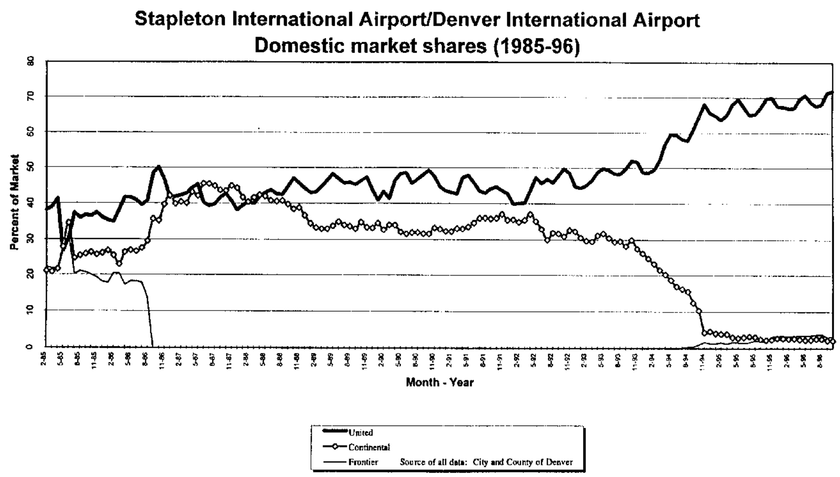
[137] Rocky Mountain News, Nov. 14, 1996.

[138] Ian Oldeirson, United Launches Image-Improving Bid, Denver Business J., Dec. 6, 1996, at 5A.

speaking before about 300 Denver business leaders, when asked how large a market share the carrier seeks at DIA, United Airlines Vice President Roger Gibson responded, "I'd like all of it." [139]

United Airlines wants all of it.

APPENDIX A

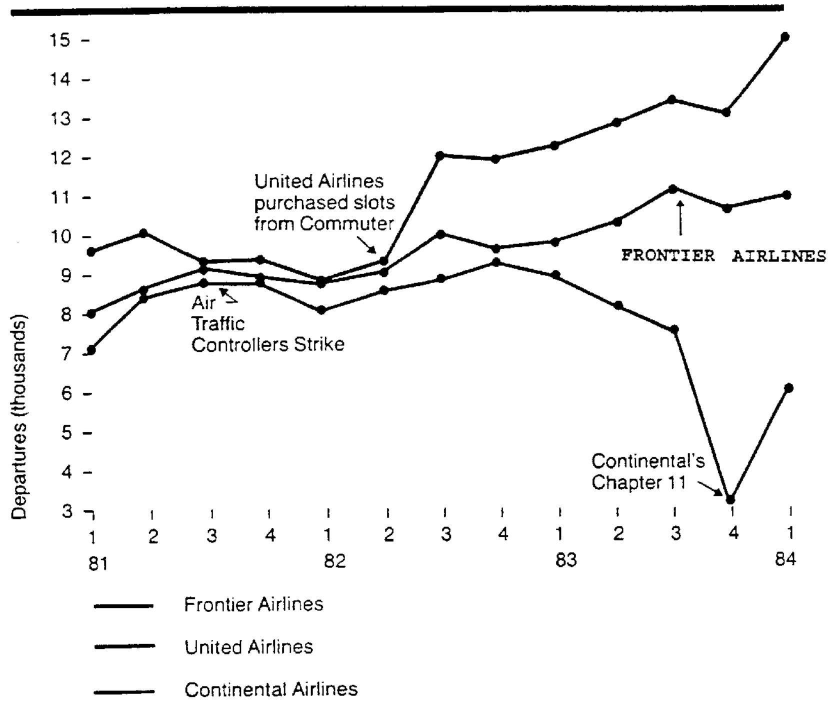


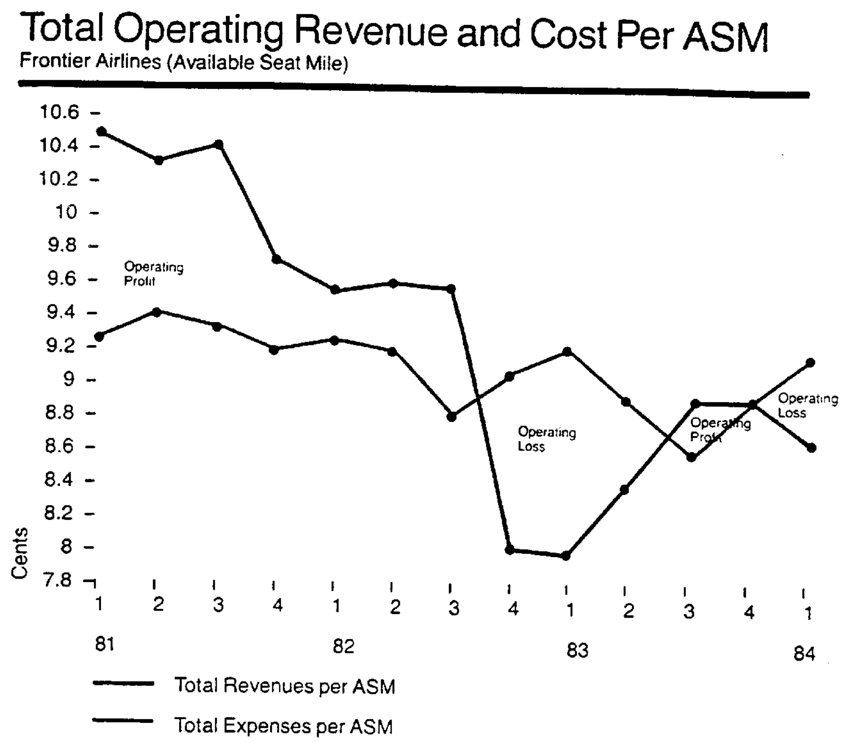
[139] Statement before the Denver Rotary Club breakfast meeting at the Denver Athletic Club, Dec. 12, 1996.

APPENDIX B

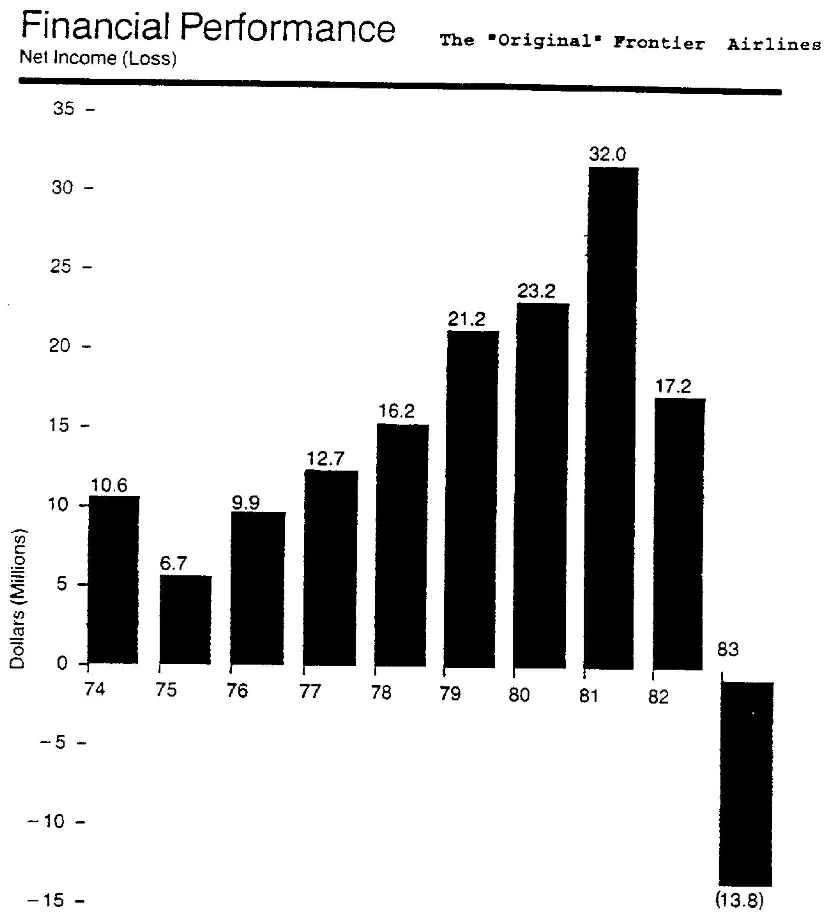
Jet Departures at Denver

Quarterly From 1981



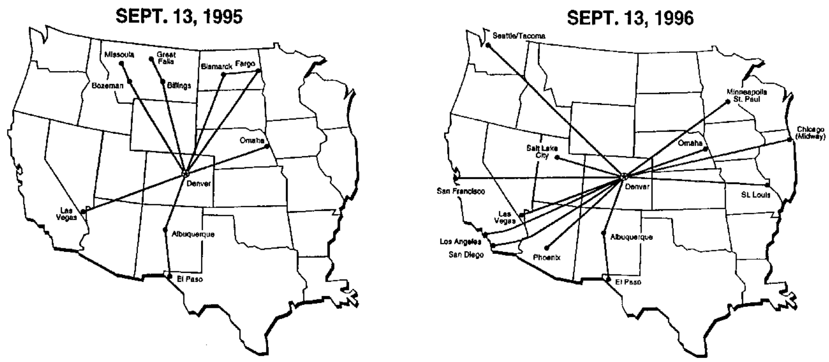

Total Operating Revenue and Cost Per ASM
Frontier Airlines (Available Seat Mile)
10.6
10.4
10.2
10
9.8
9.6
9.4
9.2
9
8.8
8.6
8.4
8.2
8
7.8
Cents
Operating Profit
Operating Loss
Operating Profit
Operating Loss
1
2
3
4
1
2
3
4
1
2
3
4
1
81
82
83
84
Total Revenues per ASM
Total Expenses per ASM

APPENDIX D


Financial Performance
Net Income (Loss)
The "Original" Frontier Airlines
35
30
25
20
15
10
5
0
-5
-10
-15
Dollars (Millions)
10.6
6.7
9.9
12.7
16.2
21.2
23.2
32.0
17.2
(13.8)
74
75
76
77
78
79
80
81
82
83

APPENDIX E

FRONTIER ROUTE SYSTEM DEVELOPMENT



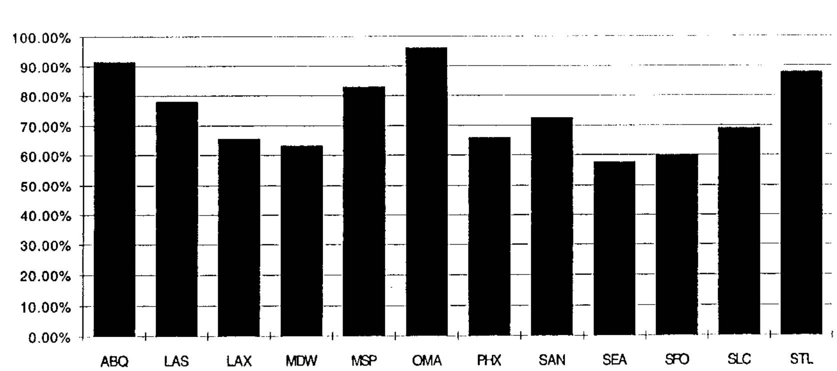
Frontier AIRLINES

APPENDIX E

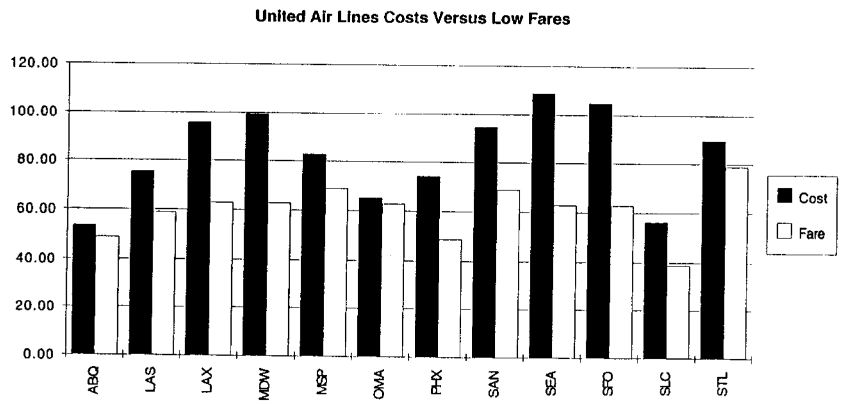
	Number of Cities Served from Denver	Cities Served Among Denver's Top 25 Markets	Fleet Size B737-200's	Fleet Size B737-300's	Daily Departures from Denver	Total Route-Miles	Average Flight Length
SEPT. 1995	10	3	5	0	15	4,400	380 miles
SEPT. 1996	13	12	7	2	25	8,800	680 miles

APPENDIX F

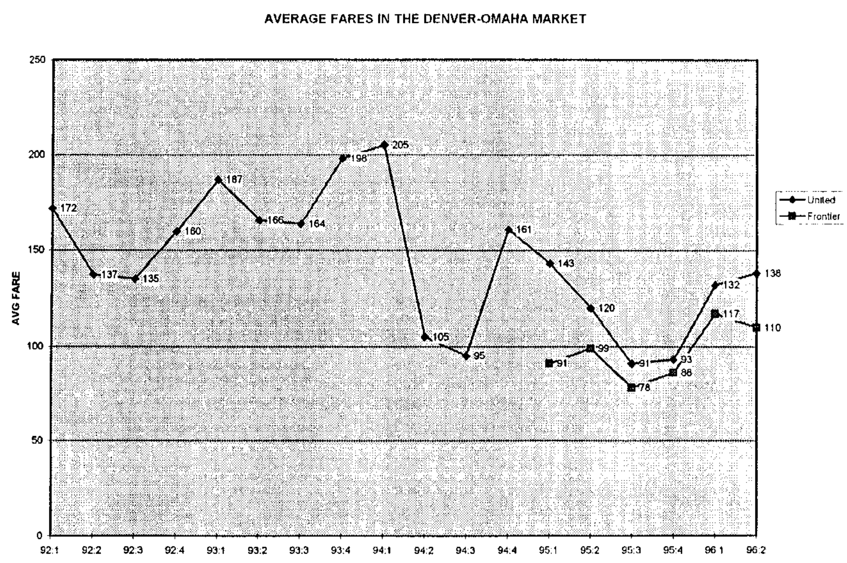
United Fares as % of Cost



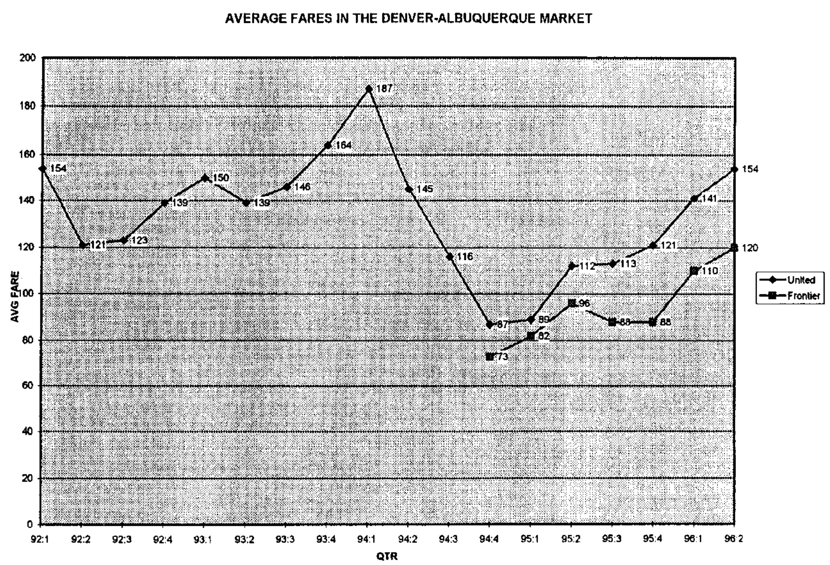
APPENDIX G



APPENDIX H



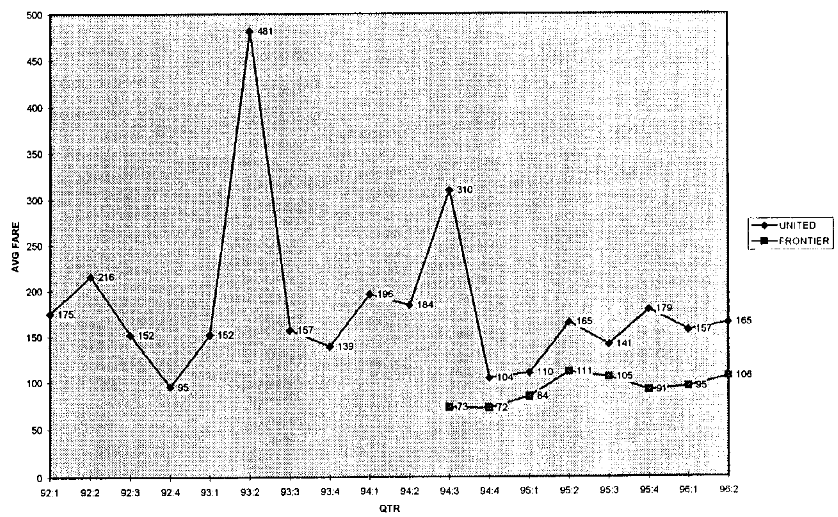
APPENDIX I



Source: DATA BASE PRODUCTS, INC O and D PLUS+

APPENDIX J

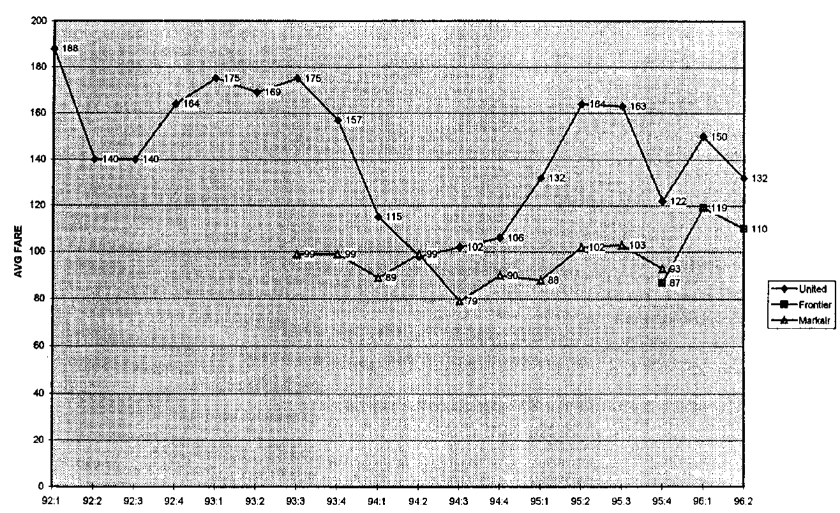
AVERAGE FARES IN THE DENVER-BISMARCK MARKET



Source: DATA BASE PRODUCTS, INC. O and D PLUS+

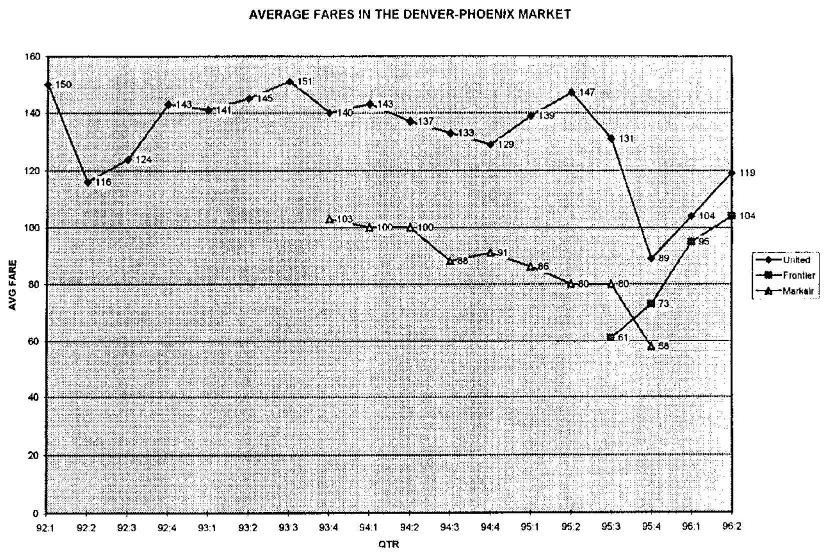
APPENDIX K

AVERAGE FARES IN THE DENVER-LOS ANGELES MARKET



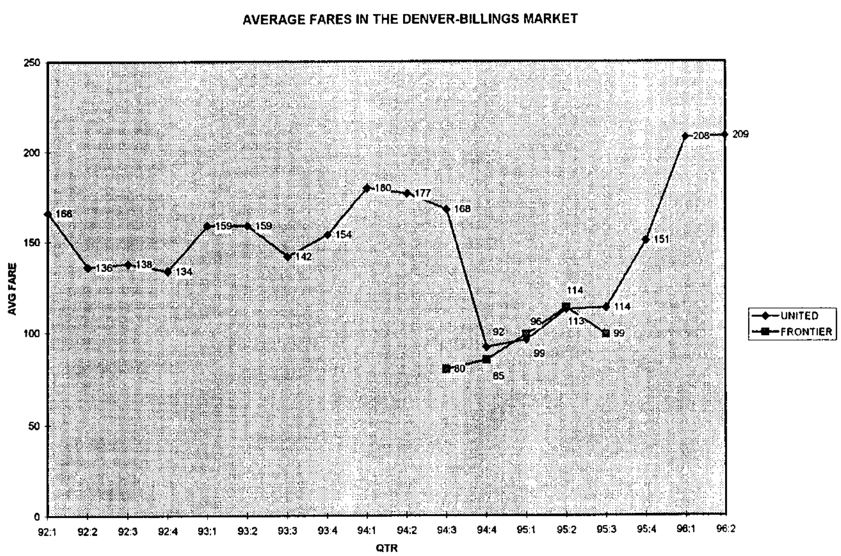
Source: DATA BASE PRODUCTS, INC O and D PLUS+

APPENDIX L



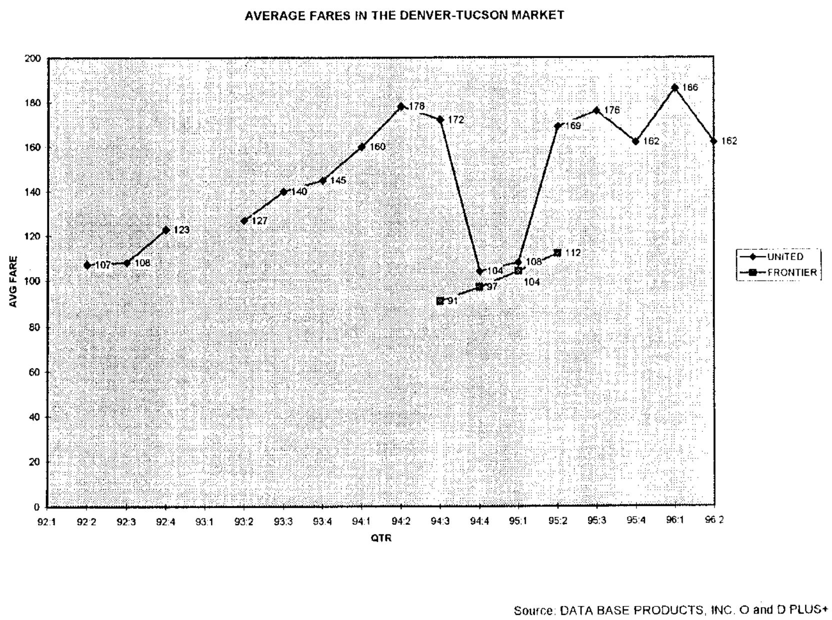
Source: DATA BASE PRODUCTS, INC O and D PLUS+

APPENDIX M

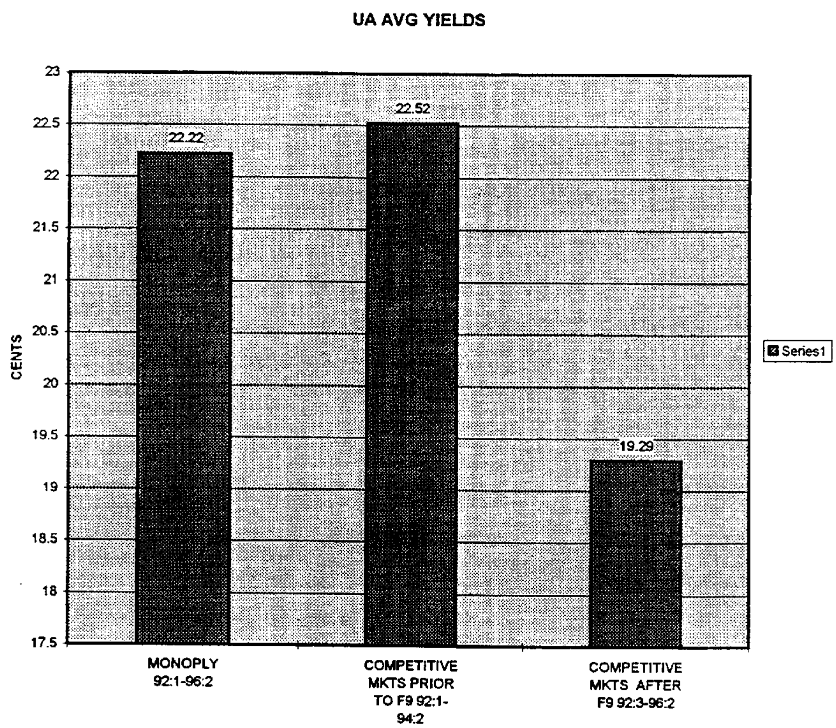


Source: DATA BASE PRODUCTS, INC. O and D PLUS·

APPENDIX N


AVERAGE FARES IN THE DENVER-TUCSON MARKET
AVG FARE
QTR
UNITED
FRONTIER
107
108
123
127
140
145
160
178
172
104
108
169
176
162
186
162
91
97
104
112
Source: DATA BASE PRODUCTS, INC. O and D PLUS+

APPENDIX O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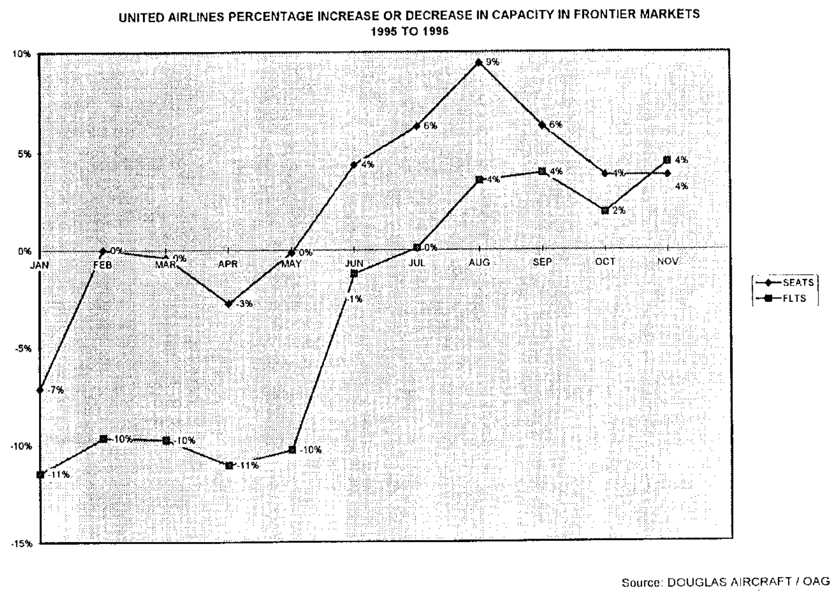
COMPETITIVE MKTS AFTER F9 92:3-96:2

APPENDIX P



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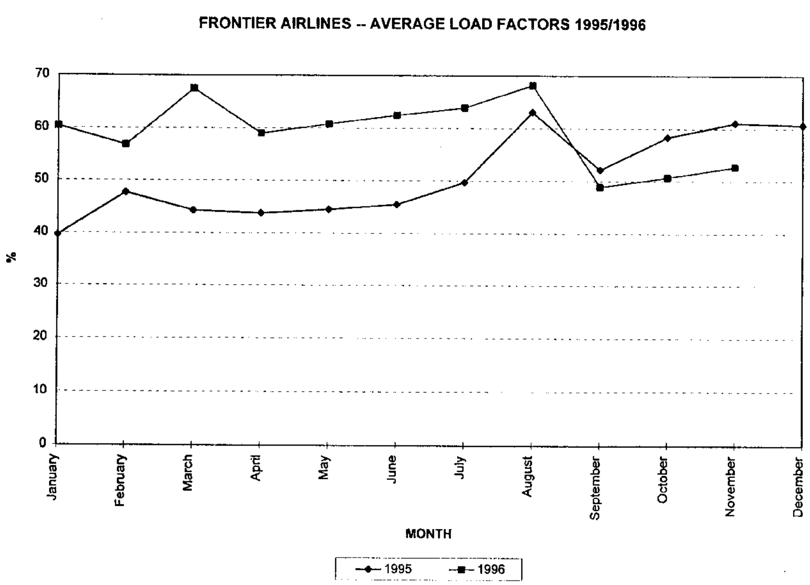

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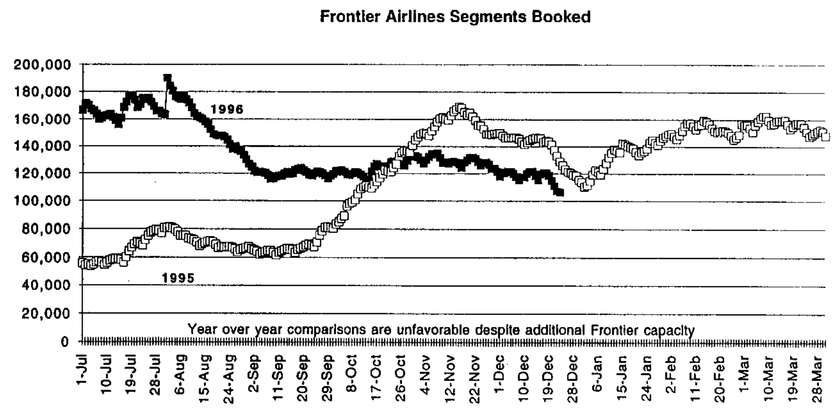

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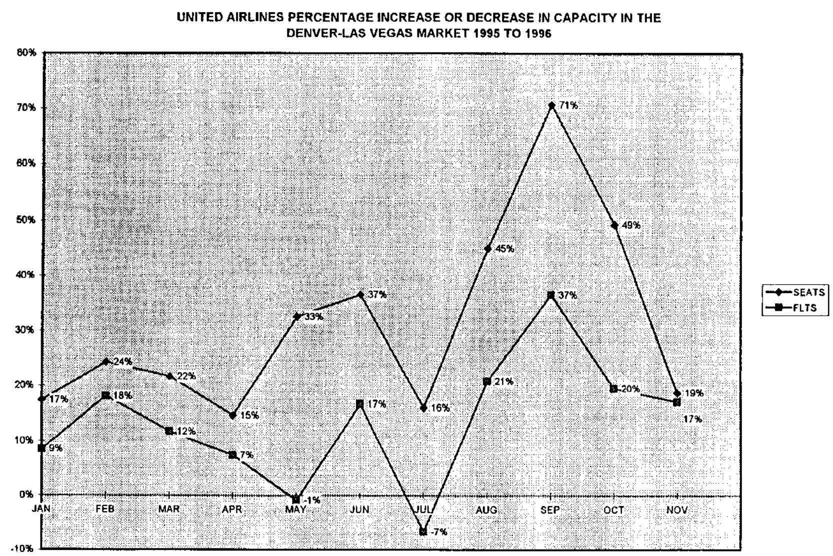

Source: DOUGLAS AIRCRAFT / OAG

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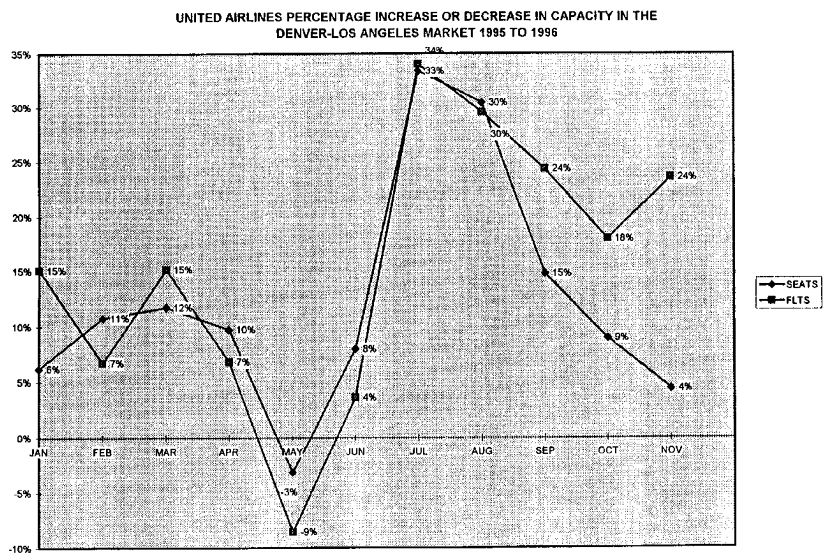

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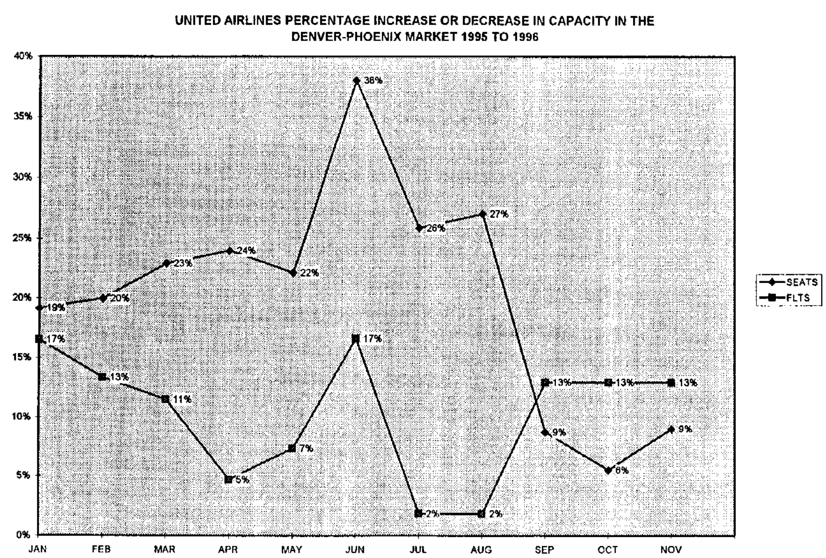
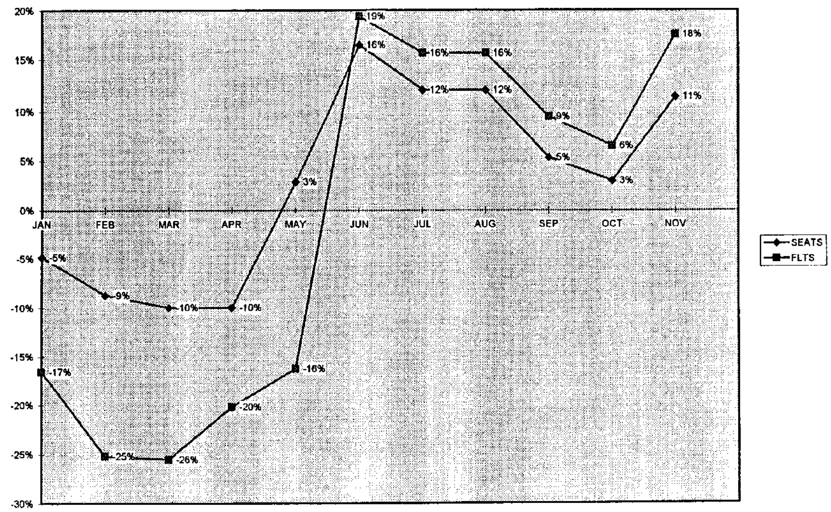
APPENDIX U



Source: DOUGLAS AIRCRAFT / OAG

APPENDIX V

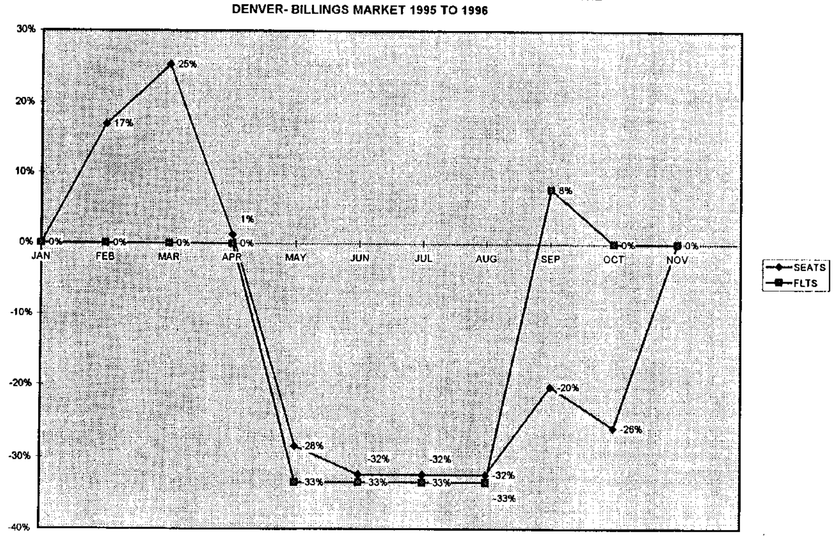
UNITED AIRLINES PERCENTAGE INCREASE OR DECREASE IN CAPACITY IN THE DENVER-SAN FRANCISCO MARKET 1995 TO 1996



Source: DOUGLAS AIRCRAFT / OAG

APPENDIX W

UNITED AIRLINES PERCENTAGE INCREASE OR DECREASE IN CAPACITY IN THE DENVER- BILLINGS MARKET 1995 TO 1996



Source: DOUGLAS AIRCRAFT / OAG

APPENDIX X

PUBLIC COST OF A FORTRESS HUB

Colorado Air Passenger Market

16.5 million enplaned passengers (per year-SIA)
8.25 million O&D passengers
Average airfares $362 × 8.25 million = $3 billion

Airfare Increases With Fortress Hub[140]

Scenario 1—27 percent increase in fares × $3 billion = $810 million
Scenario 2—15 percent increase in fares × $3 billion = $450 million

APPENDIX Y

Total Cost of a Fortress Hub

[In millions of dollars]

Airfares	450.0
Airport Funds Lost	10.2
Tourism Dollars Lost	....
Multiplier	....
Total Cost	+500

APPENDIX Z

Domestic Market Share—October 1996

[Percentage]

United	71.8
Delta	4.6
Other	4.5
Continental	2.2
American	3.8
Northwest	2.0
Frontier	3.2
America West	1.5
United Express	6.4

[From the Denver Business Journal]

RIP UNITED AIRLINE'S HOLD FROM DIA

(By Paul Dempsey)

Welcome to Denver International Airport, the impenetrable fortress hub of United Airlines. Air fares have risen here an astounding 46 percent since last year, sucking $400 million out of the Colorado economy. Watch as the convention and tourism industries wither. Observe Denverites drive their families down 1–25 to Colorado Springs to get a fair price for a flight.

This is not the vision Mayor Federico Peña had in mind when he told us to "Imagine a great city." In the years DIA was planned, Denver was uniquely blessed with three hub competitors. In 1986, Frontier was absorbed by Continental, and then there were but two.

But in the last few years, United turned up the heat, increasing Denver capacity by 30 percent in a deliberate effort to shove Continental out. Continental lost $10 million a month at Denver, and no politician would lift a finger to save its maintenance base at Stapleton (cost—three flights a day, max. on one north-south runway; benefit—1,500 good-paying jobs and at least 60 flights a day to discipline United). Continental, which inaugurated service half a century ago in Pueblo, all but abandoned the state that give it birth, moving its planes east of the Mississippi. And United has raised fares to monopoly levels in virtually every market Continental abandoned.

Along the way, United cut a remarkable deal with the city to strip essential parts from the infamous BAE automated baggage system out of Concourse C and move them to Concourse B so that only United would have a high-speed system. Other airlines were relegated to 19th century tug-and-cart technology. Unfortunately,

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[140] 1990 General Accounting Office and Dept. of Transportation Studies.

DIA's massive cost overruns have dissuaded many low-fare airlines from entering the market.

In fact, one by one, the low-cost, low-fare airlines have exited Denver—Morris Air, Midway Airlines and GP Express. Now MarkAir languishes in Chapter 11 bankruptcy, while United tries to push it into Chapter 7 liquidation, selectively lowering fares on flights in close proximity to MarkAir's and bribing travel agents to steer traffic to United via commission overrides.

United also refuses to enter into joint fare and code-sharing relationships with domestic jet airlines, which results in relegating small communities to inferior and high-cost turboprop aircraft, flying below the weather without in-flight amenities or lavatories.

Code-sharing is a way of defrauding consumers into believing they will be flying a megacarrier's jets, when in fact they are funneled onto a tiny carrier's turboprop or piston aircraft at the hub, all in a deliberate attempt to steer feed traffic away from jet competitors. The new Frontier Airlines sought joint fares and code-shares with United so that Frontier can continue 737 jet service to Montana and North Dakota. United refuses. Although consumers clearly prefer jets to turboprops, United's computer reservations system adds an astounding 1,440 minutes to the United-Frontier interline, often shoving it off the first page of the computer screen, where 90 percent of all flights are sold by travel agents.

Could anyone imagine that the Federal Communications Commission would tolerate U S West entering into preferential connections and rates with Sprint, making it difficult for consumers who preferred MCI or AT&T to get access? As yet, no one has litigated the antitrust implications of discriminatory connections related predatory conduct in aviation. But if the telecommunications industry is at all analogous, United Airlines has an antitrust problem—a serious antitrust problem.

Unfortunately, antitrust takes years to litigate, and the people of Denver need relief now. The man who conceived DIA, Peña, is now our nation's secretary of transportation. The Federal Aviation Act commands the secretary protect the "public interest" by forbidding "unfair and deceptive practices" and "unfair methods of competition." The public interest is defined in that statute to include "preventing unfair, deceptive, predatory or anticompetitive practices" and "avoiding unreasonable industry concentration, monopoly powers, and other conditions that would tend to allow at least one carrier * * * unreasonably to increase prices, reduce services, or exclude competition in air transportation." That hits the nail on the head. If only we can convince Secretary Peña to pick up the hammer and swing.

Join me in urging Peña to loosen the monopoly stranglehold United Airlines has on the great airport he imagined. His address is: The Honorable Federico Peña, Secretary of Transportation, 400 Seventh St. S.W., Washington, D.C. 20590.

Do it, or pay the price.

[From the Denver Post, Sept. 4, 1986]

DEREGULATION'S TOLL IS RISING

(By Paul Stephen Dempsey)

The bankruptcy of Denver-based Frontier Airlines is but the latest chapter in an industry struggling in the turbulent headwinds of deregulation. Even deregulation guru Alfred Kahn admits the airline industry is becoming an "uncomfortably tight oligopoly" in the Darwinian marketplace of bankruptcies and acquisitions.

In the short run, deregulation has meant a more competitive marketplace, where consumers have been given a wider choice of price and service (mostly price) options. Braniff became the first major casualty of improvident management after deregulation, and its bankruptcy served as a warning to others. Carrier management and labor, which had grown fat and lethargic under regulation, were forced to tighten their belts—to become mean flying machines.

Lower lean, ticket prices and increased industry productivity are considerable benefits of airline deregulation. But deregulation has not been without its costs.

Low fares have been distributed unevenly in favor of America's major cities, where the competition has been most intense for market share. But the empirical evidence suggests a positive correlation between higher ticket prices and fewer competitors. "Transcontinental fares are sometimes lower than the price of flying to a small American city at less than half the distance away.

Passenger convenience has waned; today's traveler is flown on intensely packed aircraft funneled into congested hubs on flights that are chronically delayed, while he is served cardboard food. With all that, he feels lucky that he wasn't stranded by overbooking, as are many others less fortunate.

Stockholders and employees also have been stranded in the icy headwinds of deregulation. In the early years of deregulation, its advocates were slow to accept any blame, pointing fingers at the economic recession and wildly escalating fuel prices. But the recession hasn't reared its ugly head in a while and aviation fuel prices have been sent wildly crashing through the floor, as have wages for many employees.

Frontier's economic Armageddon may be People Express's as well, for its founder, Donald Burr, suffers from the fatal flaw of the first of deregulation's airline mavericks, Sir Freddie Laker—excessively aggressive expansion. By purchasing Denver-based Frontier last year, Burr hoped to join the club of the four or five megacarriers that analysts predict will eventually dominate the industry. But Burr bit off more than he could chew in the hotly competitive Denver market, dominated by three major hub carriers—United, Continental and Frontier.

Burr was forced to reverse course, signing an agreement earlier this year to sell Frontier to the industry behemoth, United. The United purchase fell through and People put Frontier into bankruptcy as a tourniquet to stop the hemorrhaging of losses totaling $10 million a month.

Although United failed to acquire Frontier, it had already purchased many of its aircraft, hangers and gates at Denver. As the nation's largest airline and the premiere industry proponent of deregulation, it is vertically and horizontally integrated into a megacarrier that owns Weston Hotels and the Apollo computer reservations system, and has recently purchased Hertz Rent-a-Car as well as Pan American's transpacific routes.

How quickly will the industry come to be dominated by only a handful of airlines? Northwest Orient and Republic have just consummated the largest merger in aviation history. Texas Air (which owns Continental and New York Air) will likely refile its application with the Department of Transportation to acquire ailing Eastern Airlines (which purchased Braniff's South American operations upon the bankruptcy of that airline). TWA's application for acquisition of Ozark is also pending at DOT. TWA's owner, Carl Icahn, admits it will still need another merger partner if TWA is to be successful.

Together, Frontier's bankruptcy and these massive mergers will likely result in less competition and higher ticket prices at the hubs of Denver, Detroit, Minneapolis/St. Paul, New York, St. Louis and Washington, D.C.

These mergers and bankruptcies are not the last we will see. The weaker birds cannot fly in such fierce headwinds. Some will be consumed by larger predators. The skies of deregulation will get darker and stormier still before the dust settles on an indus try dominated by giants.

The social Darwinists can celebrate the net result of deregulatlon. But we consumers have been taken for a ride.

STATEMENT OF MARK KAHAN, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, SPIRIT AIRLINES

Senator SHELBY. Mr. Kahan.

Mr. KAHAN. Thank you, Mr. Chairman.

I am Mark Kahan, vice chairman of Spirit Airlines headquartered in Detroit. As a personal note, I came to Washington 20 years ago with Dr. Alfred Kahn to deregulate the airlines. In fact, my job was airline pricing. I was supposed to be an expert in the law and economics of pricing, and my job was to get the Government out of airline pricing and also to raise high barriers to any complaints about predation. Interestingly, the first one that came before the CAB in 1979 was from United Airlines, which we denied. I feel very much at home with many of the themes expressed by all the Senators here today, and I am honored to be here.

I think the common theme is none of us is here because we want reregulation. In fact, 20 years of my life would be a nullity if that were the case. Like any Government policy, there are unanticipated problems. I think the chairman's opening statement pointed to the complexity of the industry.

The fact of the matter is, gentlemen, that the industry is, indeed, far more complex than we thought it was 20 years ago, and, in fact, we were wrong about many of the basic assumptions that we had 20 years ago. That does not mean that our policy was wrong. I contend that it was right. But it does mean that it is appropriate for us to be here and talk about what has happened since.

I am a representative of a small carrier and its 840 employees. We are among the oldest of the smaller carriers. We were always profitable from founding in 1989 through 1996, and I am happy to say that we are profitable today. Primarily I would like to think because of hard work, but also—and I think this is the area which is of some concern to public policy—because we have consciously determined to reposition our operations away from competition with the major carriers. In my testimony, I first describe the problems of airport access, and specifically the well-known, well-described problems of gates and slots.

Gentlemen, there is no downside. There is no possibility that the cure will be worse than the disease if the Government, the legislative branch and the executive branch, attacks the problems of airport access. I hope we will have a chance to talk about that.

Now, on our part we are seeking to serve some of the high-density airports from some small communities. We have some applications pending. I certainly hope that those will be granted so we will have an opportunity to bring some service from small communities to some of the high-density airports. If you cannot get gates, if you cannot get slots, if you cannot take off or land, you cannot operate an airline no matter how good your airplanes or how good your management. I hope we will have a chance to talk about that.

Much of my testimony is devoted to the area of predatory practices because that is the difficult part, that is the controversial part, that is the thing that worries legislators. They want to make sure that, indeed, the cures are not worse than the disease. I understand that.

In my testimony, I try to give you the facts, what happened when Spirit, a profitable and successful carrier, attempted to contest at its Detroit hub with the monopoly carrier in two markets and what happened, the kind of tactics that were used and the case that we make is that no carrier no matter how well managed could have made it under the circumstances that we were put under.

The question for public policy is whether that is OK. In which case, there will not be any competition in those kinds of markets or whether we want to take a hard look at it, first, the antitrust laws and fine tune such policy as is necessary to be fine tuned. I am glad that Senator Faircloth brought up the question of subsidies.

Senator, I contend that at hub airports all the subsidies go into a different direction. The monopoly carrier at Detroit pays lower landing fees than we do. It has Government-conferred monopolies in terms of routes to places like Tokyo and London in all kinds of ways where they are capable by fine tuning the governmental process and by employing people whose whole reason in life is to game the Government process to lower their cost and increase our costs. I look forward to that discussion with you, Senator.

I see that my time is coming up.

PREPARED STATEMENT

Mr. Chairman, we are not here to whine. We are going to do what is in the interest of our owners and employees. It is up to Government to help protect the public interest in low fares and service to small communities. We are pleased that public attention is focusing on this issue today. I agree with you it is complex. My warning is, indeed, one or two hearings is not going to solve the problem, one or two DOT orders is not going to solve the problem. I hope that 6 months from now, 1 year from now we have made some progress.

Thank you very much.

[The statement follows:]

PREPARED STATEMENT OF MARK S. KAHAN

Mr. Chairman, my name is Mark Kahan. I had the privilege of coming from New York to the Civil Aeronautics Board in 1977 with Chairman Alfred E. Kahn to assist in deregulating the airlines, and am honored to be appearing before you today as Vice Chairman and Chief Operating Officer of Spirit Airlines, Inc. Spirit is among the oldest of currently operating post-deregulation carriers. We began service in 1989 and, until 1996, were profitable every quarter.

As the Airline Deregulation Act reaches the ripe age of 20 this year, the nation can look back with pride on a truly bipartisan reform. How many today argue that Washington bureaucrats are better equipped than the marketplace to decide precisely which city pairs deserve airline service, the efficient number of carriers that can fly a route, or the exact price to be charged? Most analysts have concluded that the net benefits of deregulation outweigh the costs, and that the average traveler is much better off. Having been part of the deregulation process, I am proud of this result.

We cannot, however, ignore some serious adverse industry trends, including loss of service to smaller communities, extreme price differentials between business and leisure travelers, and actions by established carriers to eliminate low fare competitors. Furthermore, tangible "barriers to entry" are actually getting higher, as time has marched on. When essential resources such as airport slots and gates are scarce, entrenched, politically savvy companies, with entire staffs whose purpose is to game the regulatory system in their favor, have an undeniable advantage over new entrants.

All of these problems, which combine with particular intensity at single carrier dominated "fortress hubs," have been well documented in the economic literature and in any number of GAO and DOT reports. There is nevertheless frustration as Executive Branch spokesmen have expressed understanding and concern, but with little action. We at Spirit are pleased that the logjam seems to be breaking. The Departments of Transportation and Justice are to be commended as they begin what should be a serious effort to find practical solutions for current problems, cures which are not "worse than the disease" and which actually help travelers and communities.

Several of the major carriers argue that current Congressional initiatives such as this hearing—designed to improve competitive conditions in the airline marketplace—are a de facto effort to re-regulate the industry. Mr. Chairman, this kind of diversionary thinking should be firmly rejected. These carriers overlook that the actions under consideration are themselves substantially deregulatory in nature. To understand this, we might reflect on how Delta Airlines and US Airways can charge $404.00 for an unreserved round trip coach ticket between New York and Washington, while a comparable ticket between San Francisco and Los Angeles costs $237.00. The answer does not lie in differing costs. The New York-Washington trip, 216 miles, is actually much shorter than San Francisco-Los Angeles, at 338 miles. All the airports in question are highly congested; the passenger volumes are ample to exploit the relevant economies of scale. Why are New York-Washington passengers paying so much more?

The essential answer is straight-forward: The USAir-Delta duopoly faces almost no actual or potential competition in this city pair because a regulation, called the High Density Rule (HDR), rigidly excludes any new entrants at New York's La Guardia and Washington's National Airport, among others. The HDR was designed in 1967 to eliminate runway delays, before the advent of wide body aircraft and during the era of rigid mileage based price controls. It has long since become a tool of monopoly whose anti-competitive consequences have managed to evade the level of skepticism that outdated regulations are supposed to receive in 1998. If current efforts in Congress have one central theme, it is the relaxation of the HDR. That some major carriers think such ideas are "re-regulation" is more than a little ironic.

It should be understood that the architects of airline deregulation did not advocate a simplistic laissez-faire approach to the marketplace. They firmly believed in the importance of pro-competitive antitrust principles, and clearly intended their enforcement to be a Federal executive responsibility shared by the Departments of Transportation and Justice.

Subsequent events have justified this concern for effective enforcement. Concentration in the industry continues to increase. In a recent report, "Airline Competition at the 50 Largest U.S. Airports—Update," Salomon Brothers investigated market shares on a route-by-route basis (rather than by the customary national averages) and identified "an unprecedented degree of concentration in the airline business." This trend, which helps explain some of the recent real increases in airline fares, is worrisome. Though no one knows what the efficient market structure of this dynamic industry will ultimately turn out to be, this level of increased concentration does suggest the need for a modicum of caution before we assume that oversight of anti-competitive practices is unnecessary.

The real issue is not re-regulation vs. deregulation but whether deregulation can ultimately succeed if there is increasing concentration and no new entry into the marketplace. No advocate of deregulation ever dreamed that the industry would evolve without the discipline of actual and potential competition. Quite the contrary: Analysts in 1978 posited extremely low barriers to entry into airline markets, believing aircraft to be the most mobile of assets. Now, as Salomon Brokers and others have shown, concentration has increased to the point where actual competition on most non-stop routes is limited to carriers with a hub at one end, leaving most consumers with a maximum of one or two choices. Many small-to-medium sized communities have lost service altogether. Under these circumstances, passengers with relative inelastic demand, primarily business travelers, and travelers from smaller communities, will pay an enormous fare premium.

What all analysis has shown is that the single most effective competitive discipline arises from entry by a low fare competitor, such as Southwest Airlines. (Its competition largely accounts for the low fares in the Los Angeles-San Francisco market noted earlier). For a while, there were several would-be imitators of Southwest but, since the Valujet crash in 1996, and in the wake of predatory practices by major carriers, the number of these new entrants is swiftly declining. The number of new scheduled passenger carriers certificated by the Department of Transportation declined from 8 in 1996 to 3 in 1997. Only a few of these ever began operating and even fewer continue to do so. This is an unprecedented situation which should be a source of genuine concern.

Can public policy help? To an unreconstructed deregulator like myself, the prospect of real re-regulation is dismaying. But, relaxing the High Density Rule and taking other steps to increase competitive access for new airlines who did not receive "grandfathered" airport slots and gates simply cannot be construed as re-regulation. We should be suspicious when entrenched carriers defend these entry barriers as their unique entitlement.

The more difficult question is whether public policy should intervene to defend smaller carriers from predatory activities, particularly in the pricing area. Again, it is difficult to see how actual enforcement of antitrust standards on a timely basis, which is all current legislative proposals would require, can be deemed re-regulation. Indeed, Section 102 of the Airline Deregulation Act (now 49 U.S.C. § 4101(a)(7)) expressly requires "the prevention [by the Department of Transportation] of unfair, deceptive, predatory, or anti-competitive practices in air transportation."

It should be clearly understood that there is no doubt as to whether predatory pricing and capacity dumping actually occurs, only whether there is anything that can usefully be done about it. In fact, predatory conduct can be remarkably blatant. At Spirit, we are most familiar with competitive conditions at Detroit, our home base. On December 15, 1995 we began a single DC–9 (about 100 passengers) daily roundtrip flight from Detroit to Philadelphia offering fares as low as $49 one-way and extending in tiers to $139.00. Northwest, the dominant carrier at Detroit, did not "match" immediately. Instead, it continued on a previous strategy to raise its fares in that market.

According to DOT statistics, Northwest's Detroit-Philadelphia yield in the first quarter of 1996 was 42.82 cents per mile (cpm), 11 percent over the previous year. This route was profitable, and our low fares developed a passenger base which otherwise would not have traveled. Encouraged by this success, on April 15, 1996, Spirit began a single DC–9 roundtrip from Detroit to Boston. The introductory fare was $69.00 one-way, with our highest fare $159.00. Northwest had, however, evidently decided to ensure that our success at Philadelphia not be repeated. It immediately "matched" by making the $69.00 introductory fare available on all of its eleven daily flights and on virtually all coach seats. Northwest's cent per mile in the second quarter of 1996 in the Detroit-Boston market fell to 17.09 cpm, 52 percent below the previous year.

On May 11, 1996, the Valujet tragedy unfolded in the Everglades. As the Committee is aware, the publicity surrounding the crash and the FAA response to it had a short run, debilitating affect on public confidence in smaller airlines. In June 1996, we began hearing rumors that "Northwest will unload on Spirit" in the Detroit-Philadelphia market. And that is what happened. On June 30, 1996 Northwest "matched" Spirit's $49.00 fare in the Detroit-Philadelphia market on all flights and simultaneously increased its capacity by more than 15 percent over the previous year. Its yield dropped from 37.85 cpm in the third quarter of 1995 to 17.59 cpm, a drop of more than 54 percent. The story is detailed on Charts 1–2 (Philadelphia) and 3–4 (Boston).

It is probable that Northwest sacrificed out-of-pocket not less than $10 million because of its fare decreases and capacity increases in the Detroit-Boston and Detroit-Philadelphia markets in the third quarter of 1996 alone. These actions clearly made no sense unless Northwest was confident that Spirit would be obliged to exit the market. And they were correct. On September 8, 1996 Spirit flew its last flight to Boston. On September 30, 1996, we flew our last flight to Philadelphia. Within a few months, a passenger traveling from Detroit to Boston would pay a one-way fare of $460.00, an increase in excess of 500 percent. The lowest, heavily restricted discount fares were $263.00 roundtrip (Thursday through Monday) and $219.00 (Tuesday and Wednesday, only). A passenger flying from Detroit to Philadelphia on Northwest paid a one-way fare of $381.00. The heavily restricted Thursday through Monday roundtrip fare would have been $181.00 and the Tuesday and Wednesday fare $151.00. The loser was first and foremost the traveling public, and of course Spirit as well.

As we studied the matter more closely, it became clear that Northwest was not taking extraordinary actions only in the few East Coast markets in which we attempted to compete. In the fall of 1994, Spirit entered into the Detroit-Orlando market. Again, it met initial success. However, as you can see from the accompanying graph (Chart 6), Northwest subsequently flooded the market with seats, During the third quarter, 1994, Northwest had offered 150,000 seats. After our entry, during the third quarter of 1996, its capacity exceeded 275,000 seats, an amazing 40 percent rise for a mature market such as Detroit-Orlando. (During this entire period, as set forth on Chart 7, Northwest's overall domestic system was exceedingly stable from both a capacity and yield standpoint.) The carrier simultaneously dropped its average yield to 9.22 cpm, the lowest it has been in recent history and plainly below a remunerative level (Chart 5). You will pardon us for believing that Northwest tried to put Spirit out of business in the third quarter of 1996.

Charts 1–4 confirm that in the Detroit-Boston and Detroit-Philadelphia markets, Northwest has reduced its capacity since Spirit's exit and, of course, raised fares drastically. A slightly different but no less ominous picture emerges in Detroit-Orlando, where we have chosen to draw the line and attempted to defend ourselves. Northwest has steadily poured on capacity so that it now offers almost 350,000 seats in the most current quarter, almost doubling its schedule over a two-year period. Mr. Chairman, these tactics only make sense if the big guy is trying to tell the little guy that no step is too extreme, no matter how unprofitable or costly, in order to "hold on to our passengers." With all deference, some steps are indeed too extreme and do cross the line into illegality. If there is going to be a low fare industry in this country alongside hub dominating "fortress carriers," then it is important to define the line between legitimate, hard-nosed pricing and predatory tactics. Unless public policy does not want competition in markets like Detroit-Philadelphia, this work must be done. There is now no choice.

Even in the absence of predatory pricing and capacity dumping, issues previously identified by GAO and DOT as barriers to entry need urgently to be addressed. Mr. Chairman, Spirit Airlines enplaned over 19,000 passengers from Detroit in December, 1997, without a gate. We go from one carrier to the next seeking unused space for which we may contract at odd times of the day. Because we lack a gate, we are not entitled under the rules of the local airport authority to be a "signatory airline." Because Spirit is not a signatory airline, we are assessed a 25 percent surcharge over the rates charged to other carriers including, obviously, our major competitor.

Aside from totally constraining our ability to grow any further, this Catch-22 situation violates the following basic economic and legal principles.

1. *It is discriminatory*.—When a Spirit MD–80 lands, it certainly costs no more than a MD–80 operated by our competitor. In fact, it costs less. The costs of a hubbing airport like Detroit are largely driven by the need to have enough facilities available to meet the intense demands of the connecting banks which occur sporadically throughout the day. We at Spirit are more than willing to schedule around the peaks of Northwest's hub system, if we have the gates and flexibility to do so. Charging more when costs are less is the very essence of economic discrimination.

2. *It degrades our service*.—Because we are obliged to obtain such gate space as is available from other carriers during periods of their slack use, our passengers can be delayed through no fault of our own. If the carrier with which we are dealing has a delay, our plane and passengers must wait until space becomes available.

3. *It raises our costs*.—Not only do we have to pay the discriminatory landing charge, we must pay very high gate use fees. The carriers who accommodate us are not charitable institutions. We pay handsomely as these carriers quite understandably take advantage of our predicament. No one at Detroit, however, has ever charged us as much as Northwest.

Interestingly, although Northwest has always taken the position that it is fully utilizing its gates at Detroit, it permitted Spirit to use one of these gates for our flight to Atlantic City, a route where we do not compete with them. We were recently obliged, against our strongest wishes, to move even this flight because of obligatory "tied" de-icing charges which ranged up to 10 times higher than those imposed by other suppliers. It is well recognized in the economic literature that deliberately raising a rival's costs, particularly with respect to an essential facility like gates, is itself predatory.

Mr. Chairman, I have elaborated primarily on predatory practices, gates and airport slots because they are the most fundamental and direct barriers to entry. They are not the only ones. To the extent requested by the Committee and staff, we will be pleased to offer for the record our real world experiences with respect to computer reservation systems, frequent flyer programs, commission overrides, and kindred practices.

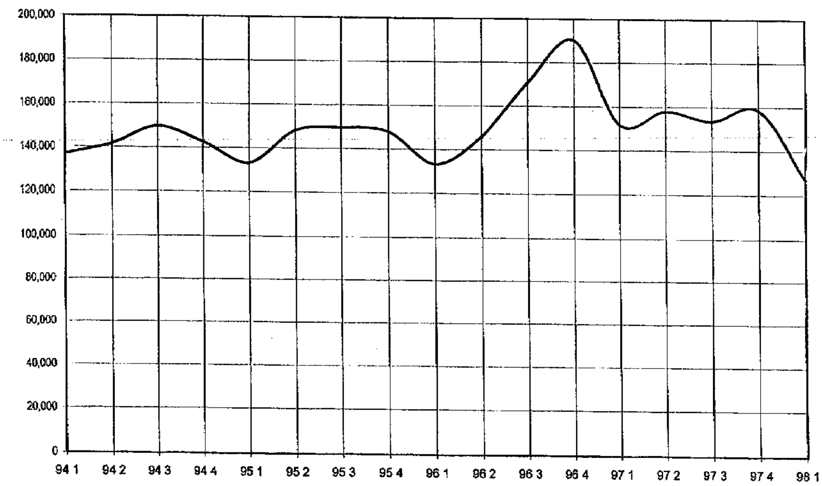
In conclusion, I wish to emphasize that Spirit and its 881 employees seek no special favors from anyone. For the last eight years, we have competed in the marketplace each and every day and we are committed to the success of Airline Deregulation. We commend the Committee on its initiative in fostering this hearing. The competitive issues we have discussed are fixable if the nation has the will and desire to make the deregulation process work to its fullest potential.

CHART 1.—QUARTERLY STATISTICS FOR DOMINANT CARRIER FLIGHTS BETWEEN DETROIT AND PHILADELPHIA

	1q95	2q95	3q95	4q95	1q96	2q96	3q96	4q96	1q97	2q97	3q97	Total
Onboard Passengers	77,984	96,728	100,965	93,403	75,290	98,618	132,018	114,400	76,321	95,173	88,156	1,049,056
Total Seats	133,100	148,035	149,507	147,794	133,243	146,016	170,675	190,37	151,713	157,843	153,434	1,681,731
Load Factor (percent)	58.6	65.3	67.5	63.2	56.5	87.5	77.4	60.1	50.3	60.3	57.5	62.4
O&D Passengers	40,520	45,850	47,760	46,650	36,350	43,140	68,510	62,540	39,700	47,710	N/A	478,730
Market Share (percent)	68.0	69.0	69.1	67.6	58.2	53.2	62.2	69.8	65.7	62.6	N/A	64.4
Average Fare	$163.73	$175.23	$166.12	$170.46	$222.23	$196.97	$79.07	$128.67	$230.64	$196.32	N/A	$165.26
Yield per CPM (¢)	36.23	38.64	36.70	37.63	49.03	43.47	17.45	28.41	50.81	43.29	N/A	36.44

CHART 2

Detroit-Philadelphia

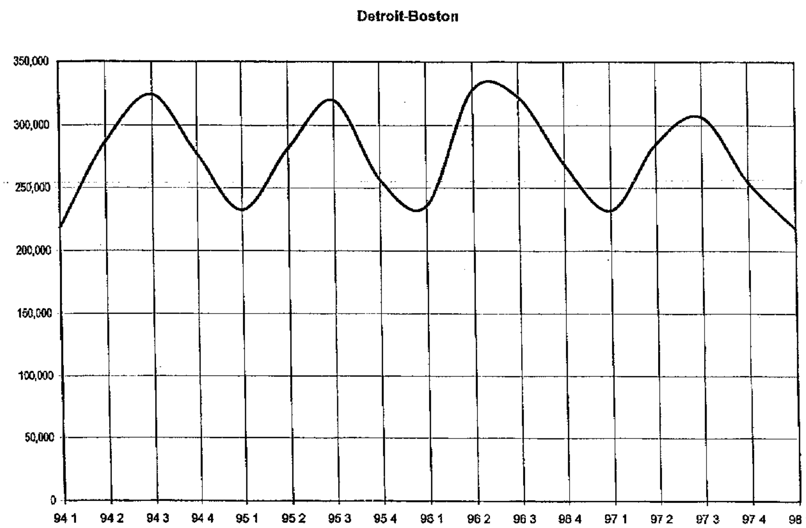


'Source: DOT T100 Statistics 1994-97 (Thru 3 QTR 97) and OAG data (For 4 97 and 1 98 QTRs) at an assumed 98% completion factor

CHART 3.—QUARTERLY STATISTICS FOR DOMINANT CARRIER FLIGHTS BETWEEN DETROIT AND BOSTON

	1q95	2q95	3q95	4q95	1q96	2q96	3q96	4q96	1q97	2q97	3q97	Total
Onboard Passengers	139,756	188,508	212,719	167,522	127,520	224,353	252,734	173,347	123,179	172,014	188,938	1,970,590
Total Seats	232,523	281,545	319,662	256,464	235,878	327,974	322,039	268,449	232,077	284,895	306,550	3,068,056
Load Factor (percent)	60.1	67.0	66.5	65.3	54.1	68.4	78.5	64.6	53.1	60.4	61.6	64.2
O&D Passengers	40,140	60,280	67,900	59,700	45,250	97,340	119,060	76,080	48,240	65,540	N/A	679,530
Market Share (percent)	84.3	89.4	90.6	87.4	89.3	91.7	91.5	89.2	89.1	90.0	N/A	89.7
Average Fares	$230.70	$206.20	$191.84	$209.42	$258.83	$106.05	$100.01	$169.52	$267.54	$218.14	N/A	$178.45
Yield per CPM (¢)	36.38	32.56	30.31	33.15	40.92	16.78	15.84	26.80	42.36	34.48	N/A	28.21

CHART 4

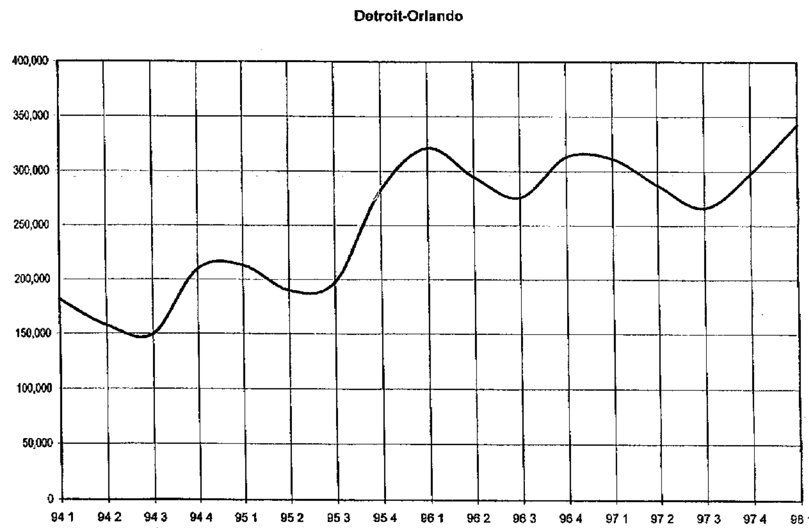


'Source: DOT T100 Statistics 1994-97 (Thru 3 QTR 97) and OAG data (For 4 97 and 1 98 QTRs) at an assumed 98% completion factor

CHART 5.—QUARTERLY STATISTICS FOR DOMINANT CARRIER FLIGHTS BETWEEN DETROIT AND ORLANDO

	1q95	2q95	3q95	4q95	1q96	2q96	3q96	4q96	1q97	2q97	3q97	Total
Onboard Passengers	180,135	167,937	162,153	218,920	275,973	248,504	208,217	236,224	258,318	243,489	205,867	2,405,737
Total Seats	213,242	189,653	197,602	282,954	320,956	294,556	275,834	312,947	311,078	287,125	266,297	2,952,244
Load Factor (percent)	84.5	88.5	82.1	77.4	86.0	84.4	75.5	75.5	83.0	84.8	77.3	81.5
O&D Passengers	81,120	75,060	73,340	103,070	140,190	128,280	105,110	105,420	113,590	109,390	N/A	1,034,570
Market Share (percent)	60.3	60.2	67.5	75.4	76.6	75.5	79.7	76.2	70.4	74.2	N/A	72.0
Average Fare	$113.42	$111.00	$96.70	$96.09	$105.83	$99.02	$88.33	$98.88	$127.78	$108.13	N/A	$104.51
Yield per CPM (¢)	11.78	11.49	10.07	10.02	10.99	10.30	9.22	10.34	13.31	11.28	N/A	10.90

CHART 6



'Source: DOT T100 Statistics 1994-97 (Thru 3 QTR 97) and OAG data (For 4 97 and 1 98 QTRs) at an assumed 98% completion factor

CHART 7—NORTHWEST AIRLINES—U.S. DOMESTIC

	951	952	953	954	961	962	963	964	971	972	973
Onboard Passengers	9,732,731	10,902,331	11,441,401	10,454,422	10,288,362	11,548,677	12,041,123	10,907,414	10,766,006	11,763,243	12,371,706
Seats	16,047,032	16,730,609	16,961,857	16,746,153	16,491,412	17,236,219	17,816,378	17,447,384	17,003,030	17,406,703	17,736,261
Load Factor (percent)	66.2	70.5	72.5	66.4	67.6	70.9	71.8	66.8	66.6	72.0	73.8
O&D Passengers	12,576,520	13,617,000	14,072,760	13,737,600	13,341,340	14,794,720	15,195,520	14,343,840	14,197,360	15,294,960	N/A
Market Share (percent)	7.38	7.39	7.45	7.52	7.36	7.43	7.65	7.48	7.61	7.54	N/A
Average Fare	$167.15	$170.71	$170.14	$165.47	$184.50	$183.91	$177.68	$169.95	$184.92	$173.32	N/A
Yield per CPM (¢)	14.28	14.54	14.18	14.68	15.71	15.78	14.96	14.73	15.58	14.85	N/A

STATEMENT OF MIKE BOYD, THE BOYD GROUP, EVERGREEN, CO

Senator SHELBY. Mr. Boyd.

Mr. BOYD. Mr. Chairman, thank you very much. I appreciate the opportunity of being here.

My name is Michael J. Boyd. I am with the Boyd Group/Aviation Systems Research, a consulting and planning firm based in Evergreen, CO. My background is in the airline business. I grew up in the airline business. I have been with new entrant carriers on both sides. I have worked at new entrant carriers as a vice president of planning. Our firm has worked with new entrant carriers to begin operations. I know what they face. I know small community air service.

Framing this issue, I think what Senator Lautenberg said, I think, perfectly frames the issue in a manner that as a template I think we should follow as we look into these issues of barriers to competition. There are three things. You have airline failures. No question they have taken place in the last 20 years. We have lost competition. There is no question about that, enormous amounts of lost competition. Small communities have lost air service. There is no doubt about that, either.

I think what we need to do is sort of look at the problem and try to define the problem rather than define some of these misconceptions people have. For example, I have looked at Senator Frist's bill and we have looked at Senator McCain's bill, and neither one will fix the problem. As a matter of fact, it will probably make it worse because it does not understand the nature of the problem.

Let me talk about a few things. First of all, let me just say at the outset I am a contrarian. I appreciate bureaucrats and I appreciate bureaucracy. We would not be sitting here otherwise. I appreciate the people who work at the Department of Transportation like Patrick Murphy who try to make a system work. Although the system I think is broke, people like that try to keep it up and running.

Let us look at why we have a lack of competition out there. Let us go back 20 years—not 20 years, let us go back to about the mid-1980's. There were three mergers there: Ozark-TWA, Republic-Northwest, Piedmont-USAir. All of those merged. Those eliminated a number of connecting hubs. They eliminated three good airlines that were not failing.

In all of those cases, the Department of Transportation said that would not reduce competition. That does not make any sense. We did not have a good understanding of the situation then. There was no competitive problem with that? There certainly was. Today, the Department of Transportation is not working with the right tools. Just recently, we worked with the cities of Moline, a quad city—or the airports of Moline, a quad city, and Bloomington, IL, on an application for an exemption to fly to LaGuardia Airport. It was rejected mainly on the basis that the DOT found that there were only about 8,100 people in those combined cities of over almost 2 million people that flew to New York.

Those numbers were not accurate. Their O&D data is not accurate. Yet, planning has been done on the basis of that data, data that now that apparently the DOT inspector general last week came out and said is inaccurate. We cannot plan an aviation system or define an aviation system until we have those tools.

I can get also into the issue of the study done 2 years ago that defined the low-fare revolution. That document was shameful. It talked about the savings that low-fare airlines had done. But when you took out Southwest, the remaining of those carriers had a very small impact, not a sufficient impact to make much of a hit on the consumer, but what the worst part was they said all of those airlines were safe. That is the outrage.

The No. 1 carrier, ValuJet, they knew at the time to be unsafe, and to convince the public that it was safe is an outrage. After the ValuJet crash when there was a material reduction in traffic on startup carriers, the public should not be blamed for that because the reality is they were told those airlines were safe and we found out later in other hearings that the major one of those airlines was not safe. I do not find that to be something that really will fix this problem.

I looked at the McCain bill and we looked at the Frist bill. Basically, they assume that if you increase service to four slot-controlled airports small communities will have better air service. It will not happen. It just does not make any sense.

Senator SHELBY. Say that again.

Mr. BOYD. Well, they assume that if you open up additional access to LaGuardia, Kennedy, Washington National, and O'Hare, suddenly small communities will have better air service. In the system we have today, which is not an interline system it probably would not. Startup carriers like Frontier would have no business trying to fly from Lexington, KY, to, let's just say, Chicago O'Hare nonstop because there is not enough traffic there to keep them up and running. That would not fix the problem.

How do we fix this problem? Let us talk about things we can do right here without reregulating, without changing things, without upsetting the entire system. Do you want to reregulate the system? We do not. Do we want to deregulate it further? Good, let's do it. Let's start with some things. The Wright amendment at Love Field.

Why that is still there is an outrage. The Wright amendment should be eliminated as quickly as possible. Now, will that change DFW and make it, as Mr. Crandall says, some sort of a juggernaut that will destroy service to South America? The man needs a vacation if he thinks that. The reality of this is that the Wright amendment right now if it were eliminated would allow a lot of fare competition East and West, so let's just start with that.

Second, the perimeter rule out of LaGuardia and Washington National, get rid of those; they are anachronistic. Fourth, free flights, implementing an air traffic control system that makes a lot more sense. Airlines are losing about $5 billion in excess cost because of an air traffic control system that I do not think—not I do not think—that is not particularly safe and, indeed, is a system that does not make any sense left out of the 1950's.

The fifth is we need airport capacity, but we need it built where it is necessary, not just new airports that cost too much for airlines to fly to like the one in West Virginia or like what happened in Denver. We need airport capacity where it is needed and done in an efficient way. Those are options that I think this committee should look into. I think the framework that Senator Lautenberg brought up is the one, or the template that we should follow through.

Thank you very much, sir.

[The statement follows:]

PREPARED STATEMENT OF MICHAEL J. BOYD

BARRIERS TO AIRLINE COMPETITION

Mr. Chairman, I appreciate the opportunity of providing input to your committee today regarding the important issue of airline competition.

I have attached to my testimony my bio which provides my background in the airline and aviation industries.

The Boyd Group has worked with a number of new-entrant carriers.

I am no stranger to the issue of new entrant carriers and the barriers that they face in today's market place. In my 27 years in this industry, I have held management and planning positions at all three general types of airlines—major, commuter, and new-entrant start-up carriers, including experience as Vice President of Marketing and Planning for a new entrant. Since co-founding The Boyd Group I have worked with a number of new-entrant airlines.

We accomplished the original Colorado Springs feasibility study for what became Western Pacific Airlines. We accomplished the original business plan for Northern Airlines, a potential new entrant seeking funds to begin service. Just recently, we have assisted Pro Air, a new entrant at Detroit, with preparing a slot request for access to New York/LaGuardia.

In our air service development work with airport clients, we have been successful in marketing efforts to new entrants. We helped Bloomington/Normal, Illinois become the fastest-growing airport in 1997 by helping them attract two new entrant airlines, Frontier and AirTran Airways.

In January, I was honored to facilitate the National Air Service Roundtable, which aired the challenges facing small community air service. I believe that this experience gives me a wide and I believe objective insight into the issue of air service issues and barriers to competition.

Myself and my firm have gained a reputation for telling the facts as we see them, as-is and where-is. Unlike many consultants, we provide our clients with what they need know, not necessarily what they want to hear. Today, I am providing your subcommittee with some insight that is factual, but in many ways may not coincide with ambient thinking about the airline industry. We need to recognize that a lot of the realities we face in the matter of airline competition and air service are not pleasant. And a lot of the solutions will not be pleasant, either.

I also have a reputation—of which I am proud, by the way—of being often blunt and to the point. My time is valuable, our client's time is valuable, and certainly, your time and that of this Subcommittee are valuable. My comments and written testimony today will adhere to that template.

We are witnessing a period where immediate pre-determined solutions are demanded for problems that are not properly understood.

On that note, let me start by outlining the key points in my testimony:

I am very concerned that the tenor of the discussion on the matter of air service and airline competition is beginning to resemble that of an angry lynch mob. Take action now and ask questions later. Act less on hard data than on innuendo, anger, and bravado. Lynch the villains and pirates right now. Assume easy explanations to difficult questions and propose easy, mom-and-apple-pie "solutions." It is a situation of "ready, aim, fire."

The symptoms are obvious. But the causes are sometimes issues that people do not want to face.

We do have issues facing us regarding barriers to entry into the airline industry. This affects the levels of competition consumers face, and also the levels of air service that is offered at many mid-size and smaller cities. There is no argument regarding what we have seen in the past several years:

1. *Airline Failures*.—Dozens of new entrant passenger jet carriers have failed in the last 20 years. Indeed, of those started between 1978 and 1992, only two survive today. One had to go through bankruptcy to get here, and the other was not even a low-cost airline.[1]

[1] The first is America West. The second is Midwest Express.

2. *Materially reduced competition*.—The number of airlines has declined in the last 15 years. This has resulted in 14 fewer connecting-hub operations today compared to the mid 1980's.

3. *Reduced service to small communities*.—Our studies indicate that as many as 100 smaller communities will lose scheduled air service in the next decade.[2]

These are not arguable observations. It is a fact that new entrant airlines have gone down like flies. It is a fact that we've lost existing airlines like Piedmont, Republic, and Ozark, along with their connecting hub operations. And it is an unfolding dynamic that smaller communities are losing service at their local airports.

What is arguable is the way that these facts are being interpreted, and the conclusions—mostly incorrect—that many people are assuming regarding their causes and their solutions.

I have seen some very disturbing suggestions regarding approaches to "fixing" these problems. One general thread flows through most of them: they have little understanding of the causes of the problems, and less understanding of the dynamics of airline operations.

There are a lot of people that believe that the causes of this current situation are simple and the solutions are simple. They are not. And if we jump on trendy, high-horse "solutions" such as some proposed in Congress, the result will be worse air service, not better.

Defining the Challenges Accurately

I am concerned that some of the agencies that are attempting to define the issue of competition have no real understanding of today's airline system.

Furthermore, the problems are being "broad brushed" with assumptions that do not stand up to reality. If we are to solve the problems at hand, we must first understand what they are. In the past several weeks I have again heard a host of misconceptions regarding airline competition. We can fix problems, or we can chase misconceptions. Unfortunately it is the latter that is being all too often pursued. These include.

"Major Airlines Unfairly Dominate Hubs" is a common complaint. But it is based on an incredible lack of knowledge of our air transportation system. What needs to be understood is that no airport is a hub. An airline creates a connecting hub by making the conscious decision to focus resources at a given airport. Charlotte is not a hub, but US Airways operates a connecting operation there. It is more correctly a hub-site. Denver is not a hub, but United has decided to operate a connecting hub there. Airlines, not airports, create hubs. They also eliminate hub-sites, such as happened at Dayton. Therefore, discussions of airport traffic dominance and facility constraints at these airports must be carefully weighed. The fact that US Airways has most of the leaseholds at Charlotte, for example, is not prima face evidence that the airline is intentionally gobbling up gates to keep out competitors. On the other hand, if American Airlines or its parent company has leaseholds on most of the facilities at DFW, including those that it does not use, perhaps that might be an issue.

The hub operation and the airline which creates it are not mutually exclusive. This doesn't mean that a given airline can't use this position to unfairly keep out competitors, but dominating the business that it creates is not by itself anti-competitive. Criticizing an airline for dominating its own connecting hub-site is like complaining that Sears Roebuck is unfairly dominating Sears stores.

Fare Levels at Hub-site Airports.—There have been studies to "prove" that fares are higher at hub-site airports. That type of data must be weighed carefully. First, many of the routes are those that would have no service at all into the hub-site airport if the airline did not operate connecting flights there. There is likely little local traffic between Lexington, KY and Cincinnati. It is likely that Delta's published fares in that market are very high. One reason is that there isn't much demand. The second is that the reason Delta serves the market is to feed traffic from Lexington to the rest of its system. They want the seats to be occupied by consumers connecting to their other flights, and hence the seat has more value than what some few consumers may be willing to pay just to get to Cincinnati.

Monopoly markets always means sky-high fares.—In general, it is accurate to state that where only one carrier provides service, lack of competitive pressure means fares will be high. But even here, a broad brush cannot be applied. Recently I booked a one-day mid-week trip from Denver to Rockford, Illinois, a routing where only one carrier exists, Northwest, and where there is limited service. The round trip fare was $240, much less than the fare I was quoted from Denver to O'Hare, a market that has competition and where the sky is nearly black with frequency.

[2] "The Future or Regional Air Service—The challenge of the New Realities." Published by The Boyd Group/ASRC, 1997.

There is high consumer demand for additional airline competition.—This is generally accurate, but not in all places at all times. Recently I attempted to fly AirTran Airlines (nee ValuJet) from Flint, Michigan to Atlanta, a market where that carrier alone offers nonstop service and very attractive fares. The flight was cancelled, with less than 20 people booked. At Akron/Canton, another market where this low fare airline has nonstop monopoly to Atlanta, the load factors are less than 60 percent. Both Flint and Akron/Canton serve populations of over 1 million, and both were in the top five fastest growth airports in 1997. Yet a carrier like AirTran, offering a reasonable product at very attractive fares, and the only nonstop service to Atlanta has difficulty in winning over the consumer.

Major airlines will price their product below cost to match a competitor.—This is accurate. But it has always been accurate, even when competing with each other. The question is whether these pricing actions are intended to be predatory, or merely a response to competition. This can only be determined on a case by case basis. A lot of new entrants do not have clean hands in this regard, either. At Denver, Western Pacific tried to buy market share by consistently pricing its product well below cost. In that case, United was the victim, and so, too was Frontier.

AIRLINE COMPETITION—THE CONTEXT

Let me move on to some of the issues at hand directly affecting airline competition. Since 1978 over 40 new entrant jet airlines have failed.

In most cases, predatory competition was not the reason.

Airline Failures.—The assumption seems to be gaining currency that failures of new entrant airlines are due to some sinister anti-competitive actions on the part of existing airlines. That is another trendy, easy conclusion. It is also wrong. This is not to say that there are instances of a major carrier stepping over the line, as Professor Dempsey has noted.

The DOT is questioning the "dominance" of Northwest at Detroit and Minneapolis/St. Paul. That's like an arsonist complaining about fire.

But we have extensively studied new entrant carriers, and the causes of failure of each. I daresay that most analysts who pass judgement on this have not done this. As noted in a subsequent section, in most cases the causes of failure were not due to predatory competition, as many would like to believe.

The Department of Transportation is attempting to have us believe that the ValuJet crash is the reason for the lack of new carrier entrants in the past year. That is sheer nonsense. True, the crash did not encourage new capital for start-ups, but the track record of failure and financial loss by this genre of carrier was in place and documented before that unfortunate—and avoidable—incident.

Materially reduced competition.—I understand that the second panel today includes the DOT. I think it should be kept in mind that one of the major causes of lost airline competition in the last dozen years has been due to the ineptitude of the Department of Transportation, which in the mid 1980's blithely allowed a number of mergers between perfectly healthy carriers, and in each case assured the public that competition would not be materially reduced.

They allowed TWA to acquire Ozark, which eliminated the latter carrier's competitive hub operation at St. Louis.

They approved the Northwest acquisition of Republic, eliminating competitive hubbing operations at Detroit and Minneapolis/St. Paul, not to mention the eventual elimination of significant former Republic operations at both Atlanta and Phoenix.

The DOT approved the acquisition of Piedmont by USAir, reducing competition in areas such as Upstate New York, and causing the eventual elimination of Piedmont's former Dayton hubbing operation.

Incredibly, it was the Department of Transportation that declared in each of these cases that competition would not be adversely affected, a conclusion that a semi-literate school child could have successfully questioned. Anyone with a modicum of understanding of airline economics knew that in allowing these carriers to merge, there would be increased concentration, less competition, and there was little chance that new carriers would grow to replace those eliminated by the mergers.

It is almost Kafka-esque to now hear the DOT call for an investigation into Northwest's dominance at Detroit and Minneapolis/St. Paul, when it was that very organization that declared the merger that immediately created that dominance would not reduce competition. First they allow and bless Northwest's acquisition of Republic, and now blame that airline for dominating the airports where the two carriers were the major players. This type of double-bind decision making on the part of the DOT couldn't housetrain a puppy, let alone provide the type of expertise we need today to accurately analyze the nature of airline competition. If there is a problem here, the cause is not in Northwest's corner.

Reduction in air service at smaller communities.—This is not due to uncaring actions by nasty robber-baron airlines, as some would have us believe. Nor is it due to deregulation. It is due mainly to economics.

The loss of scheduled air service at many smaller airport is the result of economics that legislation can't reverse.

Airlines operate to make money, like any other business. Whether it be a major carrier like Delta or a new entrant like Frontier, profit is the goal. The fact is that many smaller communities just don't have the traffic to support scheduled air service which local consumers will use. Today, consumers are increasingly reticent to utilize flights operated with turboprop aircraft, particularly 19-seaters. As a result, at many smaller communities, it is the local consumer who makes the decision to decline use of the local airport. But in many cases, the consumer still has access to air service, usually within 90 minutes or less from a larger airport.

Trying to keep air service at communities that cannot support it, when there are alternatives nearby, is a waste of resources. Today, for example, tax dollars are subsidizing passengers at McCook, Nebraska to the tune of over $300 each, when unsubsidized air service is available just 45 minutes away.

Brief Summary of Competitive Situation

I now like to summarize the facts as I see them. Then I'd like to outline some solutions.

The failure of New-Entrant Carriers has not been primarily due to predatory behavior by major carriers. New-entrant carriers have largely failed in the past 20 years for reasons other than the effects of predatory competition. As I will note below, to blame unfair competition for the failures of most of these carriers is to engage in trendy nonsense. Most have died from internal causes, as we have recently witnessed at Denver with Western Pacific, and at Miami with the "new" Pan Am. Both airlines had business plans that, competition notwithstanding, doomed them.

Examples of Predatory Behavior do exist, however. There certainly are clear examples of predatory actions on the part of major carriers against new entrants, as the testimony of Professor Dempsey clearly shows. I believe that United Airlines has stepped over (at least) an ethical line in their activities at Denver in dealing with Frontier.

And "predatory behavior" is not the sole province of major carriers. It is clear that Western Pacific—a new entrant itself—attempted to flood markets at Denver with excess seats at below-cost fares in an attempt to kill Frontier. Luckily, the incompetence of Western Pacific management caused the carrier to self-destruct. At Las Vegas, Sunworld failed after entry by other low-cost airlines, not major carriers.

Airline competition has been adversely affected more by actions or inaction from Washington than from unfair competition. Consumers across America should be very concerned to hear that the Department of Transportation is considering action to address the need to increase competition.

Mr. Chairman, I will put this as bluntly as I can: the DOT must first gain an understanding of how airlines work before they apply their heavy and unskilled hands on fixing the industry.

The DOT's "Low Fare Revolution" study is a shocking example of how key statistics are sometimes withheld or masked from the public.

The report claimed ValuJet was safe, when the data clearly indicated otherwise.

As an example—a shameful one—I would point to the DOT's 1996 "study" entitled "The Low Fare Revolution." Many have quoted this document as if it had professional credibility. It does not. It claimed that low fare airlines had saved the consumer $6 billion and inferred that new entrant carriers were a major part of this, and they were as safe as the major carriers. The Department lumped the statistics of Southwest Airlines, a billion-dollar airline that is a quarter of a century old, into the data. The numbers from this large and well-run established airline successfully masked some key data from the public view.

When that long-established carrier was removed from the mix, two factors became immediately apparent. The first was that the "savings" were much less. But the second was more shocking: the "safety" claims made by the report were inaccurate and covered up important statistics that the public had a right to know. Indeed, after Southwest was culled out, the single largest new-entrant, ValuJet, clearly had an abominable safety record, contrary to the claims made by the DOT.

Furthermore, in addition to the statistics, there was internal data also covered from public view. it has now come to light that this airline was so bad that prior to the issue of the "Revolution" report, an FAA inspector recommended that ValuJet be shut-down and undergo re-certification.[3] (The inspector testified that he was ordered to bury his report. In May 1996, 110 people died because ValuJet employees were not trained properly in hazardous materials handling.) This "Revolution" report should be ample evidence that the Department of Transportation at best does not have the expertise to deal with the issue of airline competition, and at worst is subject to political intervention.

Small community air service has dropped off in most cases because of economic realities, not deregulation. The real cause is evolving airline operating economics. Furthermore, many of the communities that are seeing service decline or eliminated are not losing access to air service, which in many cases is an hour or less drive away. And in many of these cases it is the consumer who has made the decision not to use the air service that the local airport can support.

Proposed Senate Legislation to increase small community air service will fail. We have reviewed both Senate Bill 1331 and Bill 1353. The only real benefit is the suggestion to dump the perimeter rules at LaGuardia and Washington National. The rest of the contents of these Bills would be ineffective in their aims, and are woefully inconsistent with economic and operational realities of the airline industry. These two bills will not only fail to enhance either competition or small community air service, but they will—not may, but will—make matters worse.

These Bills are reviewed below.

A REVIEW OF BILLS TO "IMPROVE" COMPETITION

Well Meaning Legislation That Will Only Make Things Worse

Two Bills have been developed in the U.S. Senate, both ostensibly designed to reverse the decline in air service at smaller airports.

Opening just four airports—three of which are not hub-sites—to new entrants, even if successful, would not materially improve access the air transportation system.

Both Senators involved with these Bills have good intentions. But the contents of the proposed legislation are way off the reality meter. They sound good. They have high sounding titles. They are touted as solutions to consumer malaise at smaller communities. But beneath this hype there is little substance. With due respect to the Senators involved, it is Bills like these that only make matters worse, because they distort the realities of air service to the consumer. And if passed, they will—not might, but will—hurt the consumer.

These Bills have wonderfully-worded titles that any red-blooded American could support: Aviation Competition Enhancement Act of 1997, and the Air Service Improvement Act of 1997. Now, everyone is for more competition. And everyone wants to improve air service. But these Bills make assumptions that are wrong.

—They assume that simply opening four airports to new entrants will create both new air service and new competition;

—They assume that there are new entrant carriers that want to place scare resources into small markets;

—One Bill assumes that loan guarantees on new airplanes will get carriers to invest millions to serve communities where the returns on such investment may be small or non-existent.

However, the Bill introduced by Senator McCain does address the issue of the perimeter rule. That part is viable and positive. The rest of the contents of these Bills are essentially either non-effective or detrimental to enhancing air service.

It assumes that just launching airplanes from small cities into four slot-controlled airports will instantly result in lots of passengers for the airlines involved.

Let's look at each.

Senate Bill 1353—"Air Service Improvement Act of 1997"

Introduced by Senator Frist of Tennessee, the Bill proposes

—Airports "not receiving sufficient service" be given slots at high density airports.

—Loan guarantees for airlines who buy small jets to serve "underserved" airports.

Defining "underserved" will be a political football. All of this sounds nice, but not only will it not achieve the intended ends, but could actually hurt air service levels. Let's look at the specifics:

The Bill focuses only on accessing "high density" airports. This means ORD, LGA, DCA, and JFK. This brings up several issues:

The Bill assumes that flights to these four airports gives access to air service.—Nope. It would give only access to those four airports, three of which are not really connecting hubs. In the case of ORD, unless the airline involved is American or

[3] This was discovered at the NTSB hearings subsequent to the ValuJet crash.

United (or one of their regional partners) such service from "underserved" airports would be merely to Chicago, with little or no connectivity to the hub systems of AA and UA. At the other three, service by Air Fred wouldn't do diddly, and in fact, there is no guarantee that the consumer would want to use an independent airline. Even if US Airways was the carrier, say to LGA or JFK, there would be little or no connectivity. For all those folks in Dickinson, ND who have a hankering to visit Queens, this Bill would be a godsend.

There is limited traffic to these points from "Underserved" airports.—Service to JFK, LGA, and DCA—none of which are true connecting hub-sites—would only result in access to the specific cities of Washington and New York. It is questionable if an airline would want to apply scarce and expensive resources to serve very small markets into these major airports, when other opportunities can give them higher revenues. Slots at LaGuardia are nice, but there still must he enough traffic on the airplanes that use them.

Airports that may need more competition into New York and Washington would not benefit.—Cities with high need for frequent service to New York, like Syracuse and Rochester, might even lose some access if slots at LGA are re-allocated for use at "underserved" points. (And there is no way that cities such as SYR or ROC would be declared by the DOT as "underserved.") So larger, more viable cities may lose out to smaller ones where traffic demand is much less.

Higher fares could result at airports that lose access to these airports as a result of re-allocation. Loss of slots for use at SYR, ROC and some other airports would be further barriers to getting fare levels down.

Where's the consensus on the term "underserved?" The process of determining what airports are "underserved" will be a political football of Super Bowl dimensions. Does that mean number of flights? Does it mean "not enough jets" or "too many turboprops?" Does it mean not enough airlines? Does it mean high fares? This will be a field day for paid consultants and politicians at cities that can barely support a 7–11, let alone jet service.

And for an encore, the Bill has loan guarantees. These won't achieve the desired ends, either.

The second part of the Bill—"Regional Air Service Incentive Program" essentially proposes loan guarantees for airlines who purchase small jets and use them in "underserved" markets."

Are airlines going to apply $15 million assets to markets where traffic and revenue generation are non-co mpetitive. Loan guarantees cannot create traffic.

Aside from trying to determine how these jets must be used (entirely in such markets? Ten hours a day? One flight a day?), we need to get some reality on aircraft economics. Let's think about this. Small jets will cost between $11 and $18 million. Payments on these machines would tend to run between $120,000 and $200,000 per month just to own or lease. Add operational costs of between $1,200 and $2,000 per hour—give or take—and some reality comes into the picture: These aircraft require a lot of revenue to be economically viable. They need passenger traffic at relatively high levels and—note this—at relatively high fares. Ownership costs are only one part of the cost mix. Revenue is another important part. Assuming that some loan guarantee will get airlines to operate multi-million dollar aircraft in markets where there is limited revenue is, to put it directly, nonsense.

"Underserved" markets (if that is defined by low traffic generation) are by and large that way not because airlines have made them that way. It's because they generally have insufficient traffic to support higher traffic levels. "Loan guarantees" will not be sufficient to offset losses in markets that cannot support such service. And one point missed is that if the carrier has to fall back on that loan guarantee, it means that its credit rating will go right into the fixture.

Conclusion: S. 1353 has great intentions. But it's naive and is not going to have a material effect on bringing air service to airports where traffic is no longer sufficient to support the relatively high costs of jet service. It focuses on access to four large airports, and not access to the air transportation network. Finally, "loan guarantees" are not a way of attracting jet service where there is insufficient traffic to support it.

Senate Bill S. 1331—Aviation Competition Enhancement Act of 1997

The best part of this Bill is in removal of perimeter rules. Beyond that, it is based on assumptions that have little connection to reality.

Introduced by Senator McCain of Arizona, the Bill has a wonderful but misleading title, but like the Frist Bill, is essentially inept. The Senator's office has claimed that its intent is not to re-regulate, but in fact it does just that, and not in a particularly efficient way.

It is based again on the assumption that if slots at the four high density airports (ORD, LGA, JFK, DCA) are re-allocated, it will magically make massive improvements in air service at smaller communities and result in more competition. Incredibly, the Bill assumes this also for airports that today have no air service. Like, AA, UA, and other airlines simply would fly to airports where there is no traffic just to get LGA slots. This may make good theater, but it won't result in better air service.

The Bill would require that slots at these airports be reallocated by first taking those that are unused, and then taking 10 percent of existing slots and auction them off for service that will be only to smaller deserving airports that meet some "underserved" criteria. On a time table no more frequent than every two years, 5 percent of the slots at these high density airports would again be re-allocated.

The bill would direct the Secretary of Transportation to use safe guards (whatever that means) to promote increased competition to rural areas and to keep competitive rates (what ever that means.) Again, there is a credibility gap here: putting service into some of the nation's most expensive airports, from airports where there's hardly enough traffic to fill a 4-door Yugo, and then make sure that the fares are low.

Bidders on these reallocated slots must be "new entrants or limited incumbents." Again, it is assumed that there are "new entrants" (the Senator might want to check on this) and "limited incumbents' that are interested in serving such communities. If it's a new entrant (what few they are), they need to fly in markets where they can generate strong revenue. Flying to communities with low traffic demand isn't going to make the payroll. And a "limited incumbent" at ORD would be one that would only access Chicago traffic. Ditto for almost any carrier at the other three airports.

There are major side effects of this Bill:

It would hurt the consumer.—By taking slots away from incumbents, and requiring that they be used only for service to smaller airports, it is highly likely that the net result will be worse access to these large airports, by using slots to serve fewer consumers.

Re-allocation of slots will surely result in less access to smaller communities which today have connectivity to these four airports.

It would cause a legitimate firestorm from other communities. It could cause major problems at other cities. For example, is Syracuse going to be happy if the result of this political grab bag reduces LGA or DCA service? Probably not.

It would materially harm communities that depend on Chicago as a gateway. Ponder for a moment the fact that dozens of small and mid-size communities depend on AA and United service into Chicago as a gateway. Now consider the decisions facing these airlines when they are told to give up 10 percent of their slots (not to mention another 5 percent every two years.) When faced with loss of slots, what cities do you think the planners at the AA and UA systems would reduce service to? Miami or Moline? Los Angeles or Albany? It doesn't take an MBA degree to figure this out.

The supporters of this Bill might counter that the recipients of these re-allocated slots would just replace service lost at MLI and ALB, and other airport victims of this Bill. That assumes that their are such airlines (which there are not) and that such service would offer the same connectivity to the rest of the world as the AA/UA service (which it would not.) Take this one to the bank: this Bill would result in worse overall air service, not better. Again, this is a proposal that is built around a type of airline industry that does not exist.

It would reduce access to these high-density airports. For example, what if TWA loses some LGA slots, seeing them re-allocated to new entrants, assuming—dangerously—that there are any that want to operate to "underserved" airports. The proponents of this Bill would probably show their ignorance by saying that would be okay, and would result in more competition and better consumer access. Wrong again. What that means is that all those smaller communities that TWA feeds to LGA over its STL hub will be adversely affected. That's not what near-failing airports dependent on TW for access to New York need. As an example, if Springfield, Illinois (whose major carrier is TW) loses some access to LGA, it could encourage more leakage to other airports in its region. What this Bill would do is help create "underserved" airports.

It would not engender additional air service for the smaller airports affected. Access to New York, Chicago, and Washington is not necessarily a panacea to viable air service. Trying to force service to four airports from a lot of smaller ones may improve service to those four cities, but—especially in the case of LGA—it won't improve access to the rest of the air transportation system. This is no longer an interline system. If Air Fred gets slots to O'Hare, it will have very little connectivity to other airlines.

Conclusion: The Bill sounds very consumer-friendly, but in the real world of airline economics it would have a detrimental effect on air service. The blind assumptions made in this Bill are (a) there are airlines interested in this stuff, and (b) there will be enough traffic to support such service. Neither of these points are not consistent with reality.

Legislating Air Service Won't Work

What is really needed is to first gain some understanding about future airline industry dynamics. Then comes the hard part—facing those realities. One of these realities is that many airports are "underserved" or not served at all because of economics and consumer preferences. Legislation can't change economics. And only brain surgery will change consumer preferences.

Both of these Bills are based on inaccurate and/or outdated assumptions. Just access to "high density" airports is not necessarily an improvement, nor is it any guarantee of economic success for the carriers involved. To believe that just giving an airline slots at a high-density airport will magically create lots of traffic at a small airport is foolish. Worse, it takes energy away from facing the hard decisions that must be made at many smaller airports. For many, it will be to cooperate on a regional basis or lose all access to air service.

SUGGESTED SOLUTIONS TO ENHANCING COMPETITION

I believe that there is a problem with the competitive picture in the U.S. And, I believe that there are solutions more effective then the legislation suggested.

I would strongly suggest the following actions—most of which are within the realm of Washington—to enhance competition.

Eliminate the Wright Amendment at Love Field.—This will have an enormous effect particularly in east-west traffic flows. No, it won't turn Love into some giant juggernaut to which lots of airlines will flock. D/FW Airport is a much better access point to the Metroplex, simply because it accesses all of the region, including the fast-growing I–35 corridor, which Love does not. But it will allow Southwest to flow passengers to more destinations over the airport. Midland/Odessa, Little Rock, Corpus Christi, and a host of other cities will see airfares drop to distant destinations. And without getting into the specifics, Mr. Chairman, repealing the Wright Amendment won't torpedo D/FW. American's PR blitz opposing the repeal is laughable. If Mr. Crandall thinks that fights from Love to Cleveland will kill off American's D/FW-Peru service, it is time for him to take a much needed vacation.

Eliminate the Perimeter Rule at Washington National and New York LaGuardia.—This has no real value except to restrict access to these important airports. Dulles Airport does not need protection any longer. And the LaGuardia restrictions are left over from the 1950's.

Eliminate Slots at All Four High Density Airports.—Agreed, this tends to send the FAA into an episode, but it is time that the market made the decisions regarding how these airports are utilized. Airlines will adjust their schedules to accommodate the capacity at these airports. Furthermore, the value of O'Hare slots tend to make the hubbing airlines ignore smaller airports that depend upon American and United hubs there as gateways to the rest of the world.

Move Rapidly Toward Free Flight Air Traffic Control.—Airline operating costs can be reduced by up to $5 billion annually if a true Free Flight system is implemented.[4] The technology is there, and the system can be implemented within 5 years for less than $1 Billion. The FAA is dithering and is acting as a bureaucratic barrier, not a facilitator.

Plan Airport Capacity Within The Context of Airline Economics.—Airport costs are critical to competition. High airport costs drive competition away, and at the least make it expensive for airlines to operate.

Despite the nonsense put out by the FAA, Denver's new airport has costs that are clearly detrimental to new competition. Forget the hype. Here are the competitive facts: In the three short years since it opened, five—count them, five—airlines have gone bankrupt trying to focus service at this new and expensive airport. Two of these were low-fare airlines. Three others were regionals.[5] Another low-fare airline—Reno—just moved its flights out of Denver because of the high costs. And no, Mr. Chairman, these costs are not offset by fewer delays. In 1996, Denver's new airport had a higher percentage of departures delayed than in the last year of the airport it replaced. As for small communities that can only support 19-seat aircraft, the burden is nearly obscene. The costs of departing this size aircraft at Denver

[4] Source: "Free Flight—The Economic Impact," RMB Associates & ASRC, 1994.

[5] MarkAir, Western Pacific were low fare carriers attempting to hub at Denver. Maverick, GPExpress/Continental, and Mountain Air Express filed bankruptcy.

International is over $300, which equates to over $30 per passenger with a typical 50 percent load factor.[6]

If the goal were to reduce competition, the way to do it is to have expensive airport facilities. Where airport costs are high, service and fares will be affected. Unfortunately, we have a number of such projects in the planning stages, including one in West Virginia and one in Northwest Arkansas. We need to spend scarce dollars on airport infrastructure where it is needed, not where special interests armed with integrity-short "feasibility" studies may want it.

START-UP AIRLINES AND NEW COMPETITION

For the purposes of this hearing, I think it is important that the members of the subcommittee get some background on the history of new entrant airlines since the advent of deregulation.

We'd like to share with you the results of a study we completed in 1996—back when ValuJet was flying high, worshipped by Wall Street. It revealed that regardless of the hype, new jet start-up airlines have never been much of a factor since deregulation. Note that this analysis was done well before the ValuJet crash, which is the event that the DOT claims ended the "Revolution" in start up airlines.

Is there a role for new entrants. The success of Midwest Express, America West, and the experience with Frontier prove that there is. But it also proves that the airline industry is one that has limited room for such carriers.

The Impact Of Start-Ups

There has been a great deal of confusion regarding the effects that start-up airlines have had upon the air transportation system in general and upon the consumer in particular. Simply stated, start-up airlines have not had, and most likely will not have, a significant effect upon the U.S. air transportation system.

The fact is, of all the new carriers between 1978 and 1992 that attempted to break into large scale scheduled airline service, only two—count them, two—survive today. One is America West, which detoured through Chapter 11 to get here, and the other is Midwest Express, which never was a low fare airline. Over 40 start-up passenger carriers have failed since 1978.

Since 1993 only one has clearly broken into the success column—Reno Air. Other than Reno, Frontier and Air Tran Airways (the latter of which was acquired by ValuJet) have what might be a viable niche strategy. ValuJet—now renamed AirTran Airlines—might have a chance with its new name.

There are a lot of reasons for this situation, and it varies in each case. But the fact is that most have gone to venture capital heaven. In a few cases, there has been what can only be described as predatory actions on the part of existing airlines. But in most cases, the proximate cause of start-up failure is the fact that the carriers had no business being in business, i.e., bad management. We could go into the silly stories of Air South. Or of Prestige. Or JetTrain. Or Western Pacific. Or Pan Am. Bad management, poor planning, and dimbulb business plans killed off most of these airlines.

Start-Up Airlines They've died for a reason.

Let's cover some realities of the airline business.

Understanding One: Start-ups cannot take on established mega-carriers.—There are a limited number of markets where a new jet carrier can compete successfully on a large scale with established airlines like American, United, Southwest, Delta, etc. This doesn't mean that such entrenched competition is (necessarily) unfair. It means that in the best of circumstances, it takes a lot of money to compete with established operators.

We could get into the specifics of this, but the last ten years proves it, as did Western Pacific's recent failure at Denver. It doesn't take "predatory" competition, either. Breaking into a new market with a new name is very expensive, and it is logical for existing carriers to match fares. From that point, there is no guarantee that consumers will use the new airline.

Understanding Two: Start-ups are most "successful" in price-sensitive, high-density markets.—Florida markets are typical, but even here, it has been proven to be a graveyard for start-ups. The concept of Senate legislation to have these carriers fly in small "underserved" markets is fantasy.

Understanding Three: A demonstrable and defendable niche is critical.—Just having low fares is not enough. AirTran Airways has a niche—low frequency service from smaller cities to Orlando. Frontier has a niche in scheduling low frequency in key markets from Denver, making it a small (but not invisible) target for major car-

[6] Source: United Express/Great Lakes.

riers. Another "niche" developed by Frontier is something lacking at many start-ups—service that makes the consumer want to come back.

Understanding Four: There is but one Southwest.—The chances of becoming "another Southwest" are very slim. Too many analysts and journalists lump Southwest into the start-up category. The reality is that Southwest is old enough to vote, and is a billion-dollar company.

What most of these people miss is the reason for Southwest's success. It is not because of low costs or low fares. If these were the main ingredients for success, we'd all be flying Air South, Prestige, JetTrain, Florida Express and Air21. (Which, unless one has access to the nether world, we're not.) Instead, the success of Southwest is due to something that most start-ups have failed to produce: excellence in customer service. On-time flights, dependability, and employees who view passengers as more than just interruptions of their day.

Understanding Five: Failure of start-ups in most cases has not been due to unfair competition from major airlines.—The main reason is that they fly places where they simply cannot gain enough consumer support for their service. Period. True, there are some exceptions. United in Denver has been hitting Frontier below the belt, flooding markets with capacity, and in some cases bringing in lower paid staff (aka United Shuttle) to compete, among other things. But again, this is the exception.

Understanding Six: A lot of start-ups sell their product well below their costs.—One key example: ValuJet had no real case in claiming Delta competes unfairly, because it's ValuJet that's been selling its product under cost, not Delta. WestPac, ditto. It was selling transcon tickets for $99 bucks—that's about half of what their costs were. This is because the only way many start-ups can get passengers is by offering fares that don't cover costs.

Understanding Seven: Most start-ups are their own worst enemy by offering shoddy service.—Air South killed itself by not having a schedule strategy that lasted longer than a rerun of Wild Kingdom. MarkAir raised bad service to an art form. Air21 had schedule dependability similar to lottery odds. JetTrain tried to operate with just one airplane. One bird strike, or a snowstorm at Newark, and the airline was out of business. And these are just for starters.

Understanding Eight: Return on Investment is Terrible.—In 1997, one of the most profitable years, major airlines barely made a 5 percent profit margin. For start-ups it takes a lot of capital to get to the point where they can earn these low margins. Yes ValuJet was an exception. But it also saved money by not maintaining its aircraft properly, not training its employees, and paying them wages that would embarrass a Third World bus company.

A NOT SO SHORT HISTORY OF START-UPS

Start-ups Prior To 1993

After thousands of years, mankind has learned that there are two ways to ensure near-certain financial disaster. The first is to write an insulting letter to the IRS. The second is to start an airline.

There are very few industries that can eat money faster with lower potential returns than the airline business. First, it is of value to look at the track record of carriers which began operations between 1978 and 1992. It is not encouraging.

There were several dozen planned jet start-up airlines during this period. However, of the start-ups that actually attempted primarily scheduled service, there were approximately 30 start-up jet carriers that were established prior to the end of 1992:

Air Atlanta
Air One
Air Niagara
American International
America West *
Best 7
Braniff "III"
Discovery Airlines
Jet America
Hawaii Express
Kiwi *
MarkAir
MGM Grand
McClain Air
Midway "I"
Midway "II" *
Morris Air
Midwest Express *
Muse Air
Northeastern International
New York Air
Pacific Express
PeoplExpress
Presidential
Pride Air
Regent Air
Reno *
Sunworld
USAfrica
UltrAir

Of these carriers, all but five (those with an *) are gone, in most instances taking enormous amounts of investors' and consumers' money with them.

Of those still operating only two are now consistently profitable. Even here, one of the two—America West—had to undergo Chapter 11 bankruptcy reorganization, causing investors and employee stock holders to lose millions. It is clear from this track record that there has not been a market need for a large number of new airlines.

The experience of these airlines is clear: over nearly 15 years, it has been shown that there is not a huge need for new jet carriers. Furthermore, it also shows that low-costs are not a stand-alone success formula.

To be sure, there have been a few successes, and there are some opportunities that still exist for new jet carriers. Without doubt, a few are likely to be very successful. But as the track record since 1978 indicates, these carriers will not become major factors in the U.S. air transportation system.

Selected Carrier Histories

Each of the carriers noted above had a "story"—one that in many cases some financial analysts strongly supported in order to sell stock. But the fact is that all but six of them failed, and of the survivors, only one—Midwest Express—has been consistently healthy. It is not without significance that this airline steadfastly has avoided rapid expansion, and even today accounts for only 25 percent of the traffic at its home base airport, Milwaukee. And it is again noted that Midwest Express is not a low-cost carrier.

Looking at brief histories of some of the above airlines is highly informative. Of the failed carriers, one common thread can be found: they failed because the market need—i.e., passenger traffic—was simply not there. Regardless of how low their costs were, they could not generate enough revenue to stay alive. By and large, this situation still exists.

Air Atlanta.—Established 1984. The carrier offered very high levels of amenities, seeking to compete with Delta and Eastern at ATL. Like a moose charging a locomotive. Daring, but dumb. No predation here—Air Atlanta was not a low-fare carrier.

Air One.—Established 1982. The intent was to capture traffic from TWA at St. Louis by offering all first class service with 727's. It failed in 1984 because it could not win enough traffic away from "high labor cost" TWA.

Air Niagara.—Established 1982, the carrier attempted to provide service between Niagara Falls and Newark. Not exactly two of the world's great destinations. Honeymooners quit going to Niagara Falls before Ralph Cramden drove a bus. Despite low costs, the airline was unable to generate sufficient business at Niagara Falls. The traffic simply did not exist. After 1983, neither did Air Niagara.

American International.—Established scheduled services in 1982, with a hub at Atlantic City, and later at Philadelphia. Low cost (and real low class) services were intended to compete directly with high-cost USAir. American International was a darling of Wall Street, which promoted its stock heavily in a 1983 public offering that provided $20 million in capital. Sheer mis-management and inability to maintain a schedule pattern for more than a week finally killed off the carrier a year later. The chairman did have a nice limo, though, and did a nice job of lavishing money on refurbing his office.

America West.—Established in 1982. As a low-fare, low-cost, non-union 737 carrier, America West had some initial success as the dominant carrier at Phoenix. Employees were required to purchase stock in the company. America West over expanded, added 747's and service to Nagoya, Japan. (?) During this time, It encountered growing competition from Southwest expanding at Phoenix. Filed for bankruptcy in 1992. It emerged from Chapter 11, and is today profitable.

Braniff III.—Established in 1990, Braniff III had no corporate ties with the prior airlines of the same name. An airline that redefined sleaze management, some of which are now convicted felons. It attempted low-cost service from a number of cities. Ran out of cash and shut down after pre-selling millions of dollars in tickets prior to July 4th week-end in 1992, stranding and defrauding thousands of consumers.

Discovery Airlines.—This airline was planned to be a third intra-Hawaiian carrier, offering a low cost jet alternative to Hawaiian and Aloha. It received support from British Aerospace, which was to supply a fleet of BAe–146 jets to the airline. Was shut down by the DOT when they found out that the carrier's real owner was some guy in Taipei.

Jet America.—Established in 1980. Provided service from noise-sensitive Long Beach to DFW, ORD, and STL, using MD–80's, which major carriers did not yet operate. This very limited niche was invaded when American obtained MD–80's. Despite Jet America's lower labor costs, the carrier simply could not find enough niche markets, and ultimately was merged into Alaska Airlines.

Kiwi.—This 727 operator established operations at Newark in 1993. Gained notoriety for providing good customer service and extra leg room. Despite low costs, it has found that competing against established airlines at Newark is very difficult. At one point signed a financing deal with a Romanian aircraft manufacturer. Later, constant management shake-ups literally left confusion regarding who was running the company. Has not been consistently profitable, in part due to 1996 Gestapo-like treatment by an FAA eager to shut something down after its cover up of ValuJet's problems. Currently operating but future is very unsure.

MarkAir.—An outgrowth of a pre-deregulation airline, MarkAir expanded within Alaska relatively successfully with a fleet of 737's, using the code of Alaska Airlines. In early 1990's, the carrier ended its code share agreement and began to compete directly with Alaska Airlines. It slashed fares to gain market share, and ultimately went into Chapter 11. It eventually emerged in 1994, but promptly began to break payment plans to creditors that were made with the bankruptcy court. Attempted to expand into lower 48 with a "hub" at Denver, but high costs there and really bad service killed it. When it finally shut down in 1995, it left a huge number of large creditors including economic development agencies in Alaska, which had loaned the airline money in exchange for "creating jobs".

MGM Grand Air.—MGM Grand attempted ultra first class service between New York and LAX, using 34-seat 727–100's. Had neat stuff on board including stand-up bar, and secretarial staff. Trouble was that it needed to fill all 34 chairs with high rollers. Later tried service with mixed first and coach service. Both programs failed. Carrier assets sold off to a freight operator in 1994.

McClain Air.—After a long period of gestation, attempted service from ORD in 1984, claiming that it would need only a small share of traffic from AA and United to survive. Operated for a very short time before being shut down for lack of cash.

Midway "I".—Established low-fare service at Chicago/Midway in 1979. The carrier was limited in that at Midway Airport it could not gain a sufficient share of the local Chicago market from American and United. Furthermore, it was unable to compete for connecting traffic through Chicago. It then tried to become an all-business class airline. Subsequent to that, Midway attempted to interest American in a merger. It tried to expand with a hub at Philadelphia, taking over aircraft and facilities from Eastern. There, traffic didn't materialize. Finally, it tried last minute merger with Northwest. Filed bankruptcy and ceased service in 1992.

Midway "II".—Attempting to repeat the "success" of the earlier carrier of the same name, Midway "II" could only lease a limited number of gates at MDW, and competition with Southwest doomed the low-cost carrier's Chicago operations. In 1994, made decision to move to Raleigh/Durham, in concert with American Airlines' pulldown there. In 1997 re-equipped its fleet by downsizing to 50-seat jets. Today, a good chance of survival.

Midwest Express.—For airports seeking additional airlines, there are two home runs. One is getting Southwest. The other is getting Midwest Express. Established in 1984, Midwest Express built a small hubbing operation at Milwaukee, focusing on all first class service. With support of parent company, Kimberly-Clark, the airline expanded very slowly, and has been profitable. This airline has survived with ASM costs that are 75 percent higher than those at Southwest. In 1995, was spun off by the parent, but with same management in place. It is highly likely that Midwest Express will be one of the few long-term players. Has built business on basis of excellence in customer service.

Muse Air.—Muse Air was started in 1982 essentially as a "grudge" airline by the ousted founder of Southwest. Was going to teach the ingrates at Southwest a lesson. Unfortunately, Muse Air failed the course. The program failed miserably and Muse was eventually taken over by Southwest in 1986–1987. It operated for a time as TranStar, before being shut down completely.

Northeastern International.—A low-fare, low-cost, airline established in 1981 initially to carry traffic to Florida from airports peripheral to the New York metro area. Expanded rapidly in all directions adding widebodies. Undercapitalized and on the edge financially, it ceased service in 1985.

New York Air.—A product of Frank Lorenzo and Texas Air, NYA began service in 1980 as a direct competitor to the Eastern Shuttle in the NYC–BOS/WAS markets. Failed at attempts at building hub operations at IAD and RDU. Assets were merged into Continental in 1986.

Pacific Express.—Pacific Express attempted low-fare service on the West Coast, starting in 1981. Received support from British Aerospace in exchange for ordering BAe–146 jets, which it never got. It could be argued that United drove Pacific Express out of its markets and into bankruptcy in 1984. One possible case of predatory activities, but it's ancient history now.

PeoplExpress.—In the early to mid-1980's, this airline was revered on Wall Street. Its growth and "unique" employee culture made PeoplExpress a favorite among airline analysts and investment houses. Employees were all "managers" and were required to buy stock, with the company loaning them the money on a payroll-deduction basis. This, analysts reasoned, would make employees more "loyal". (Read: keep them non-union.)

Founded in 1981, the carrier originally was a 737 operator flying under-served markets from Newark. Initial success led the carrier to expand rapidly. Its huge "profits" fueled acquisitions that made no business sense at all. It purchased a large commuter in the Midwest, Brit Air. This airline had good feed into ORD, but PeoplExpress had very little presence there. It also bought a large bankrupt commuter in Florida—another investment that gave PeoplExpress no synergies. But these did give the stock brokers an exciting story to tell unwary investors.

It purchased the original Frontier Airlines and within a year had it heading into bankruptcy. With 747's flying routes like Newark—London, and Brussels—Los Angeles, the carrier impressed financial analysts but was running itself into the ground.

In 1986–1987, financial realities set in, and PeoplExpress began to very quickly implode. It was acquired by Frank Lorenzo's Continental Airlines.

Presidential.—Founded by a another former partner of Frank Lorenzo. (This guy had more clones than the Stepford Wives.) Presidential attempted a hub at Washington/Dulles. It depended on the same template as many other start-ups, i.e., low fares intended to generate high revenues. Tried 737–200's and BAe–146's on a variety of routes. Matter of fact, it took a scorecard to figure out this carrier. Changed fleets. Bought a commuter partner. Became a Continental code-sharer. Then became a United code-sharer. Went to airline heaven in 1989.

Pride Air.—Founded in 1984 by a group of former Continental pilots, Pride Air operated 727's between Florida and western destinations, with headquarters at New Orleans. Had no success in breaking into traffic carried by major carriers, and shut down in 1986.

Regent Air.—Tried ultra first class service with 34-seat 727's (these same aircraft were later taken over by MGM Grand Air, with similar results). Could not compete on transcon routes with first class service offered by American, United, and TWA.

Reno Air.—Originally planned to have a hub at Reno, the carrier has had several major route re-alignments since beginning service in 1992. Only start-up since that time that is now fundamentally profitable.

Sunworld.—Started at Las Vegas in 1980, the airline was owned by a bus company on the East Coast. Low costs and low fares allowed the airline to compete on initial routes with DC–9's. In 1984, acquired 737–300's, and expanded into the Midwest from Las Vegas. Poor traffic, low fare yields, and expansion at LAS by other low-fare carriers (not majors) had Sunworld heading out of business by 1988.

UltrAir.—Intended as an all-first class airline serving New York and Los Angeles from Houston, UltrAir began service in 1991. Competing directly against Continental resulted in very poor passenger loads. Its basic product was confused by a high-priced "premium" cabin, and a 5-abreast "first class" cabin on the carrier's fleet of 727's. Ceased operations in 1993. It briefly re-surfaced as a high-density, low-cost carrier between Newark and Florida. Ceased service in 1994.

More Recent Start-ups

We can look at some other passenger start-ups that have been established in the last three years. The picture is not encouraging.

Air South	Vanguard
AirTran	ValuJet
Frontier "II"	Western Pacific
Spirit	

On a long-term basis, only two of the above, Frontier and AirTran, appear to have a strong chance of survival. Three—Western Pacific, Air South, and Pan Am are already dead.

Air South.—Air South, instead of being a response to a market need, was first formed as an airline, and then its founders looked around to find someplace that needed it. Civic hubris in South Carolina resulted in a $17 million financing commitment by the state in exchange for the airline basing itself at Columbia. Ran through money like Sherman through Georgia. The results were predictable. It's now gone, along with the State's money and about $30 million more.

AirTran/ValuJet.—AirTran was a small airline with a small niche. Focused only on service to Orlando with single daily flights from secondary cities such as Albany, Richmond, and Syracuse. Was purchased by ValuJet, which acquired the name. Combined entity has some chance of profitability.

Frontier "II".—Frontier "II" has now re-focused on low-frequency service between Denver and large population centers such as Los Angeles and Phoenix. A strategy along with good service that should provide a reasonable niche and a strong future.

Spirit.—A small DC–9 operator attempting to provide service from Detroit/Metro. Going head-on with hubbing carrier Northwest will be very difficult. NW typically matches fares with invading start-ups. The potential for long term success—unknown.

Vanguard.—Established at Kansas City in 1994, Vanguard has revised its route system repeatedly, looking for markets where it can make money. In 1995, Vanguard had an initial stock offering that provided the airline approximately $14 million. However, much of this was needed to pay overdue bills and fund aircraft maintenance reserves. The prognosis is that low-cost Vanguard is an airline eating cash while it looks for a reason to be in business.

Western Pacific.—Had a niche at Colorado Springs. Its board wanted faster results, and hired a messiah management team to part the financial seas. Instead they just raised the water table. Tried head-on competition with United at Denver. Lost $80 million in 1997. Say Good-bye.

Pan Am.—No connection with the earlier airline of the same name, the airline attempted service with widebody aircraft, intending to connect with second tier international airlines at JFK and MIA. Physically and economically, the plan had no chance of working. Lost millions. Bankrupt in February 1998.

STATEMENT OF SENATOR REID

Senator SHELBY. Thank you.

Senator Reid, do you have an opening statement?

Senator REID. I do, Mr. Chairman. I will ask permission to make that part of the record.

Senator SHELBY. Without objection, so ordered.

Senator REID. I would also say I hope Crandall takes a vacation to Las Vegas.

Senator SHELBY. Thank you. [Laughter.]

And brings money. We do not have that and Mississippi is not here today, right.

Initially, Mr. Boyd, I want to compliment you and others on your testimony in particular for noting that one way to reduce airline operating cost is to move forward, not backward toward a free-flight air traffic system. I share your view that there are investments that we can make and that will make the entire system more efficient and which will translate into lower operating cost, increased capacity and ultimately lower fares for the American traveling public.

I am not sure that I share the FAA's vision of free flight or that they have even fully articulated it yet, but I am convinced that at least a portion of the answer to maintaining a competitive aviation environment is to enhance the efficiencies of the air traffic control system.

Now, would you comment, Mr. Boyd, on the problems that Frontier and Spirit have faced and whether you view the source of their difficulties as predatory or anticompetitive actions by network airlines?

Mr. BOYD. OK. Is that somebody's pacemaker going off I hope?

Actually, we have done a study of startup airlines. We are probably the only people that have. We have looked at virtually every one. The reality is, like Professor Dempsey said, the majority have gone out of business at their own hand. Dembold plans, bad marketing, bad ideas, terrible air service. But there are exceptions to that. Frontier is one, I believe. I am not familiar with the Spirit situation. I do know Frontier in Denver, it is very obvious what has happened in Denver.

It is one thing, I have been with the airlines, when a competitor comes in you match the fare. That is good, there is nothing wrong with that. But when you only flood the markets that your competitor is in with fares, like that lucrative Omaha-Denver market gets suddenly wide-body airplanes, I think we have an indication. Then when we have a situation where that same carrier goes to major companies and says, "We will give you a deal on fares, but do not fly somebody else," I think that is a problem.

Then the third part of it is bringing in lower-paid employees, a/k/a the United Shuttle, to compete in markets just where Frontier is, I think there is more than a prima facie case that United Airlines probably has stepped over the line.

Let me say that we have advised major carriers on how to deal with startups. My example or my advice has always been, Mr. Chairman, to these major carriers, "Let them go. They will go out of business on their own. They are their own worst enemy." I told Delta that, "Don't worry about ValuJet, it's a bottle rocket."

I did not know that was prophetic at the time, but is what has happened. The fact of the matter is I thought they would collapse under their own financial weight. They may have anyway. These startup carriers are not a real threat to major carriers. I think the paranoia was there at United Airlines for sure.

Senator SHELBY. Mr. Dempsey, in your view how do the network airlines compete with the new entrant airlines, and do the network airlines compete with each other the same way that they compete with new entrant airlines?

Mr. DEMPSEY. Well, in answering your later question first, they do not.

Senator SHELBY. OK.

Mr. DEMPSEY. We have taken a look at major carriers in terms of how they respond to other major carriers entering their market, both in terms of capacity and in terms of pricing, and we found some very interesting things.

Delta, let's say, enters a market where Northwest is competing and the DOT historical data will reveal that Northwest will maintain its capacity levels about where they were as Delta ramps up into the market, OK, with pricing. Delta would come in with a low fair in order to ramp up the market and fill some seats. Northwest would maintain its fairs pretty much where they were until Delta met those fairs and the two carriers lived in peaceful coexistence.

Then we looked at what happens when Southwest enters a major airline market. Southwest comes in with capacity. How does the incumbent airline respond, the major airline? The answer is they do not tend to add lots of new seats and new flights; OK.

What about pricing? Southwest comes in with a new price. Now, there have been exceptions to this. There has been pricing competition in places like Baltimore and on the west coast, but in many, many markets what we see is Southwest coming into the market with a very low price and the incumbent carrier maintains its price where it was; OK.

Now, what happens when a carrier like Spirit or Frontier comes into a market that is dominated by a major airline? We see radically different behavior. What we see is the major carrier drops—no, adds capacity to the market. When Frontier made the unfortunate decision to announce its second consecutive quarterly profit, United Airlines added 8,600 seats a week in the Denver-Los Angeles market summer over summer, year over year. We see an increase in capacity when a post–1990 low-fare entrant enters the market.

What about pricing? Well, what we see is the major carriers tend to drop their price down to the new low-fare entrant's price, and that is an average fare, OK, the average fare data of the Department of Transportation which includes a first-class component, which the new entrant airlines typically do not have. They are engaging in below-cost pricing, and they maintain those levels of lock-step pricing until the low-fare entrant exits the market and then they raise prices up typically to levels that are higher than they were before the new entrant entered.

Now, why does the major carrier respond one way when a major airline enters its market, the same way when Southwest enters its market, but a radically different way when a low-fare, post–1990's carrier enters the market? I think the answer is that they perceive that the new up-start airlines are less capitalized and have a lower pain threshold and they can be driven from the market.

You know, it is a question of whether or not you can engage into a bleeding contest with the American Red Cross. Any of us would lose that contest very quickly. As for the other network advantages, one need only look in telecommunications. If we had the same regime in telecommunications that we have in air transportation, Bell South would determine that you, Senator, would only be allowed to connect with MCI; and if you wanted AT&T or Sprint, you could not have it.

Senator SHELBY. Mr. Kahan, do you have any comments?

Mr. KAHAN. Only that as an executive of a smaller airline it is part of my job and my colleagues to understand that large carriers may react aggressively, and that is their right, when we go into their rights. We have our own strategies for dealing with that.

In particular, we go in with very, very low capacity. We are looking to offer low fares to a segment of the marketplace that wants low fares. We try to set things up so that it is highly irrational for the large carriers to drop nuclear bombs on us, unless their sole objective is to put us out of the market entirely. In my testimony, I talk about that.

Senator SHELBY. As far as lack of access to gates, Mr. Kahan, would you please recount how a lack of access to underutilized gates presents operational and financial barriers to carriers such as yours and other small airlines?

Mr. KAHAN. Senator, we are in a deplorable situation at Detroit, our home base. We enplaned 20,000 passengers in December without a gate. We have to go from one carrier to the next finding out when they might have some spare space on their gates so that we can operate. We are in a catch–22 situation.

Senator SHELBY. Why? Why do you have to do that?

Mr. KAHAN. We have to do that because the monopoly carrier at the airport has 85 percent of the gates. To my amazement and to my sorrow over the last 18 months as 6 new gates were being built at the airport with PFC funds, they all went to the monopoly carrier. Because we did not have any gates and we were not the signatory carrier, we did not even get noticed under the FAA regulations that that plan was afoot.

I do not have that in my testimony. Sir, I uncovered it as I was preparing for the hearing today. I, frankly, am going to take that up with the FAA. It is just outrageous that we cannot get any gates——

Senator SHELBY. We will help you take it up.

Mr. KAHAN. Thank you, sir.

Senator SHELBY. Senator Lautenberg.

Senator LAUTENBERG. Thanks, Mr. Chairman.

One of the things that puzzles me is whether or not pricing below cost is exclusively a tool of the majors. Because when we see new entrants come in, they will come in with absurdly low fares and break into a new market. When airlines drop their prices below their costs, is there an automatic assumption that that is predatory pricing, or is it a tactic that is commonly used to boost traffic?

Mr. BOYD. I think it is common. Airlines do that all the time. Major airlines have done it from time to time. As I put in my testimony, startup airlines have done this as well. I mean, when West Pacific came into Denver, they just slashed fares well below their cost. That is why they are not in business today. Pricing alone I do not think is a yardstick of predatory behavior, it has to be attached to something else usually, and it is usually is.

Senator LAUTENBERG. Dr. Dempsey.

Mr. DEMPSEY. Senator, every carrier when it enters the market or virtually every carrier when it enters the market is going to ramp up the market. It starts out with a zero load factor and it is going to have a lot of available capacity there until consumers are acquainted with the new operations. It is quite common for any carrier to open the market with below-cost pricing for a period of time and to gradually step its prices up over time.

The question, the Justice Department has addressed this and they said, "Well, for us to believe that it is predatory, we want to see it in conjunction with some other activity like, for example, lots of new seats or lots of new flights or some other anticompetitive activity to suggest that more is going on than just meeting the fare of the new entrant. At least in our markets, what we have seen is that the pricing behavior of the United Airlines changed profoundly only after Frontier announced it was profitable.

Senator LAUTENBERG. Do you have any comment, Mr. Kahan, on that?

Mr. KAHAN. Only, sir, that to some degree New Jersey is the beneficiary of some of the carriers' predatory tactics. As you may know, we have put a large part of our operation in Atlantic City, sir. We are offering low-fare service out of Atlantic City. I think if you take a look at what happened in the Detroit-Philadelphia market, which we went into in December 1995, you can see very clearly what happened.

It was not in the interest of the big carriers, USAir or Northwest—Northwest being the dominant carrier—to immediately lower their fares. It would be crazy. They would lose millions of dollars a month by doing so, because we had such a small amount of capacity in the market. Just 87 seats to begin with.

Our fares covered our cost. We were very happy with that market. I guess we got too uppity because in the third quarter of 1996 Northwest determined that they were going to train all of their guns on us, and you can see it in Chart 2 of my testimony, how they went from a situation where there had been 140,000 seats per quarter in the market, for several years it was a very stable market, they went in one quarter from 140,000 to 190,000 seats. In a quarter, 50,000 seats was about 5 times more than the seats that we had put in the market.

Sir, there is nothing we can do when that happens. It is the combination, a combination of very, very low pricing together with such dramatic increases in capacity that the new traffic stimulator is all soaked up by the big carrier. That is the problem. It is a common tactic, and it is something which I hope the Department of Justice will be looking at in their current investigation.

Senator LAUTENBERG. Pricing is only one part of the configuration of things. Because if you add seats and do not fill those seats right away, I assume if an airline wants a better chunk of the market, that they are willing to add seats even if they do not fill those seats just to be able to provide more service? Is that a fair——

Mr. DEMPSEY. I think, yes; to get back to the Detroit-Philadelphia market, we had one flight eastbound in the morning, at about 7:30 in the morning. I think it would be normal aggressive competition for Northwest to match our price on the flights right around our flight; OK. That is fine, that is fine. What the problem is if they offer the price on all of the flights and they add 50 percent more capacity to the market, a combination of the two that makes it impossible for us to compete. I would never as an airline executive or as an antitrust analyst just look at pricing in isolation. It is a complicated subject and we do have to be careful.

Senator LAUTENBERG. What do you think we ought to try to do in Government to level out the field? You have got slot controls in some places. Most of them are spoken for. They add seats or add service. That can be considered a predatory practice. Fares below cost, a predatory practice.

At what point do we get to either Government interference or forcing what might be a freer market, which I think is OK. I mean, I would love to see competition wherever it goes. I noticed one thing. When the new entrants come in, usually the service is pleasanter, seating capacity is a little more generous or prices are lower. I mean, there are inducements that follow a new entrant's position in the market. What can we do, Mr. Boyd, without overlaying the hand of Government and, in effect, reregulating the industry?

Mr. BOYD. Senator, I think it is not what you do, it is what you take away. Like I said, the Wright amendment, now that is not going to change the world but doing away with the Wright amendment in Love Field would open up some fare discipline east and west and in other markets. You take that, the hand of Government, away.

The high-density rule at some airports does not make any sense. I believe the high-density rule at O'Hare hurts smaller communities. Getting rid of that and working to get rid of that would be something. The issue of airport capacity, adding it where it is needed and making sure people can use it. I mean, building more gates at Detroit and giving it to the incumbent carrier does not encourage new competition, so maybe the application of PFC's. I think in the near term it is what Government can do to take away existing regulation, that will work, rather than new regulation.

Mr. KAHAN. Senator, could I just add? I think there are two separate problems. There is a small community problem and there is the problem of price competition at hub airports.

Senator LAUTENBERG. We are discussing the voting situation. That is what the alarm was. It says," Fly down here and do your voting before we get a bad report card." What I am going to do is temporarily—that is to remind me to get to the floor. What I am going to do is temporarily adjourn. If you will, hold your place. It will take us about 5 to 10 minutes to turn around and we would like to continue at the chairman's disposal.

[A brief recess was taken.]

Senator SHELBY. We are back in order. We apologize. I will on behalf of my colleagues and myself. We had two back-to-back votes on the floor of the Senate. We have to do those things, I hope you understand. It does disrupt hearings, though.

Mr. Boyd, price competition by the network airlines among themselves and with a few entrants is not new. Is it realistic to expect that any carrier would not match the lowest fares offered in any market that they intend to serve; and in your view, what distinguishes additional aggressive price competition from pricing action that you would characterize as predatory? In other words, it is my understanding, it has been always, that predatory pricing was illegal basically. Is that correct?

Mr. BOYD. I am not a lawyer; I assume so.

Senator SHELBY. I thought it was. I am not an expert on it. Go ahead.

Mr. BOYD. Well, typically we have a competitor that comes in with a lower fare and you will match that fare.

Senator SHELBY. Absolutely.

Mr. BOYD. That is not a problem. But when you have a competitor, let us just say it is a small airline, and I have been with one of these, where the competition decides that, "Wait a minute, this airline is on the ropes financially. A bird strike or an engine change could put them out of business, so let's just keep lowering the fare on our own."

When they match the new entrant's fare, that is OK. But when they lower it below that, that is when you have a problem. Or, when you do it through the back door by flooding the market with seats, then you have a problem. That is predatory in my mind.

I mean, I was with a startup airline, very similar to the Spirit, in Philadelphia and USAir was a major competitor. All USAir ever did was just match our fares, and they let us put ourselves out of business very successfully. That is the way major carriers and network carriers really should deal with startup carriers. Let the consumer put your competitor out of business, not fares.

Senator SHELBY. Mr. Kahan, you have had experience in it both ways, as a regulator and as a deregulator and also in the business you are today. Go ahead.

Mr. KAHAN. Yes; I think that matching fares is not a problem. I fought for a carrier's right to be able to match fares, and I stand by that. If we put 100 seats on the market between Detroit and Philadelphia, if our hub competitors want to match our lowest fare, a fare that we are offering on a finite number of seats, then that is one thing. However, if we put 100 seats on the market at a certain price, and they put 1,500 seats in the market at that same price and add more seats to make sure that the additional demand created by the lowest prices can now be accommodated on them, I believe that that is more often than not predatory, sir.

Senator SHELBY. Mr. Dempsey.

Mr. DEMPSEY. Senator, every carrier will likely offer every other carrier's fare on the market. The question is over how many seats. The carriers are able to expand the bucket of seats in order to sop up low-fare demand when they want to engage in predation and drive the competitor out of the market.

As I said earlier, that behavior seems to be focused on carriers which are less well capitalized than Southwest or than the major airlines, where there is peaceful coexistence. Moreover, it is not just pricing, predatory pricing. It is monopolistic practices at hub airports, and it is monopolistic practices——

Senator SHELBY. Expand on that, monopolistic practices at hub airports.

Mr. DEMPSEY. Monopolistic practices at hub airports.

Senator SHELBY. Now, tell me how that works?

Mr. DEMPSEY. How does that work?

Senator SHELBY. Yes.

Mr. DEMPSEY. Well, unlawful monopolization under section 2 of the Sherman Act, under most of the case law, exists when a company has more than 70 percent of a market and engages in activities designed to suppress competition.

Senator SHELBY. OK.

Mr. DEMPSEY. Typically, what goes on there is the major carrier does not want to see a low-fare carrier in its backyard. This is particularly true since ValuJet grew to more than 50 aircraft in Delta's backyard.

Senator SHELBY. In other words, they do not care about having real market forces working, do they?

Mr. DEMPSEY. No; they do not. They obviously do not want market forces working. That has a pernicious impact both in terms of the people who begin or end their trip at the hub, but also the small and medium-sized communities that are served from the hub. It is the ability to monopolize the hub that makes it very difficult for a low-fare carrier to go in and provide competition. It is through a variety of means, not just pricing and capacity, which we have talked about.

Senator SHELBY. Go ahead and elaborate on those means.

Mr. DEMPSEY. OK. Travel agent commission overrides, where they take the larger travel agencies and they effectively bribe them to give them business and dissuade them from giving business to their competitors.

Senator SHELBY. How do they dissuade or persuade them?

Mr. DEMPSEY. They give them a monthly check based on meeting certain quotas.

Senator SHELBY. OK.

Mr. DEMPSEY. The travel agency, usually it is a large travel agency, has to book a certain number of seats on the major airlines' flights in order to receive what can be a very significant check at the end of the month. That check is even more important since the major carriers have rolled back commissions by 20 percent.

Senator SHELBY. OK.

Mr. DEMPSEY. We also have refusals to connect. We have major carriers that will not engage in ticketing and baggage agreements, for example, requiring the passenger, now, to go and pick up the bag and recheck it at the hub airport if they want to connect on that little low-fare carrier.

Senator SHELBY. Is that widespread?

Mr. DEMPSEY. Well, we have certainly found it with United. I think virtually we had a very difficult time getting United to give us a ticketing and baggage agreement. It wasn't really until the Department of Transportation jawboned United into giving us one that we got it.

Senator SHELBY. Does the FAA have any play in that?

Mr. DEMPSEY. No; but the Department of Transportation does. If we had in air transportation what we have in telecommunications today, which is a requirement of nondiscriminatory connections, Senator, there might be low-fare carriers that could open up service between Atlanta and Huntsville and make it viable. The people in Huntsville do not want to just go to Atlanta, they want to go to Charleston and they want to go to Raleigh and they want to go to other places beyond Atlanta. Without the ability to connect, and it is done in a variety of ways, computer reservation system bias, they assure that a carrier that does not enjoy a code share with them, and they will not give a code share to a low-fare jet carrier——

Senator SHELBY. What does that mean to the layman?

Mr. DEMPSEY. Well, Senator, if you order a ticket, you will probably call a travel agent. The travel agent will ask you when you want to fly and will ask you at what time you want to fly. The computer has to figure out how it is going to order these flights.

A computer is going to say, "Well, the Senator wants to fly at 10 a.m. on Thursday. What is the closest flight and time proximity to that departure because obviously he wants to fly at 10 a.m?" The second question it will ask is, "What is the elapsed time from origin to destination because we want to get the Senator from A to C most quickly?" That is what he would want. The third question is, Is it an online flight, or is it a connecting flight with some other airline? All of the code-sharing arrangements, that is, a carrier—I do not know what Delta has, but in our part of the world, Delta has a bunch of carriers called—excuse me, United has a bunch of carriers that they call United Express. These are companies like Air Wisconsin.

Senator SHELBY. What we call feeders?

Mr. DEMPSEY. Yes; if those connections are in the computer reservation system, no additional elapse time is added to the display; but it if is a connection from a megacarrier to a nonrelated independent airline, the algorithm in the computer reservation system adds the equivalent of 24 hours to the display. In the United system, it is 1,440 minutes.

Now, why do they do that? The answer is the first page of the computer reservation screen is the most important shelf space in this business; OK. It is like grocery store shelf space; and if you do not have it, you do not get sold. Of all flights, 85 percent are sold off the first page of the screen.

If they add all of this time to your connection, you are not going to be on the first page of that screen and your connection is likely not to be sold. They do that in order to monopolize the connecting traffic. By monopolizing the connecting traffic, they assure that in thin markets there will be no competition.

Now, we have asked the Department of Transportation to do something about that. They promulgated a rule here in December, but it is not very helpful. What it does is it says you have got to offer, all of the computer reservation systems have to offer, at least one display that is not biased about noncode-shared connections. All of the other displays can be biased, and generally are biased, and so it is not very helpful.

If we want to resolve the problem of small-community service, if we want to have competition to more small communities, if we want to have jet service to more small communities and lower prices and lower fares and lower costs, we need to have the same regime we have in telecommunications, which is no local telephone company can monopolize the market.

If a competitor wants to choose a long-distance carrier of its choice, it should be free to do that. You know, Bell South should not be allowed to enter into a preferential agreement with AT&T if consumers want MCI or Sprint. If we had that in air transportation, we would have a lot more competition, Senator.

Senator SHELBY. Well, maybe that is something we can have a subsequent hearing, the specifics of.

Mr. Kahan, do you have any comments on that?

Mr. KAHAN. No; I thought that was a very good answer, sir.

Senator SHELBY. Mr. Kahan, your testimony outlines the concern that although no one knows what the efficient market structure of the aviation industry will ultimately, ultimately turn to be, and you know from your work with the other, Dr. Kahan, we should be very concerned about the lack of new entrants in the marketplace, given the degree of increased concentration in the industry.

Under that assumption, is it enough to have new entrants, or is it fair to say that any new entrant must be sufficiently capitalized to weather the inevitable competitive pressures and attendant barriers to competition that is endemic to this industry?

Mr. KAHAN. I absolutely agree that any new entrant in this industry must be well capitalized. Certainly, we at Spirit do not expect subsidies or any free lunches or any help from the Government that is going to get us out of problems.

Senator SHELBY. You want help from the Government to make sure that there is a competitive environment, do you not?

Mr. KAHAN. We want to have an opportunity to succeed, sir.

Senator SHELBY. That is what I mean, yes. No guarantee you will succeed, but you will never succeed if you do not have an environment that you can succeed in—in other words, real competition—do you?

Mr. KAHAN. Yes, sir; the airline industry is the last industry that I would say there are any guarantees of success, sir. At a minimum, we have to have an opportunity to do so.

Senator SHELBY. Describe, Mr. Kahan, an ideal market for an airline such as yours or others to initiate service into. What passenger or community profile would you look at? Is that too proprietary?

Mr. KAHAN. Well, that is an interesting question, and I think I can take a shot at it, sir.

Senator SHELBY. OK.

Mr. KAHAN. Clearly, under prevailing Government policy and given the pattern of predatory behavior at hub airports, we are looking for underserved markets, where the communities involved are looking for low-priced reliable transportation. We are working with the community, Melbourne, FL, right now, which actually has, I was thinking about it, some similarities with Huntsville because it is space-based there, right near Cape Kennedy. The main way out of Melbourne is seven flights a day through Atlanta, which might sound familiar.

We are working very hard with them right now. We are convinced that that is a market which combines leisure and business traffic, because there is a large Government contractor coming down there which wants to come to Washington and New York. Right now, we are waiting for the Department of Transportation to tell us whether we are going to have access to airports up in the North.

Senator SHELBY. Mr. Boyd, what are the biggest hurdles that underutilized airports in communities that are seeking increased service must overcome to increase airline service? Your statement implies that airline competition is an evolving dynamic currently characterized in part by the willingness of people to drive an hour for better service or lower fares. What can a midsized community within a couple of hours drive of a network carrier's hub do to improve the level of service to the airport?

Mr. BOYD. Two issues here. A midsized community, that is a valid comment. Smaller communities like McCook, NE, as I put in my testimony or Mattoon, IL, has no business having air service because they are too close to larger ones. Let us deal with things near Huntsville, for example. How many people drive today from Huntsville to Atlanta? A lot. How many are driving from Gainesville to Jacksonville? A lot.

Now, why is that? It is not necessarily because they do not like the local airport. We do a lot of air service development work with a lot of communities. There are airlines out there that beg us to get into their communities. They beg us to call ComAir, they beg us to call Sky West. There are other airlines that give such bad service to midsized communities, that people will not fly from that midsized airport; they will drive.

Our suggestion has been to these communities, and some of us have taken it up already, do not accept that. When you have an airline system like Delta who has a commuter partner or a regional partner that may give bad service, you need to stand up and do something about it.

The biggest challenge today to midsized air service—I mean aside from the competitive issues, which is another whole smoke—the problem you have in a lot of midsized communities like Huntsville, like Montgomery, like Gainesville is that some of the service these megacarriers are giving them in terms of getting to the hub is so bad no willing consumer will get on it.

I will not put my 85-year-old mother on a Delta flight that involves ASA, for example, because I would not want to abuse her that way. That is one of the ways you have to deal with this. Communities have to get up and say, "You are the only game in town. You are killing my airport, stop it."

You do not do it with ASA. You go to the president of Delta and raise hell with him. That is the biggest challenge right now to midsized communities is the bad service, which is killing traffic. When traffic goes down, airlines say I am not going to fly there. It becomes a self-fulfilling philosophy.

Senator SHELBY. Mr. Boyd, you mentioned in your earlier testimony the perimeter rules and also the Wright amendment. Would you comment on, first, the perimeter rule, why it needs to go, and then the Wright amendment and what it has done to competition?

Mr. BOYD. Well, the perimeter rule has no real value anymore. I mean, original LaGuardia was supposed to get long-haul traffic into John F. Kennedy. That is not necessary anymore. Now, having a four-engine rule or whatever at LaGuardia because it constrains, I have no problem with; but a perimeter rule does not serve any real value for anyone. The same thing at Washington National, we do not need to defend or protect Dulles Airport anymore. A lot of people, folks, have moved out there. It can stand on its own very well.

The Wright amendment, and I just understood from one of the people here, that Dallas and Fort Worth are trying to get together to do a new mini-Wright amendment, which takes away the Wright amendment——

Senator SHELBY. Elaborate on that. Elaborate on what a mini-Wright amendment would do? Would that still impede competition?

Mr. BOYD. Oh, absolutely. What they are talking about is allowing through ticketing, but only allowing nonstop flights to where you can have it today. That does not fix anything really, because people are doing it. There are today, as I remember, something like 100——

Senator SHELBY. It is just a fraud in a sense?

Mr. BOYD. Bingo. It is a fraud. What you have is a situation——

Senator SHELBY. A fraud on the traveling public?

Mr. BOYD. A fraud on the traveling public. How many people do you have today between Birmingham and New Orleans on Southwest? Maybe 120,000 people. Well, guess what? About one-half of those people are crossing the aisle buying a ticket and flying to Love Field. What we need to do is eliminate the whole thing and not go with these halfway measures that are really just meant to pull the wool over the consumer's eye.

If the Wright amendment is removed, Midland and Odessa will have much lower fares east and west, so will Corpus Christi, so will Birmingham. Everybody will benefit. Again, if Mr. Crandall has an out-of-body experience over this, but it will make him a better airline to have that kind of competition.

Senator SHELBY. They create a mini-Wright amendment, in other words, a ploy to get around real competition? That is what you are saying, is it not?

Mr. BOYD. That is all that is. It is hypocritical on the part of Fort Worth. It tries to make us believe that if they take away the Wright amendment it will hurt DFW, then they go on and let Ross Perot build a cargo airport just north of there. The fact is we have too much politics here and too little concern for the consumer.

Senator SHELBY. Anybody that can see, can see right through that, couldn't they?

Mr. BOYD. Ray Charles could see this one coming. [Laughter.]

Senator SHELBY. OK. Thank you.

Do any of you gentlemen have any comments on the perimeter rule or the Wright amendment or the mini-Wright amendment, Wright amendment II, or whatever it is, junior?

Mr. DEMPSEY. I agree with Mr. Boyd. The Wright amendment is an anachronism. The perimeter rules are unnecessary and competition would be much enhanced if they went away.

The other thing I want to say in Mr. McCain's bill, which I think would be helpful, is that he proposes that the Department of Transportation decide complaints brought for predatory practices within 30 days. I think that would be very helpful.

Senator SHELBY. Mr. Kahan.

Mr. KAHAN. I cannot see a case to be made for protecting the Dallas-Fort Worth Airport, sir, not 20 years later after the Wright amendment, and I think that should be seriously looked at.

Senator SHELBY. What has the Wright amendment in the last few years done to run up the price of the traveling public, interstate commerce people, traveling West? It costs money?

Mr. KAHAN. I am not an expert on that. I think that may be a complicated question because people talk a lot about Southwest, sir. Perhaps, the secret of Southwest's success is that they enjoyed some protection from the competition in the early part of their company and were able to develop that big, fat balance sheet that makes them uniquely successful today. I think that overall we have to say that perhaps the Wright amendment succeeded in helping Southwest become the important source of competition that it is, but that does not mean that what was right 20 years ago makes sense today.

Senator SHELBY. Whether it is the Wright amendment, it is the mini-Wright amendment, or junior, or whatever, the third, or Wright amendment, III, it has no place in real competition does it, gentlemen? Is that right?

Mr. BOYD. No.

Mr. KAHAN. No, sir.

Mr. DEMPSEY. That is right.

Senator SHELBY. Thank you. I thank you. I appreciate your coming. I appreciate your contributions. Thank you.

Mr. KAHAN. Thank you, Mr. Chairman.

PANEL 2

GENERAL ACCOUNTING OFFICE

STATEMENT OF JOHN ANDERSON, DIRECTOR, TRANSPORTATION ISSUES, RESOURCES, COMMUNITY AND ECONOMIC DEVELOPMENT DIVISION

DEPARTMENT OF TRANSPORTATION

STATEMENT OF PATRICK V. MURPHY, DEPUTY ASSISTANT SECRETARY, AVIATION AND INTERNATIONAL AFFAIRS

INTRODUCTION OF WITNESSES

Senator SHELBY. Our second panel will be John Anderson, Director of Transportation Issues, General Accounting Office and Patrick Murphy, Deputy Assistant Secretary, Office for Aviation and International Affairs.

Gentleman, your written statements will be made a part of the record in their entirety.

Mr. Anderson, do you want to proceed first?

Mr. ANDERSON. Mr. Chairman, we appreciate the opportunity to testify today on competition in the domestic airline industry. With me is Marnie Shaw, who is an assistant director who overseas our work concerning airline competition issues.

Our work has consistently shown that airline deregulation has led to lower fares and better service for most air travelers. This is due largely to increased competition spurred by the entry of new airlines into the industry and established airlines into new markets. However, as others have testified today, the benefits of deregulation have been uneven and pockets of pain exist, especially in small and medium-sized communities in the East and upper Midwest.

For example, in Huntsville, AL; Charleston, WV; and Pittsburgh, PA, fares in real terms have increased over 20 percent since deregulation. A combination of factors have limited competition at these airports and adversely affected fares and service. These factors include slow economic growth and the dominance of routes to and from these airports by one or two traditional hub and spoke airlines.

BARRIERS TO ENTRY

In addition, restrictive gate leases, slot controls and perimeter rules continue to block entry at key airports in the East and upper Midwest. These operating barriers combined with certain marketing strategies by established airlines, such as frequent flier plans, have deterred entry by new airlines and fortified established airlines' dominance at these airports.

For example, we identified several airports in which entry was limited because of long-term, exclusive-use gate leases with one airline. The vast majority of gates at Charlotte, Cincinnati, Detroit, Minneapolis, Newark, and Pittsburgh are exclusively leased usually to one established airline.

For example, nearly 90 percent of the gates at Pittsburgh are leased to USAir until 2018. As a result, it is extremely difficult for other airlines to gain competitive access to these airports.

ACTIONS TO ADDRESS PROBLEMS

Because a variety of factors have contributed to the fare and service problems that some communities have experienced since deregulation, no single action will solve these problems. Instead, addressing them will require a combination of Federal, regional, local and private-sector initiatives.

At the Federal level, DOT shares our concerns about limited competition in some markets, and DOT is formulating a policy to identify anticompetitive behavior that could be subject to formal enforcement action. DOT is also evaluating how effectively slots are being used at the four slot-controlled airports. In addition, to address the slot problem that we identified, DOT has granted several additional slots for new entrant airlines at O'Hare and LaGuardia.

Several bills have been introduced in the Congress to promote domestic competition and improve fares and service. The proposals include increasing access to slot-controlled airports, limiting the time that DOT has to respond to complaints of predatory behavior and providing loan guarantees to commuter air carriers to purchase regional jets to use in their underserved markets.

Regardless of the outcome of these proposals, Federal actions alone cannot solve the problems. Community leaders in the Southeast and Appalachia have initiated a coordinated effort to improve air service in their regions. Their efforts include periodically convening national roundtables to bring together Federal, State and local officials, as well as airline, airport and business representatives to explore potential solutions to their air service problems. Businesses concerned about the high fares they are paying in markets dominated by one established airline need to continue to work together to find market-based solutions and focus attention on the problems.

Economic forces in the private sector appear to be creating opportunities for air carriers to use 50- to 70-seat regional jets. Regional jets can improve the quality of air service on existing routes when carriers substitute them for turboprops, and can provide new service for routes that turboprops cannot economically serve. Although regional jets currently make up only a small portion of commuter aircraft, as commuter carriers continue to order them, the air service problems of some of the communities might be mitigated.

PREPARED STATEMENT

In conclusion, our work has identified pockets of pain in a number of small and medium-sized communities, and a growing number of business travelers seem to be increasingly concerned about the air fares they are paying. This underscores the importance of congressional hearings like this to examine potential solutions to the problems.

That concludes my statement. I would be happy to answer any questions.

[The statement follows:]

PREPARED STATEMENT OF JOHN H. ANDERSON

AIRLINE COMPETITION: BARRIERS TO ENTRY CONTINUE IN SOME DOMESTIC MARKETS

Mr. Chairman and Members of the Subcommittee: We appreciate the opportunity to testify on the air service problems that some communities have experienced since the deregulation of the industry in 1978. Airline deregulation has led to lower fares and better service for most air travelers largely because of increased competition spurred by the entry of new airlines into the industry and established airlines into new markets. As we reported in 1996 and 1997, however, some airports have not experienced such entry and thus have experienced higher fares and/or less convenient service since deregulation.[1] Our testimony today summarizes the findings from our prior work on these fare and service trends, factors contributing to the problems, and the initiatives by the Department of Transportation (DOT) and others to address these problems. In summary:

—Not all communities have benefited from airline deregulation. Certain airports—particularly those serving small and medium-sized communities in the East and upper Midwest—have experienced higher fares and/or poorer service since deregulation. There are several reasons for the substantial regional differences in fare and service trends, including the dominance of routes to and from these airports by one or two traditional hub-and-spoke airlines[2] and operating barriers, such as long-term exclusive-use gate leases at hub airports. In contrast, the more widespread entry of new airlines at airports in the West and Southwest since deregulation—and the resulting geographic differences in fare and service trends—has stemmed largely from the greater economic growth in those regions as well as from the absence of dominant market positions of incumbent airlines and barriers to entry.

—Operating barriers—slot controls, restrictive gate leases, and perimeter rules[3]—continue to block entry at key airports and contribute to fare and service problems in the East and upper Midwest. To minimize congestion and reduce flight delays, the Federal Aviation Administration has set limits since 1969 on the number of takeoffs or landings—referred to as "slots"—that can occur during certain periods of the day at four congested airports—Chicago O'Hare, Ronald Reagan Washington National, and New York's Kennedy and LaGuardia. A few airlines control most of the slots at these airports, which limits new entrants. In 1996 we reported that the vast majority of gates at six airports in the East and upper Midwest were exclusively leased to usually one airline, making it very difficult to gain competitive access to these airports. In addition, perimeter rules at LaGuardia and National airports limit the ability of airlines based in the West to compete at those airports. These operating barriers, combined with certain marketing strategies by established carriers, have deterred new entrant airlines while fortifying established carriers' dominance at key hubs in the East and upper Midwest.

—Increasing competition and improving air service at airports serving communities that have not benefited from deregulation will likely entail a range of federal, regional, local, and private-sector initiatives. DOT is undertaking several efforts to enhance competition, such as granting slots to new entrants at 2 airports and formalizing a policy that will identify anticompetitive behavior and factors DOT will consider if it pursues formal enforcement actions to correct such behavior. In addition, recently proposed legislation would address several barriers to competition: slot controls, the perimeter rule, and predatory behavior by air carriers. Recent national and regional conferences exemplify efforts to pool available resources to focus on improving the airfares and quality of air service to such communities. Other steps—

[1] "Airline Deregulation: Changes in Airfares, Service, and Safety at Small, Medium-Sized, and Large Communities" (GAO/RCED–96–79, Apr. 19, 1996), "Airline Deregulation: Barriers to Entry Continue to Limit Competition in Several Key Domestic Markets" (GAO/RCED–97–4, Oct. 18, 1996), "Airline Deregulation: Addressing the Air Service Problems of Some Communities" (GAO/T–RCED–97–187, June 25, 1997), and "Domestic Aviation: Barriers to Entry Continue to Limit Benefits of Airline Deregulation" (GAO/T–RCED–97–120, May 13, 1997). Related GAO products are listed at the end of this statement.

[2] These airlines include the nation's seven largest: American Airlines, Continental Airlines, Delta Air Lines, Northwest Airlines, TWA, United Airlines, and US Airways.

[3] Rules that prohibit flights to and from airports that exceed a certain distance.

such as improving the availability of gates—may also be needed to further ameliorate current competitive problems.

BENEFITS OF DEREGULATION HAVE BEEN UNEVEN

Our April 1996 report found that since deregulation, as expected, fares had fallen and service had improved for most large-community airports. However, without the cross-subsidy that was present when the industry was regulated, experts also expected fares to increase somewhat at airports serving small and medium-sized communities and expected service to decline. We found, in fact, that since deregulation, substantial regional differences have existed in fare and service trends, particularly among small and medium-sized community airports. A primary reason for these differences has been the greater degree of economic growth that has occurred over the past two decades in the West and Southwest and in larger communities nationwide. In particular, we noted that most low-fare airlines that began interstate air service after deregulation, such as Southwest Airlines[4] and Reno Air, had decided to enter airports serving communities of all sizes in the West and Southwest because of these communities' robust economic growth. By contrast, low-fare airlines had generally avoided serving small- and medium-sized-community airports in the East and upper Midwest, in part because of the slower growth, harsher weather, and greater airport congestion in these regions.

Our review of the trends in fares between 1979 and 1994 for a sample of 112 small-, medium-sized, and large-community airports identified 15 airports where fares, adjusted for inflation, had declined by over 20 percent and 8 airports where fares had increased by over 20 percent.[5] Each of the 15 airports where fares declined was located in the West or Southwest, and low-fare airlines accounted for at least 10 percent of the passenger boardings at all but one of those airports in 1994.[6] On the other hand, each of the eight airports where fares had increased by over 20 percent since deregulation was located in the Southeast and the Appalachian region.

Our April 1996 report also discussed similar trends in service quantity and quality since deregulation. Large communities, in general, and communities of all sizes in the West and Southwest had experienced a substantial increase in the number of departures and available seats as well as improvements in such service quality indicators as the number of available nonstop destinations and the amount of jet service. Over time, however, smaller- and medium-sized communities in the East and upper Midwest had generally experienced a decline in the quantity and quality of air service. In particular, these communities had experienced a sharp decrease in the number of available nonstop destinations and in the amount of jet service relative to turboprop service. This decrease occurred largely because established airlines had reduced jet service from these airports and deployed turboprops to link the communities to those airlines' major hubs.

AIRLINE BARRIERS TO ENTRY PERSIST AND PREDOMINANTLY AFFECT COMPETITION IN THE EAST AND UPPER MIDWEST

We reported in October 1996 that operating barriers at key hub airports in the upper Midwest and the East, combined with certain marketing strategies of the established carriers, had two effects on competition. The operating barriers and marketing strategies deterred new entrant airlines and fortified established carriers' dominance of those hub airports and routes linking those hubs with nearby small- and medium-sized-community airports. In the upper Midwest, there is limited competition in part because two airlines control nearly 90 percent of the takeoff and landing slots at O'Hare, and one airline controls the vast majority of gates at the airports in Minneapolis and Detroit under long-term, exclusive-use leases. Similarly, in the East, one airline controls the vast majority of gates under exclusive-use leases at Cincinnati, Charlotte, and Pittsburgh and a few established airlines control most of the slots at National, LaGuardia, and Kennedy. Perimeter rules at LaGuardia and National further limit the ability of airlines based in the West to compete in those markets.

[4] Before deregulation, Southwest provided intrastate air service within Texas.

[5] Our sample of 112 airports included 49 airports serving small communities, 38 serving medium-sized communities, and 25 serving large communities. In 1994, these airports accounted for about two-thirds of all domestic airline departures and passenger enplanements in the United States. We defined small communities as those with a metropolitan statistical area population of 300,000 or less, medium-sized communities as those with a metropolitan statistical area population of 300,001 to 600,000, and large communities as those with a metropolitan statistical area population of 1.5 million or more.

[6] Of the 15 airports, 5 serve small communities, 5 serve medium-sized communities, and 5 serve large communities.

Particularly for these key markets in the upper Midwest and East, the relative significance of these barriers in limiting competition and contributing to higher airfares has grown over time. As a result, our October 1996 report recommended that DOT take action to lower the operating barriers and highlighted areas for potential congressional action. Our 1996 report also discussed the effects of some marketing strategies of incumbent airlines on competition.

Slots

To reduce congestion, the Federal Aviation Administration (FAA) has limited since 1969 the number of takeoffs and landings that can occur at O'Hare, National, LaGuardia, and Kennedy. By allowing new airlines to form and established airlines to enter new markets, deregulation increased the demand for access to these airports. Such increased demand complicated FAA's efforts to allocate takeoff and landing slots equitably among the airlines. To minimize the government's role in the allocation of slots, in 1985 DOT began to allow airlines to buy and sell them to one another. Under this "Buy/Sell Rule," DOT "grandfathered" slots to the holders of record as of December 16, 1985. Emphasizing that it still owned the slots, however, DOT reserved the right to withdraw slots from the incumbents at any time. In addition, to mitigate the anticompetitive effects of grandfathering, DOT retained about 5 percent of the slots at O'Hare, National, and LaGuardia and in 1986 distributed them in a random lottery to airlines having few or no slots at those airports.

Even with the lottery, we found that the level of control over slots by a few established airlines had increased over time. By contrast, the share held by the airlines that started after deregulation has remained low. (See app. I.) To address this problem, in October 1996, we recommended that DOT redistribute some of the grandfathered slots to increase competition, taking into account the investments made by those airlines at each of the slot-controlled airports. We were envisioning that a small percentage of slots would be redistributed. In response to our report, DOT has begun to use the authority that the Congress gave it in 1994 to allow additional slots for entry at O'Hare, LaGuardia, and Kennedy.[7] In October 1997, DOT awarded Reno Air and Trans States Airlines exemptions from slot limitations at O'Hare, while Frontier Airlines, ValuJet Airlines,[8] and AirTran Airways were granted exemptions at LaGuardia. These exemptions should help to enhance service in the East and upper Midwest. For example, Trans States Airlines received 8 exemptions to provide service between O'Hare and its choice of Asheville, North Carolina; Chattanooga, Tennessee; Roanoke, Virginia; and Tri-Cities, Tennessee/Virginia.[9]

Long-term, Exclusive-use Gate Leases

Our reports have also identified restrictive gate leases as a barrier to establishing new or expanded service at some airports. These leases permit an airline to hold exclusive rights to use most of an airport's gates over a long period of time, commonly 20 years. Such leases prevent nonincumbents from securing necessary airport facilities on equal terms with incumbent airlines. To gain access to an airport where most gates are exclusively leased, a nonincumbent must sublet gates from the incumbent airlines—often at nonpreferred times and at a higher cost than the incumbent pays.

While some airports, such as Los Angeles International, have attempted to regain more control of their facilities by signing less restrictive, shorter-term leases once the exclusive-use leases expired, our October 1996 report identified several airports where entry was still limited because of long-term, exclusive-use gate leases with one airline. We identified six airports in particular where this occurred: Charlotte; Cincinnati; Detroit; Minneapolis; Newark, New Jersey; and Pittsburgh. The vast majority of gates at each airport are exclusively leased, usually to one established airline. (See app. II.) As a result, it is extremely difficult to gain competitive access to these airports, according to executives at many airlines that started after deregulation.

Although the development, maintenance, and expansion of airport facilities is essentially a local responsibility, most airports are operated under federal restrictions that are tied to the receipt of federal grant money from FAA. To address the gate lease problem, we recommended that when disbursing airport improvement grant

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[7] The FAA Authorization Act of 1994 (Public Law 103–305, section 206) created an exemption provision to allow additional slots at O'Hare, LaGuardia, and Kennedy when DOT "finds it to be in the public interest and the circumstances to be exceptional." The number of flights at National Airport is further limited by federal law to address local concerns about noise. As a result of these additional limits, the Congress chose not to extend DOT's exemption authority to include National.

[8] ValuJet is now AirTran Airlines.

[9] Each exemption is one arrival or departure.

moneys, FAA give priority to those airports that do not lease the vast majority of their gates to one airline under long-term, exclusive-use terms. DOT did not concur with this recommendation. According to DOT, because the number of airports that we identified as presenting gate access problems is sufficiently small, the agency would prefer to address those problems on a case-by-case basis. DOT emphasized that in cases where incumbent airlines are alleged to have used their contractual arrangements with local airport authorities to block new entry, the agency will investigate to determine whether the behavior constitutes an unfair or deceptive practice or an unfair method of competition. If so, the agency noted that it will take appropriate action.

Perimeter Rules

At LaGuardia and National airports, perimeter rules prohibit incoming and outgoing flights that exceed 1,500 and 1,250 miles, respectively. The perimeter rules were designed to promote Kennedy and Dulles airports as the long-haul airports for the New York and Washington metropolitan areas. However, the rules limit the ability of airlines based in the West to compete because those airlines are not allowed to serve LaGuardia and National airports from the markets where they are strongest. By contrast, because of their proximity to LaGuardia and National, each of the seven largest established carriers is able to serve those airports from its principal hub.

While the limit at LaGuardia was established by the Port Authority of New York & New Jersey, National's perimeter rule is federal law.[10] Thus, in our October 1996 report, we suggested that the Congress consider granting DOT the authority to allow exemptions to the perimeter rule at National when proposed service will substantially increase competition. We did not recommend that the rule be abolished because removing it could have unintended negative consequences, such as reducing the amount of service to smaller communities in the Northeast and Southeast. This could happen if major slot holders at National were to shift their service from smaller communities to take advantage of more profitable, longer-haul routes. As a result, we concluded that a more prudent course to increasing competition at National would be to examine proposed new services on a case-by-case basis.

Marketing Strategies

Our October 1996 report also emphasized that certain marketing strategies of incumbent airlines, taken together, had created strong loyalty among passengers and travel agents, making it difficult for nonincumbents to enter markets dominated by an established airline. Two strategies in particular—booking incentives to travel agents and frequent flier plans—have encouraged business flyers, who represent the most profitable segment of the industry, to use the dominant carrier in each market. Because about 90 percent of business travel is booked through travel agencies, airlines strive to influence the agencies' booking patterns by offering special bonus commissions as a reward for booking a targeted proportion of passengers on their airline. Similarly, frequent flier programs have become an increasingly effective tool to encourage customers' loyalty to a particular airline. As such, entry by new and established airlines alike into a market dominated by one carrier is very difficult. This is particularly true given that to attract new customers a potential entrant must announce its schedule and fares well in advance of beginning service, thus giving the incumbent an opportunity to adjust its marketing strategies. Such adjustments by the incumbent may include matching low fares offered by new entrant airlines and selling far more seats at these low fares than are being offered by the new entrants. In many cases, we found that airlines chose not to enter or to quickly exit markets where they did not believe they could overcome the combined effect of these marketing strategies.

In October 1996, we reported that the effect of these and other marketing strategies tends to be the greatest—and fares the highest—in markets where the dominant carrier's position is protected by operating barriers. However, we also noted that the marketing strategies produced consumer benefits, such as free frequent flier trips, and concluded that short of an outright ban, few policy options existed that would mitigate the marketing strategies' negative impact on new entry.

RANGE OF INITIATIVES WILL LIKELY BE NEEDED TO ADDRESS AIR SERVICE PROBLEMS

Because a variety of factors has contributed to higher fares and poorer service that some small and medium-sized communities in the East and upper Midwest have experienced since deregulation, a coordinated effort involving federal, regional, local, and private-sector initiatives may be needed. Recent efforts by DOT and pro-

[10] The Metropolitan Washington Airports Act of 1986 (49 U.S.C. Sec. 49109).

posed legislation are aimed at enhancing competition. Additional public and private activities are currently under way to address regional and local air service problems. If successful, these initiatives would complement, and potentially encourage, the increasing use of small jets by the commuter affiliates of established airlines—a trend that has the potential for increasing competition and improving the quality of service for some communities.

DOT has Begun Efforts to Increase Competition

In response to our October 1996 report, DOT stated in January 1997 that it shared our concerns that barriers to entry limit competition in the airline industry. As we mentioned earlier in this testimony, in October 1997, DOT granted slots to two new entrants at O'Hare and three new entrants at LaGuardia. At the same time, DOT set forth its new policy on slot exemptions, which has been expanded to take into account the need for increased competition at the slot-controlled airports. DOT is currently considering other slot exemptions but acknowledged that there are only a limited number of exemption opportunities. Because some in government and academia believe that slots at some airports may be underutilized, DOT is also evaluating how effectively slots are being used at these airports.

In addition, DOT has expressed concern about potentially overaggressive attempts by some established carriers to thwart new entry. According to DOT, over the past 2 years, there has been an increasing number of alleged anticompetitive practices—such as predatory conduct—aimed at new competition, particularly at major network hubs. DOT is formulating a new policy to clearly delineate what is acceptable and unacceptable behavior in the area of competition between major carriers at their hubs and smaller, low-cost competitors. The policy will indicate those factors that DOT will consider if it pursues formal enforcement actions to correct unacceptable behavior.

Proposed Legislation Would Address Competition Issues

Over the past several months, a number of bills have been proposed to promote aviation competition and address some of the problems we identified.[11] The proposals include creating a mechanism by which DOT would increase access to the slot-controlled airports by periodically withdrawing a small portion of the slots that were grandfathered to incumbent airlines and reallocating them among new entrant and limited incumbent air carriers. The proposals also include requiring DOT to grant exemptions to the perimeter rule at National under certain circumstances, limiting the time that DOT has to respond to complaints of predatory behavior, and providing loan guarantees for commuter air carriers to purchase regional jet aircraft for use in underserved markets.

Regional, State, and Local Initiatives Undertaken to Improve Service

Recognizing that federal actions alone would not remedy their regions' air service problems, several airport directors and community chamber of commerce officials in the Southeast and Appalachian regions have begun a coordinated effort to improve air service in their region. As a result of this effort, several Members of Congress from these regions in turn organized a bipartisan caucus named "Special Places of Kindred Economic Situation" (SPOKES). Among other things, SPOKES is designed to ensure sustained consumer education and coordinate federal, state, local, and private efforts to address the air service problems of communities adversely affected since deregulation. Two SPOKES-led initiatives include establishing a Website on the Internet and convening periodic "national air service roundtables" to bring together federal, state, and local officials and airline, airport, and business representatives to explore potential solutions to air service problems.

The first roundtable was held in Chattanooga in February 1997. The roundtable concluded that greater regional, state, and local efforts were needed to promote economic growth and attract established and new airlines alike to serve small and medium-sized markets in the East and upper Midwest. Suggested initiatives included (1) creating regional trade associations composed of state and local officials, airport directors, and business executives; (2) offering local financial incentives to non-incumbent airlines, such as guaranteeing a specified amount of revenue or providing promotional support; and (3) targeting aggressive marketing efforts by communities toward airlines to spur economic growth. A second roundtable was held in Jackson, Mississippi, in January 1998.

[11] For example, see H.R. 2748 (sponsored by Representative J. Duncan), H.R. 3160 (sponsored by Representative C. Schumer), H.R. 3179 (sponsored by Representative T. Manton), S. 1331 (sponsored by Senator J. McCain), and S. 1353 (sponsored by Senator B. Frist).

A regional conference, held in West Virginia in December 1997, brought together federal and state officials, airport representatives, and local businesses to discuss ways to restore quality air service to small communities in the state. In West Virginia, for example, Wheeling, Elkins, and Martinsburg have lost all scheduled air service since deregulation. Throughout the state, communities have experienced declines in the number of nonstop flights, the number of seats available, and the number of jet flights. Regional concerns about air service have extended to other states and conferences were recently held in Iowa and Arizona.

Private-Sector Initiatives are Addressing Air Service

To grow and prosper, businesses need convenient, affordable air service. As a result, businesses located in the affected communities have increasingly attempted to address their communities' air service problems. Perhaps the most visible of these efforts was the formation of the Business Travel Contractors Corporation (BTCC) by 45 corporations, including Chrysler Motors, Procter & Gamble, and Black & Decker. These corporations formed BTCC because they were concerned about the high fares they were paying in markets dominated by one established airline. BTCC held national conferences in Washington, D.C., in April and October 1997 to examine this problem and explore potential market-based initiatives. At the October conference, attendees endorsed the concepts of (1) holding periodic slot lotteries to provide new entrant airlines with access to slot-controlled airports, (2) allowing new entrants and other small airlines to serve points beyond National's perimeter rule, and (3) requiring DOT to issue a policy addressing anticompetitive practices and specifying the time frames within which all complaints will be acted upon. While BTCC suspended operations in January 1998, its lobbying arm—the Business Travel Coalition—plans to continue efforts to increase competition.

Airlines' Use of Regional Jets is Improving Service

In addition to public and private-sector initiatives, the increasing use of 50- to 70-seat regional jets is improving the quality of air service for a growing number of communities. Responding to consumers' preference to fly jets rather than turboprops for greater comfort, convenience, and a perceived higher level of safety, commuter affiliates of established airlines are increasingly using regional jets to (1) replace turboprops on routes between established airlines' hubs and small and medium-sized communities and (2) initiate nonstop service on routes that are either uneconomical or too great a distance for commuter carriers to serve with slower, higher-cost, and shorter-range turboprops.

Because regional jets can generally fly several hundred miles farther than turboprops, commuter carriers will be able to link more cities to established airlines' hubs. To the extent that this occurs, it could increase competition in many small and medium-sized communities by providing consumers with more service options.

Mr. Chairman, this concludes our prepared statement. We would be glad to respond to any questions that you or any Members of the Subcommittee may have.

APPENDIX I

PERCENTAGE OF DOMESTIC AIR CARRIER SLOTS HELD BY SELECTED GROUPS

Airport	Holding entity	1986	1991	1996
O'Hare	American and United	66	83	87
	Other established airlines	28	13	9
	Financial institutions	....	3	2
	Post-deregulation airlines	6	1	1
Kennedy	Shawmut Bank, American, and Delta	43	60	75
	Other established airlines	49	18	13
	Other financial institutions	....	19	6
	Post-deregulation airlines	9	3	7
LaGuardia	American, Delta, and US Airways	27	43	64
	Other established airlines	58	39	14
	Financial institutions	....	7	20
	Post-deregulation airlines	15	12	2
National	American, Delta, and US Airways	25	43	59

PERCENTAGE OF DOMESTIC AIR CARRIER SLOTS HELD BY SELECTED GROUPS—Continued

Airport	Holding entity	1986	1991	1996
	Other established airlines	58	42	20
	Financial institutions	....	7	19
	Post-deregulation airlines	17	8	3

Notes: Numbers may not add to 100 percent because of rounding. Some airlines that held slots have gone bankrupt, and as a result, financial institutions have acquired slots.
Source: GAO's analysis of data from the Federal Aviation Administration.

APPENDIX II

AIRPORTS WHERE POST-DEREGULATION AIRLINES REPORTED DIFFICULTY GAINING COMPETITIVE ACCESS TO GATES, AND THE LEASING ARRANGEMENTS AT THOSE AIRPORTS, 1996

Airport	Total number of jet gates	Gates under exclusive-use leases	Percent	Major lease holders and dates of lease expiration
Charlotte	48	43	90	34 gates leased to USAir until 2007.
Cincinnati	67	67	100	50 gates leased to Delta with 9 leases expiring in 2015 and 41 expiring in 2023.
Detroit	86	76	88	64 gates leased to Northwest until the end of 2008, with all but 10 under exclusive-use terms.
Minneapolis	65	65	100	49 gates leased to Northwest with 16 leases having expired as of 1996 and on month-to-month basis, and remainder expiring at various times ranging from the end of 1997 to 2015.
Newark	94	79	84	43 gates leased to Continental until 2013, 36 gates leased to the other established airlines until 2018, and 15 gates reserved primarily for international use.
Pittsburgh	75	66	88	50 gates leased to USAir until 2018.

Source: GAO's presentation of the airports' data, from "Airline Deregulation: Barriers to Entry Continue to Limit Competition in Several Key Domestic Markets" (GAO/RCED–97–4, Oct. 18, 1996).

RELATED GAO PRODUCTS

"Domestic Aviation: Barriers Continue to Limit Competition" (GAO/T–RCED–98–32, Oct. 28, 1997).

"Airline Deregulation: Addressing the Air Service Problems of Some Communities" (GAO/T–RCED–97–187, June 25, 1997).

"Domestic Aviation: Barriers to Entry Continue to Limit Benefits of Airline Deregulation" (GAO/T–RCED–97–120, May 13, 1997).

"Airline Deregulation: Barriers to Entry Continue to Limit Competition in Several Key Domestic Markets" (GAO/RCED–97–4, Oct. 18, 1996).

"Changes in Airfares, Service, and Safety Since Airline Deregulation" (GAO/T–RCED–96–126, Apr. 25, 1996).

"Airline Deregulation: Changes in Airfares, Service, and Safety at Small, Medium-Sized, and Large Communities" (GAO/RCED–96–79, Apr. 19, 1996).

"Airline Competition: Essential Air Service Slots at O'Hare International Airport" (GAO/RCED–94–118FS, Mar. 4, 1994).

"Airline Competition: Higher Fares and Less Competition Continue at Concentrated Airports" (GAO/RCED–93–171, July 15, 1993).

"Airline Competition: Options for Addressing Financial and Competition Problems, testimony before the National Commission to Ensure a Strong Competitive Airline Industry" (GAO/T–RCED–93–52, June 1, 1993).

"Computer Reservation Systems: Action Needed to Better Monitor the CRS Industry and Eliminate CRS Biases" (GAO/RCED–92–130, Mar. 20, 1992).

"Airline Competition: Effects of Airline Market Concentration and Barriers to Entry on Airfares" (GAO/RCED–91–101, Apr. 26, 1991).
"Airline Competition: Weak Financial Structure Threatens Competition" (GAO/RCED–91–110, Apr. 15, 1991).
"Airline Competition: Fares and Concentration at Small-City Airports" (GAO/RCED–91–51, Jan. 18, 1991).
"Airline Deregulation: Trends in Airfares at Airports in Small and Medium-Sized Communities" (GAO/RCED–91–13, Nov. 8, 1990).
"Airline Competition: Industry Operating and Marketing Practices Limit Market Entry" (GAO/RCED–90–147, Aug. 29, 1990).
"Airline Competition: Higher Fares and Reduced Competition at Concentrated Airports" (GAO/RCED–90–102, July 11, 1990).
"Airline Deregulation: Barriers to Competition in the Airline Industry" (GAO/T–RCED–89–65, Sept. 20, 1989).
"Airline Competition: DOT's Implementation of Airline Regulatory Authority" (GAO/RCED–89–93, June 28, 1989).
"Airline Service: Changes at Major Montana Airports Since Deregulation" (GAO/RCED–89–141FS, May 24, 1989).
"Airline Competition: Fare and Service Changes at St. Louis Since the TWA-Ozark Merger" (GAO/RCED–88–217BR, Sept. 21, 1988).
"Competition in the Airline Computerized Reservation Systems" (GAO/T–RCED–88–62, Sept. 14, 1988).
"Airline Competition: Impact of Computerized Reservation Systems" (GAO/RCED–86–74, May 9, 1986).
"Airline Takeoff and Landing Slots: Department of Transportation's Slot Allocation Rule" (GAO/RCED–86–92, Jan. 31, 1986).
"Deregulation: Increased Competition Is Making Airlines More Efficient and Responsive to Consumers" (GAO/RCED–86–26, Nov. 6, 1985).

STATEMENT OF PATRICK V. MURPHY

Senator SHELBY. Thank you.

Mr. Murphy, welcome again to the committee.

Mr. MURPHY. Thank you, Mr. Chairman.

In this the 20th anniversary year of airline deregulation, the Department of Transportation continues to view deregulation as a great success. The positive benefits for the country from airline deregulation, I think, are unmistakable: average fares that are one-third lower after we adjust for inflation, more useful service for more cities, more innovation, greater efficiency, more employment, and many other benefits.

Nevertheless, not all of our cities and our regions have shared in the full benefits of deregulation. It has become increasingly clear over the past 2 years that some of these inequities are growing. We have known, for example, that average fares at hub airports where one airline dominates have tended to be high, especially if low-fare airlines have not been able to enter these airports. Premiums, that is, the difference between average fares at dominated hubs and at other airports, have increased substantially in recent years. These high fares affect more than just the hub cities.

Spoke cities served primarily by a dominant airline to the respective hubs likewise have high average fares. These facts lead us to conclude that new entry and expansion by low-fare airlines is the key to the competitive vigor of the U.S. domestic airline industry, particularly in markets that involve dominated hub airports.

We also know based on our data that the level of competition nationally is declining when measured by the number of competitors in all markets around the country. For the time being, Mr. Chairman, new entry has virtually stopped and most low-fare carriers are struggling financially. Therefore, barriers to entry faced by low-fare airlines deserve careful study.

The Department has come to the view that the single most important impediment to new entry may be unfair actions taken by major airlines against new entrant airlines, particularly in markets that involve a major's hub airport. These actions typically involve fare cuts and capacity increases. Therefore, DOT has developed a competition policy statement that it plans to release in the near future.

The policy statement will set forth a proposal for a broad competition standard and proposed guidelines that will identify the types of behavior that are likely to cause DOT to initiate an enforcement proceeding. The guidelines are designed to allow normal competitive responses and only prohibit extreme exclusionary behavior.

Secretary Slater will be calling for a full and honest discussion on the proposed guidelines in an effort to work with industry, lawmakers, consumers, city leaders, State officials, and others affected by the airline industry. The end result, we hope, will be a clear informed policy that preserves competition and protects consumers.

In addition to unfair behavior, Mr. Chairman, I have also identified in my testimony other barriers to entry. Without going into those, I will just enumerate them here again, and they are slots, computer reservation systems, airport gates——

SLOT-CONTROLLED AIRPORTS

Senator SHELBY. Excuse me, sir. Elaborate a little, expand on slots and gates or whatever.

Mr. MURPHY. Yes; we have four airports in this country that are slot-controlled.

Senator SHELBY. What are these airports?

Mr. MURPHY. Those airports are O'Hare in Chicago, LaGuardia and JFK in New York, and National or Reagan National in Washington. There are limited number of takeoffs and landings at those airports. Those limitations were put in place as a temporary measure in 1968. Thirty years later, they remain in place. They remain, we believe, a barrier to entry. We have been granting some exemptions around those limitations, but they do remain in place.

Gates are an issue that the GAO has identified. The Department has done very little in that area. I must say after today's hearing and based on comments we have received in the last few weeks, I think that the DOT and the FAA need to focus more on the issue of airport gates at dominated airports.

Senator SHELBY. Is that not a big barrier from what we are hearing here? Mr. Anderson has seemed to indicate it, and the others have testified to that.

Mr. MURPHY. Yes.

Senator SHELBY. It seems sort of obvious.

Mr. MURPHY. When we were first alerted to this by GAO, we at that time asked small carriers to notify us if this became a problem. They are now beginning to notify us. We have heard several complaints just in the last few months about unavailability of gates at Detroit, Newark, Atlanta to name three. I do believe it is time the Department spent more time with the FAA on this topic.

Other barriers, Mr. Chairman, potentially are computer reservation systems and travel agent commission overrides, which we have heard about today.

Senator SHELBY. What do you mean by an override? Is that a bonus?

Mr. MURPHY. Yes, sir; if an airline, a large airline, will pay an extra high commission, especially only on one route where there is a new entrant airline, then they will double or triple the commission on that one route, that certainly sets off concern.

Then, finally, there is even a potential for the very popular frequent flier programs to be used as a barrier to entry.

PREPARED STATEMENT

In conclusion, Mr. Chairman, I have listed several practices which have raised concerns. I must say any consideration of action in these areas must be approached carefully. The potential for doing more harm than good is real. Competition in the real world is never perfect. At this time, airline deregulation works reasonably well. While action in some areas is in the Department's estimate clearly required, we take the view that only careful, measured steps are appropriate.

Thank you, Mr. Chairman.

[The statement follows:]

PREPARED STATEMENT OF PATRICK V. MURPHY

Thank you Mr. Chairman, and members of the subcommittee. I appreciate the opportunity to discuss the subject of barriers to competition in the U.S. domestic airline industry.

In this 20th anniversary year of airline deregulation, the department continues to view deregulation as a great success. The positive benefits for the country from airline deregulation are unmistakable—average fares that are one-third lower after adjusting for inflation, more useful service to more cities, more innovation, greater efficiency, more employment, and many other benefits. All the while, the airline fleets have been getting quieter and safety has increased. And of course, the innovations and efficiencies of U.S. airlines make them the global leaders to the benefit of our economy and consumers, as well as travelers around the world.

Nevertheless, not all our cities and regions have shared in the full benefits of deregulation, and it has become increasingly clear over the past two years that some of these inequities are growing. We have known, for example, that average fares at hub airports, where one airline dominates, have tended to be high, especially if low-fare airlines have not been able to enter these airports. And "premiums", that is the difference between average fares at dominated hubs and other airports, have increased substantially in recent years. And these high fares affect more than just hub cities. We know that spoke cities served primarily by dominant airlines to their respective hubs likewise have high average fares. And we know that even between hub cities where more than one of the major network airlines flies, fares tend to be high and are only "competed down" significantly when low-fare competition enters the market.

These facts led us to conclude that new entry and expansion by low-fare airlines is the key to the competitive vigor of the U.S. domestic airline industry, particularly in markets that involve dominated hub airports. We also know, based on our data, that the level of competition nationally is declining when measured by the number of competitors in all markets around the country. For the time being new entry has virtually stopped, and most low-fare carriers are struggling financially. Therefore, barriers to entry faced by low-fare airlines deserve careful study.

The types of barriers to entry that I am going to discuss include a range of activities—from those that the department has already begun to address to others that the department believes do not necessarily need to be corrected. Some of these practices have clear consumer benefits, and we have seen successful entry by low-fare airlines in spite of some of these barriers. In fact, more than 40 percent of domestic passengers today travel in markets with low-fare competition.

On the other hand, a combination of a number of these competitive tools if used selectively to impede the entry of low-fare service in particular markets could rise to the level of anticompetitive behavior. Therefore, I list below practices which may be barriers to entry that might require action in particular instances. However, I do not suggest industrywide action is appropriate on each of them.

UNFAIR EXCLUSIONARY PRACTICES.

The department has come to the view that the single most important impediment to new entry may be unfair actions taken by major airlines against new entrant airlines, particularly in markets that involve a major's hub airport. These actions typically involve fare cuts and capacity increases. Therefore, DOT has developed a competition policy statement that it plans to release in the near future.

The policy statement will set forth a proposal for a broad competition standard, and proposed guidelines that will identify the types of behavior that are likely to cause DOT to initiate an enforcement proceeding. The guidelines are designed to allow normal competitive responses and only prohibit extreme exclusionary behavior. In investigations triggered by our guidelines, we will also look closely at the way other barriers like those mentioned below may have been used in an unfair and focused way against a new entrant.

Secretary Slater will be calling for a full and honest discussion on the proposed guidelines in an effort to work with industry, lawmakers, consumers, city leaders, state officials, and others affected by the airline industry. The end result, we hope, will be a clear and informed policy that preserves competition and protects consumers.

SLOTS

Four major airports in the U.S.—O'Hare in Chicago, LaGuardia and JFK in New York and Reagan National in Washington—have limits on the number of take-offs and landings under an FAA regulation known as the high density airport rule. Although in 1985 the regulations incorporated a market mechanism to distribute slots known as the buy-sell rule, the effect of the rule has been to concentrate slots in the hands of the larger airlines. It is virtually impossible for a new entrant to gain access to a slot controlled airport for domestic jet service. Therefore, the department has recently used authority granted by Congress in 1994 to grant a limited number of exemptions to the high density rule to new entrants as a way of promoting competition. Some additional exemption applications are pending, and we hope to act on those.

The GAO has recommended further that slots be periodically withdrawn from incumbents and distributed to new entrants. Several bills have been introduced that take this approach. The department is currently studying whether slots are being effectively used by incumbents.

COMPUTER RESERVATION SYSTEMS

Most airlines rely heavily on travel agents to sell their tickets. Travel agents use computer reservation systems to obtain information on airline services and prices and make reservations. Since each system is owned by one or more airlines, it has long been recognized that the airline owners have a significant ability to use the systems in an anticompetitive way. For this reason, the Civil Aeronautics Board, and now the DOT, have established rules that prevent CRS practices that prejudice non-owner airlines. In the past year DOT has adopted several new CRS rules designed to address practices that we found disadvantaged smaller carriers. Because such computer systems and other electronic marketing systems are rapidly developing and changing, DOT is now undertaking a complete review of the rules.

GATE AVAILABILITY

The availability of airport terminal gates, their location at an airport and the cost to lease a gate are matters that have the potential to be barriers to entry at some busy airports. Incumbent airlines may be in a position to use their contractual arrangements with local airport authorities to block or otherwise unfairly disadvantage new entry. In responding to a GAO report that dealt with this issue we encouraged airlines encountering gate problems to advise us. We have received a small number of such complaints. We are currently considering whether we need to do more in this area.

TRAVEL AGENT COMMISSION OVERRIDES

"Commission overrides" is the term for extra commission paid to travel agents by an airline, usually when the agent gives that airline a larger share of the agent's total bookings. If these extra high commissions are offered in a targeted manner against new entrants, they have the potential to do competitive harm. Most commonly, these commissions are based on the total volume of business a travel agent gives an airline and are not targeted against one carrier. According to a GAO report, the Justice Department conducted an investigation of override commissions during 1994 to 1996 and could not show at that time that they prevented entry into domestic airline markets. The European Commission Competition Directorate is now further considering this issue.

FREQUENT FLYER PROGRAMS

These very popular programs, which award free trips and service upgrades for mileage flown on an airline, are sometimes mentioned as a barrier to entry. Clearly, frequent flyer programs give larger airlines, which have more destinations for free trips, an advantage over smaller airlines. But these programs are very attractive to consumers and can be looked upon as a volume discount for loyal customers. Having programs that benefit consumers and thereby give a competitive edge is not something that should be discouraged, unless they are used in conjunction with other practices to unfairly target specific competitors.

In conclusion, I have listed six practices which have raised concern for some. Any consideration of action in these areas must be approached carefully. The potential for doing more harm than good is real. Competition in the real world is never perfect. At this time airline deregulation works reasonably well, and, while action in some areas is in the department's estimate clearly required, we take the view that only careful, measured steps are appropriate.

GATE CONSTRAINTS AND FARES

Senator SHELBY. Thank you both.

Mr. Anderson, at the airports that the General Accounting Office has determined that have gate constraints, are fares significantly higher than at other airports?

Mr. ANDERSON. Clearly, they are.

Senator SHELBY. Well, would you give us some examples, if you have any?

Mr. ANDERSON. Sure. We identified 10 airports as having operating barriers—either slot controls or long-term exclusive-use of gate leases. Of the six airports that have long-term exclusive-use gate leases, Charlotte, North Carolina, leads the pack. Their fares were 88 percent higher than the fares of comparable airports in the country.

There are 43 airports that are in the large hub category. At 10 of these airports, overall fares were 31 percent higher than at the other 33 airports in the category. At Charlotte the fares were 88 percent higher. Another example, in Cincinnati the fares were 84 percent higher. At Pittsburgh the fares were 72 percent higher. These airports are dominated by one airline.

Senator SHELBY. You have not multiplied that into millions of dollars or hundreds of millions, have you?

Mr. ANDERSON. No; we have not.

Senator SHELBY. It could be done, could it not?

Mr. ANDERSON. Yes.

Senator SHELBY. It is possible. In your testimony, you mention a potential solution that you suggested in your October 1996 report. Would you describe the possible solution and how the airports, the airlines and other interested parties have responded to your suggestion, if they have?

Mr. ANDERSON. This is about gates, you mean?

Senator SHELBY. Yes.

Mr. ANDERSON. Basically, what we recommended is that when the Department gives grants to airports for improvement of the airport facilities they give some extra credit for those airports that did not have long-term, exclusive-use gate leases——

Senator SHELBY. Incentives, in other words?

Mr. ANDERSON. Yes; incentives to get out of these long-term leases might be something they could do. The Department basically did not concur with us on that recommendation. They felt that there were other things that they could do in terms of investigating specific instances of predatory prices. There are a fairly limited number of airports with such leases. We identified six airports with long-term, exclusive-use gate leases.

What we heard here today, too, might help; and I wish we had thought about it at the time. The PFC route might be another way to go because PFC's do have to be approved, so that is another angle that you could look at and the Department could take into account. When PFC applications come in, make sure that they are going to be providing equal access.

AIRLINE COMPETITION

Senator SHELBY. Mr. Anderson, do you have any judgment on how many billions of dollars it is costing the consumers of America because of lack of competition in the airline industry?

Mr. ANDERSON. I do not have any numbers.

Senator SHELBY. There are some studies out there.

Mr. ANDERSON. I believe DOT cited that savings as a result of airline deregulation were about $10 billion. I do not have any idea what the cost is, but I do know that there are pockets of pain in the country where fares are higher and/or service is worse, and it needs to be addressed.

Senator SHELBY. Mr. Murphy, the witnesses on the first panel have described a range of questionable competitive tactics by the network airlines. Do you agree with the characterization of how network airlines compete with new entrant airlines that people testified here about?

Mr. MURPHY. Yes; I generally concur with the difficult time that the new entrant carriers have, and that is why we have been active in developing these guidelines for unfair, exclusionary behavior that we hope to be issuing in the next 2 weeks, and to start a dialog with the industry and with civic and congressional officials about our guidelines.

IMPROVING AVIATION COMPETITION AND SERVICE

Senator SHELBY. Mr. Murphy, have you thought about a way, or Mr. Anderson, ways that Congress and the executive branch and the President and others, especially the Justice Department, antitrust, could bring about some kind of a concerted effort to bring competition in America where it is not with the airlines?

Mr. ANDERSON. I would like to address that first, if I can?

Senator SHELBY. Yes.

Mr. ANDERSON. You know the causes of these problems are complex. You heard that with the first panel.

Senator SHELBY. Very complex.

Mr. ANDERSON. There are not any real simple solutions.

Senator SHELBY. But there are solutions.

Mr. ANDERSON. There are some solutions, and I have got a few suggestions that I will mention to you. One of the key things in terms of the problems that we are seeing is a lack of competition. The only thing that can be done to improve competition is to level the playing field, if you will, and that would be a good thing. I believe making more slots available through the Department's current relaxation of the exemption authority is a good thing, but it is going to be limited in what you can accomplish there.

I think you still have to look at some sort of slot lotteries or auctions or maybe eventually some sort of elimination of the slots, if you can ever get at that point. I think it is an excellent step and this is something that should pay some dividends in the future, if the Department follows through with its policy on defining predatory behavior and practices and follows up allegations very quickly to root these things out.

I believe another thing that would be good—and we need to look at this some more in terms of the advantages and disadvantages—is providing some sort of incentives for the regional jets.

Senator SHELBY. OK.

Mr. Murphy, as the Department of Transportation develops its proposed guidelines that would prohibit exclusionary competitive tactics, how do you plan at the Department of Transportation to address the barriers that have been discussed by the witnesses here this morning? Some would characterize your activities in this regard as inherently reregulatory in nature. How should we distinguish between reregulation and actions to enhance airline competition?

Mr. MURPHY. Mr. Chairman, I take the view that when the Congress deregulated the airlines 20 years ago they did not repeal the antitrust laws. They also——

Senator SHELBY. They have not worked, though, have they?

UNFAIR COMPETITIVE PRACTICES

Mr. MURPHY. They also charged, the Congress charged, the Department with the responsibility to make sure there were no unfair competitive practices. We have not taken a single carrier to task for unfair practices in 20 years.

Senator SHELBY. Why?

Mr. MURPHY. We have used informal jawboning.

Senator SHELBY. How has that worked?

Mr. MURPHY. We found, Mr. Chairman, until about 2 years ago that we had quite a bit of success there.

Senator SHELBY. OK.

Mr. MURPHY. New entry was occurring at a very healthy pace. In the last 2 years, our jawboning efforts have had much less success. We have had some limited success, but the larger carriers are more intent on competing very vigorously with the small carriers. We now take the view that we will put out these guidelines. We do not view them as reregulation. We view them as trying to set some standards.

As a matter of fact, we conducted an investigation based on the complaints of two small carriers. We went out and received boxes of material from the large airlines. When the large airlines gave us that material, they took the view that it would be unfair for us to come down on top of them after we read this material, because we had never set any standards. They had been competing in a certain way for decades; and if we want to come down on them, we ought to set some guidelines.

We looked at that material. We were somewhat surprised by what we saw. The intensity of what was going on was of concern. We decided to develop these guidelines.

Senator SHELBY. Were you surprised or were you appalled?

Mr. MURPHY. I will just stay with surprised for the record.

Senator SHELBY. That is rather mild.

Mr. MURPHY. At the request of some large carriers, we have developed these guidelines. Now we are hearing from some of these same large carriers that, This is reregulation. You have no legal authority. You have no authority at all on airline prices.

The Secretary is calling for everyone to lower their voices a little bit. Let us get these guidelines out there. Let us take a look at them. I thought that the chairman of Delta Airlines, Mr. Mullen, in New York gave an excellent speech a week ago when he asked everybody to be reasonable, to do just as I suggested, to see what the Government wants to do. The Government has a role here. He was willing to have a dialog on this. That is what the Secretary is asking for.

Senator SHELBY. You mentioned the role of the Government. Isn't the role of the Government in an environment where we have deregulated something to let market forces work, to let competition work, to make sure that the environment is a level playing field, to make sure there is real competition all over America everywhere? Isn't that true?

Mr. MURPHY. That is our view, Mr. Chairman. Our role here, if any, is to protect competition, not to protect companies.

Senator SHELBY. Absolutely.

Mr. MURPHY. Just to protect the competitive process so that it can work.

Senator SHELBY. Senator Lautenberg.

ENFORCEMENT ACTIONS

Senator LAUTENBERG. Thanks, Mr. Chairman.

I am sorry that I was away for such a long period of time. We had another transportation review that I was called to. If I am redundant in anything that I ask or any of the chairman's questions, please feel free to say that you have already answered.

I am kind of curious about things about what, if any, enforcement actions have been taken by the Department regarding the uncompetitive practices that may be around at various airports, at various airlines?

Mr. MURPHY. We have some rules in place, Senator, such as the computer reservation systems rules that we continue to modify, because that is one area where the large carriers who own these systems can take advantage of smaller carriers. We have just announced a major review over 18 months of all of our computer reservation system [CRS], rules. Well, that is one area.

Another area is in the area of slots. We have been granting some exemptions, basically allowing carriers to operate above the slot ceilings within the last few months. We plan to do a limited number of those, but we cannot do too many or it will overload the system.

In addition, as I mentioned to the chairman, we have in the past been able to work with carriers informally. We get a complaint from a small carrier and we bring in the carrier and we ask them what is going on and we ask them to be a little more reasonable. Typically, we get some response. We still do some of that.

We recently got some relief from some of our smaller carriers at a certain airport when we asked for a little more cooperation at that airport. We continue to do that informally. The informal process is not as productive as it had been, so most of our effort of late has been on developing these guidelines after we conducted two very thorough investigations.

Senator LAUTENBERG. Are we going to be awaiting the publishing of the report before any serious enforcement actions occur or are published?

Mr. MURPHY. Well, we have been working very closely in developing these guidelines with the Justice Department. They have worked with us on every line of these guidelines. I am pleased to point out to you that the Justice Department has now started, even while we are working jointly on these standards, recent investigations of some of the largest carriers and their competitive practices. DOT also will not hesitate even while developing these dialogs to move against the situation if we think that there is clear abuse.

AIRLINE LAWS AND RULES

Senator LAUTENBERG. Without, again, waiting for the final publication, do you feel, Mr. Murphy, that any of the anticompetitive laws ought to be changed or broadened in any way?

Mr. MURPHY. At this time, I would say no. I would recommend that our guidelines go out there. They will be, I am sure, challenged by some; but if they stand scrutiny and if they are allowed to operate, we think they can make a contribution. If some airline attorneys are correct, and we have no authority in this area, and I do not accept that, but if that were true, and we were directed by the courts to get out of this area, then the Congress might want to think whether more needs to be done. But for now, our authority to deal with unfair competitive practices and the Justice Department authority on the antitrust laws seems sufficient.

Senator LAUTENBERG. Do you have evidence that fares, in fact, have come down substantially from the point just before deregulation, and how does that compare to the expenses, the costs, for operating that we had at that time? We know one thing. I think it is fair to say that fuel prices are probably less than they were then. The passenger had larger seating spaces than they have now.

Much of the service that the passenger endures, and I use the word advisedly, is because there is less available. I mean, the carry-on baggage thing, I believe, has gotten out of hand because the airlines do not enforce whatever their rules are, two bags, one bag, something like that. I saw a lady trying to stuff an elephant up in the overhead. [Laughter.]

It was only disguised as a suitcase.

Mr. MURPHY. Did it work?

Senator LAUTENBERG. Well, it kind of squealed a little bit as it got up there. No; it is not partisan. The other guy put a donkey up there. [Laughter.]

Senator SHELBY. He put his——

Senator LAUTENBERG. Well, we will let it go at that.

Senator SHELBY. We had better stop. Stop.

ROUTINE STUDIES OF FARES

Senator LAUTENBERG. I wonder, are you under routine studies of fares? Because there is no doubt in my mind from personal experience, and some of this is anecdotal stuff that is not worth an awful lot, and, therefore, I wonder whether you could give us a report on fares in different marketplaces? Also, we want to be sure that fares, low fares, are not predatory. We want to be assured, if we can be, that prices in monopoly situations do not gouge the public's purse.

Can we get something back from you or your Department, Mr. Murphy, or from GAO giving us a comparison of the fares in major cities and major routings? For instance, it costs almost $400 to fly round trip between Washington and the New York area. It costs $400. When People's Express came into being, they were charging $19. They did not survive too long, but they did establish the efficacy of this kind of shuttle service.

I would be curious. Because there are a lot of places that you can fly roundtrip for $400 that are further than Washington to New York. Much of that fare, I think, is decided—not that fare only, I am not talking just about Washington to New York or Boston to New York—is decided based on market position. We can easily find that out if we do a little studying of the situation including the expenses that it takes.

I am not proposing reregulation, but the one thing that we know that we had to be wary of was that it changed to an unregulated environment did not bring problems for the public that did not exist before. I said that expenses were down. We know that meal service, and again I am not a proponent of meal service, but it is different. I think it is fair to say that salaries were, on the relative basis, higher then. Again, I am not trying to raise salaries.

I just would like to see a comparison that includes, Mr. Chairman, the cost for doing business as well as the fares that the public is paying.

Mr. MURPHY. Thank you.

Senator LAUTENBERG. Will you get that, by the way, for me?

Mr. MURPHY. Yes; Senator, we have done a lot of work in those areas, and we will be happy to put that together for you.

Senator SHELBY. Will you do this for the committee too?

Mr. MURPHY. Yes; Mr. Chairman.

Senator SHELBY. I want to thank all of the witnesses for their testimony today. I think we have had a spirited hearing and an interesting one. We have certainly heard some provocative things, and it reaffirms my conviction that this is an area that requires constant oversight and attention. It is clear that the entire area of aviation competition is very complicated.

I am also convinced that the competitive pressures in this industry will continue to evolve, creating new competitive scenarios and guaranteeing that establishing and maintaining a level playing field will remain a tricky business. Complex solutions are rarely the best answers to complex problems. We have got to work on it.

Congress and the administration must continue, I believe, to approach these issues cautiously, but at least approach them with a way and hope to do something about them. Clearly, competition benefits—communities and consumers and travelers, business travelers and personal travelers—everybody in America. I think we in Congress must promote as competitive an environment for airline competition as possible. Anticompetitive practices and barriers to competition must be exposed and eliminated where possible anywhere in America.

SUBCOMMITTEE RECESS

This hearing of the subcommittee is now recessed. The next subcommittee hearing will be a field hearing to be held next Monday at 9:30 at the University of Alabama in Birmingham. The topic will be the Appalachian Regional Corridor Highways. Any of you who want to fly down there competitively, you can see it.

Thank you. The subcommittee is recessed.

[Whereupon, at 12:05 p.m., Tuesday, March 5, the subcommittee was recessed, to reconvene subject to the call of the Chair.]

AIRLINE TICKETING PRACTICES AND ANTITRUST ENFORCEMENT

TUESDAY, MAY 5, 1998

U.S. SENATE,
SUBCOMMITTEE ON TRANSPORTATION
AND RELATED AGENCIES,
COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 9 a.m., in room SD–192, Dirksen Senate Office Building, Hon. Richard C. Shelby (chairman) presiding.

Present: Senators Shelby and Kohl.

NONDEPARTMENTAL WITNESSES

STATEMENT OF ALFRED KAHN, PROFESSOR EMERITUS, CORNELL UNIVERSITY

OPENING REMARKS OF SENATOR SHELBY

Senator SHELBY. The subcommittee will come to order. I want to welcome each of you to the third airline competition hearing of the Transportation Appropriations Subcommittee.

I realize it is a little early for the Senate, but we have a full panel, and we needed to move; so I got the hearing called for 9 o'clock, which is a little early.

If I have learned anything as chairman of this subcommittee, it is that the aviation industry is extremely complex. As a general matter, my philosophy is that the more complicated the problems are in the private sector, the less the Government should get involved.

However, there are remaining problems in the airline industry, problems, which affect real people every day. These hearings are designed to highlight some of those problems and to explore possible solutions to some of them.

In the first hearing we examined the remaining relics of regulation still present in the system, such as slots and perimeter rules. More recently, we heard from various airline executives who explained how the larger established airlines compete with each other and with new entrants.

Today, our focus is on the status of deregulation and airline ticketing practices, including yield management strategies and on the application of the antitrust laws to the aviation industry.

Before I introduce our witnesses today, I want to make one thing very clear. My end goal here is increased competition among the airlines. Competition benefits the consumer by lowering ticket prices and improving service.

I am not interested at all in trying to reregulate the airline industry. And, in fact, I will oppose any such efforts.

However, I do want to ensure that competition is maximized, and that the antitrust laws we have on the books are being enforced so that consumers may benefit from the maximum amount of competition possible.

On our first panel today, we have Dr. Alfred Kahn. Dr. Kahn is well-known and is known as the father of airline deregulation, and is probably one of the most knowledgeable individuals in the world on aviation economics.

He will give us today a sense of the state of competition in the airline industry and what has happened since deregulation.

I hope he will also comment, if he cares to, on the effect the potential airline alliances will have on consumers as well as the Department's recent guidelines on predatory pricing.

On our second panel, we will hear from Professor Darryl Jenkins, director of the Aviation Institute at George Washington University. Professor Jenkins will give us a better understanding of how airlines price their tickets and the rationale behind the yield management strategy.

We will also hear from Mr. Larry Darby, an expert in the telecommunications industry, who will discuss how lessons that were learned from deregulating the telecommunications industry could apply to the aviation industry.

We will also hear from two representatives of the travel agents, Mr. Borden Burr from my home State of Alabama, and Ms. Lauraday Kelley, who will share some real live stories of problems their customers have with airline ticketing practices.

Last, we will hear from Mr. Patrick Murphy, Deputy Assistant Secretary of the Department of Transportation. Mr. Murphy is the administration's point man on airline competition and has been a very helpful witness at our previous hearings.

I welcome all of you here today and look forward to an informative discussion.

Dr. Kahn, do you want to come on up?

Dr. Kahn, you are no stranger to Washington, as we know, or anywhere else, but thank you for coming today.

Dr. KAHN. Thank you, sir. Thank you, Senator Shelby.

Senator SHELBY. Your written statement will be made part of the record in its entirety and you may proceed as you wish.

STATEMENT OF ALFRED KAHN

Dr. KAHN. Thank you. I will attempt only to summarize it.

Senator SHELBY. Yes.

Dr. KAHN. I want to express my appreciation of your invitation. Your initial remarks have taken the words right out of my mouth. I am in total agreement with what you said. And I want to compliment you on——

Senator SHELBY. Could you bring that mike up closer to you, sir?

Dr. KAHN. Sure. Yes.

And I want to express my appreciation for the efforts that you are making here to see that we continue to enjoy the benefits of deregulation.

I am proud of the role I played in deregulating the airlines. Nothing I say today is intended to suggest the desirability of reregulation, but I agree with you totally that the essential premise of deregulation was that consumers would be protected by competition.

And it is the threats that I see to the continuing effectiveness of competition that I think are the proper occasion for your inquiry. And I am delighted to see that the Department of Transportation feels the same way and the Antitrust Division of the Department of Justice.

With that, I will just summarize briefly my written statement and supplement it with one or two additional considerations.

REASONS FOR CONCERN

I do believe that we are at a critical juncture in the development of the airline industry. And I speak to you with a great feeling of urgency for two reasons primarily, to which I will then add a third, which is the recent announcement of proposed alliances in the industry.

The first is the sharp increases that have occurred in the last few years in unrestricted fares. According to the figures of the Air Transport Association, they have gone up something like 17 percent in the last 3 years.

I presented in my written testimony estimates that if we go back to 1976, which was the first year before the Civil Aeronautics Board began to permit competitive discounting, we find that average fares, average yields per mile have declined something over 39 percent adjusted for inflation.

That is, in real terms, they have gone down something over 39 percent, and that I have no reason to quarrel with the estimates of the people at Brookings Institution, that that is saving travelers over—upward of $10 million a year.

Senator SHELBY. Dr. Kahn, do you mean that they have gone down 39 percent over the period of deregulation?

Dr. KAHN. That is correct.

Senator SHELBY. OK.

Dr. KAHN. I am going back from 1976 to 1997. And I think it is——

Senator SHELBY. And that translates into how much money saved per——

Dr. KAHN. Well, the Brookings estimates—the last I saw were that they were saving travelers $12 billion a year in 1993 dollars. I mean it has been an enormous boon——

Senator SHELBY. Yes.

Dr. KAHN [continuing]. To the overwhelming majority of travelers. What I think is creating this sense of urgency today and the hostility toward the industry and indeed incipient movements to reregulate has been what has happened to unrestricted fares.

And I cited the case in my testimony that when the Department of Transportation was tentatively considering inviting me down for the announcement by the Secretary of Transportation of their new policy with respect to unfair competition, and it was short notice.

And I called my travel agent. And she quoted me a fare of $616—and she is a friend. With that kind of friend, who needs enemies? But she quoted me a fare of $616 round trip. That is over $1 a mile.

Now, we have to qualify that, because we know that short distances are generally more expensive per mile, traveling to a place—from places like Ithaca, NY, which we often refer to as a centrally isolated town in western New York, is more costly as well.

But that compares with average unrestricted fares of 40 cents a mile. This is over $1 a mile. And you have heard complaints of the same sort of thing.

As I say, the 39 percent is a reduction in average fares. In real terms, I calculate that over the same period, unrestricted fares have gone not down, but up, over 70 percent in real terms.

PROBLEMS WITH REREGULATION

Now, in these circumstances, I find some sympathy with the mounting calls for reregulation, though I disagree with them.

The point is that I do not see how anybody can object in principle to regulation to protect consumers when you have a monopoly and increasing monopoly exploitation.

But I do not begin to know how you reregulate a small portion of an industry's fare structure, which is charged to less than 10 percent of all the travelers.

And I do not begin to know how you take into account all the ways in which carriers compete for that traffic. When I get somebody who is hiring me to pay those fares, I then get automatic upgrades to first class. I stand on separate lines. I get frequent flyer benefits.

Reregulation of a portion of a market seems to be almost hopelessly difficult. But clearly the ideal way of protecting any and all travelers is free entry, competitive entry into the business.

If it is free, it will ensure that no group of travelers is charged more than the cost of serving them alone, on a stand-alone basis.

And that, by the way, is the standard that the Interstate Commerce Commission and the Surface Transportation Board adopted for setting ceilings on captive shippers rates, that no group of shippers should ever have to pay more than what it would cost them to serve them alone on a stand-alone basis, because that is the level that would be—set the ceiling under competition.

And as you are well aware, what has happened in recent years has been that when those fares have gone up and we have had new airlines coming up on the order of 25 to 40 in the middle nineties, precisely because they see an opportunity to serve these travelers with unrestricted more or less uniformly low fares, much lower than they were being charged, the pattern is very, very clear time and again, according to the Department of Transportation.

But I would like to cite you just a few examples that——

Senator SHELBY. Go ahead.

Dr. KAHN [continuing]. Have been presented in which the incumbent carriers after jacking their unrestricted fares up and up, then when these people come in, just in the markets in which they come up, the incumbent carriers cut their fare very, very sharply.

Even more flagrantly, they greatly increase the availability of the discount fares, the very low-discount fares, which until that point they restrict in the numbers that they offer.

Within a couple of quarters, I have example after example in which then the challenger is driven out of the market. And then within one or two quarters, fares immediately go back up to higher than the previous level.

And one of the attachments that I have asked Wally to distribute is my letter to the Wall Street Journal of a couple of weeks ago, in which I was responding to—how shall I say it charitably—a stupid Op-Ed piece, which said that "Predation"——

Senator SHELBY. You said it well, Dr. Kahn. [Laughter.]

Dr. KAHN. Well, I am being moderate, as I am accustomed to being. [Laughter.]

Which said, "Everybody knows that predation never pays."

In fact, the Supreme Court has virtually said the same thing, because the moment the fares go back up, the companies will not be able to recover the cost of predation, because someone else will come back in.

Well, one example that I gave you was presented on behalf of Spirit Airlines on what happened when it entered the Detroit-to-Boston route.

The average—the average fares by Northwest when it came in were—between Detroit and Boston were $200 and—almost $260. Spirit came in with fares in the $69 to $159 range.

Northwest immediately reduced its average fares from $260 to $106, that is average. And, of course, it did it mainly by making a lot of discount fares available, and then $100, two quarters.

Spirit was driven out. Within two quarters, Northwest fares were back up to $200—first to $189 and then the second quarter to $267. In other words they were back higher than they were.

Senator SHELBY. And this happened in many other instances as well, has it not, Dr. Kahn?

Dr. KAHN. Well, there are many, many that are cited. I presented that one because it was presented——

Senator SHELBY. It was.

Dr. KAHN [continuing]. I think to this committee, Senator Shelby, by Mark Kahn, who is not a relative.

Senator SHELBY. It was.

Dr. KAHN. But it has not been refuted, so far as I know.

Senator SHELBY. How do we prevent this? You know, you are the father of deregulation. Deregulation has helped just about everybody. But that small group has not benefited, but—and it seems to me because of if you start a new business, you are soon run out of the business.

How do we keep that from happening?

Dr. KAHN. Well, it is not an easy matter——

Senator SHELBY. Yes.

Dr. KAHN [continuing]. To distinguish a legitimate competitive—defensive competitive response of the incumbents from an aggressive one that is clearly intended to drive the people out—the challengers out.

Senator SHELBY. Yes.
Dr. KAHN. And I am not referring simply to psychological motive.
Senator SHELBY. Sure.

SIGNS OF PREDATION

Dr. KAHN. I am referring to what actually happens. And that is why I think it is important to look at the cases. The Department of Transportation suggests that one—and I have suggested in the past—that one sign would be: Are the incumbents merely reducing fares to try to retain the business that they would otherwise lose defensively, or are they aggressively increasing capacity?

And one of the other examples that I was going to present was offered by the General Counsel of the Department of Transportation who showed that in a market—this was—oh, she did not say what the market was——

Senator SHELBY. Yes.

Dr. KAHN [continuing]. But within one quarter, the number of fares—the prevailing fare was $300 to $350. And the incumbent airline was offering something like 30,000 or 50,000 seats at that level.

When the entrant came in, the incumbent airline, which had been offering less than 1,000 fares of $75 or less increased it to 50,000—almost 50,000 fares that they offered at that level.

Their average fare, therefore, went all the way back down from over $300 to something like $100, because they were offering almost exclusively $75 fares.

They did that for two quarters. The entrant went back out. The incumbent then raised its fares, not to $300 to $350, but from $350 to $400. And the number of discount seats went from 50,000 to less than 1,000 again.

Now, that pattern of action tells me that what we clearly are witnessing is price discrimination——

Senator SHELBY. Yes.

Dr. KAHN [continuing]. What Corwin Edwards once called discriminatory sharp shooting clearly aimed at driving the incumbent out by leaving no room in the market for the incumbent, and then not just with the intention but with the demonstrated effect of restoring prices and eliminating the offerings, virtually eliminating the offerings of discount fares.

Now, I know no substitute for looking at that pattern of action and deciding what is the intent and, even more important, have they demonstrated the power to drive these people out, and the consequence of eliminating competition.

And I think the simple answer to the view, the simplistic view that comes from the University of Chicago and is increasingly in disrepute among economists—but I would be happy to show you things I wrote in 1954—in which I said exactly the same thing when I was a member of the Eisenhower administration's Commission on the Antitrust Laws, which clearly demonstrate that once you have done that, nobody is going to come right back in.

As I said graphically, a hunter walking past a field with a no trespassing sign may pay no attention to the sign, but when he sees that the field just beyond the sign is littered with the bodies of previous trespassers, then he is going to think twice.

So I am telling you that no matter what these economists are saying about industry generally, about the impossibility of predation, I am telling you that I see it. The Department of Transportation sees it.

And if it may be difficult to define, I remind you of what Justice Potter Stewart said about pornography. "It may be difficult to define, but I know it when I see it."

And I suggest that that is what the Department of Justice is struggling with and what the Department of Transportation is trying to get at. Perhaps, that is enough to begin on that subject.

DANGERS OF AIRLINE ALLIANCES

I do want to allude at least to the problem of alliances. That is a source of concern now that was essentially nonexistent just a couple of weeks ago when I first testified on this subject to—or when you had your initial hearings.

I must say at the onset that I do not have a confident feeling about what one should do about these proposed alliances, but that they clearly require antitrust kind of scrutiny seems to be indisputable.

And I will just give you one example. I wrote an article on defending the results of deregulation. I have written several of those, one in 1989——

Senator SHELBY. Yes.

Dr. KAHN [continuing]. In which I cited a statement by Julius Maldutis, who was a very respected investment analyst. I think he is with Salomon Brothers or was. He said that—he pointed out the importance of competition over differing hubs——

Senator SHELBY. Yes.

Dr. KAHN [continuing]. As a way of giving us the benefits of competition, even though individual hubs have increasingly come to be dominated by single airlines.

He said, as an example, a traveler planning to go between Boston and Phoenix had a choice of nine airlines, mostly one stop over different hubs.

Senator SHELBY. Yes.

Dr. KAHN. And you could figure out which they are and whether it is over O'Hare or whether it is over Cincinnati with Delta or Pittsburgh or Dallas/Fort Worth or St. Louis. There were nine.

I called my travel agent yesterday and I said, "If I were going between Boston and Phoenix, how many choices would I have?"

She said, "Eight," and she listed them for me.

I think it is worth calling them to your attention. America West, Continental, Northwest, that is three.

Now, America West already has some sort of an alliance with Continental. And Continental and Northwest are talking together about getting together in some sort of an alliance. So those three go down to one, because of what is just threatened in these last 2 weeks.

Next Delta and United, that makes five. That means the five are going down to two, if these alliances go down.

Next is USAir and American. Well, if they get together, suddenly instead of seven, we have three. And the last, which makes eight, is TWA. And I am not an expert on this, but I question the viability of TWA in competing with these gigantic alliances. Certainly the rumors are that TWA will have to be looking for a partner as well.

So within just the events of the last few weeks, we are confronted with real travelers between Boston and Arizona being confronted with alliances, the content of which I am not prepared to analyze, but clearly they raise the specter that you will not have eight competitors individually vying for your patronage, but only four, just with this change—and highly likely, only three.

So all I can really say about the alliances is, I recognize the benefits. I recognize that there are efficiencies consequent on this.

I recognize the arguments of the carriers that code-sharing is an essential part of the deal for the cooperation and integration of schedules. But I think that the Departments of Justice and Transportation have simply got to look into this and determine whether here is another threat to the maintenance of competition, which has been the main source of the benefits of deregulation.

DEREGULATION VERSUS ANTITRUST LAW

Last sentence, Senator Shelby, whenever I mention these things to people, newspaper people or wise guy professorial colleagues of mine at Cornell, almost invariably I get a smirk.

The smirk, in effect, says either explicitly or implicitly, "I thought you were in favor of deregulation, and now you are proposing reregulation."

First, I restrain myself in my answer from saying, "You stupid jerk. Do you not know the difference between the antitrust laws and direct regulation?"

The essence of deregulation was a belief that competition would protect the public. That makes the application of the antitrust laws more important, much more important than before, because we no longer are having direct regulation.

The antitrust laws, therefore, must be applied rigidly. They are a form of regulation, I guess you would have to concede. But the philosophy is totally different.

It is to preserve competition from monopolistic practices of exclusion of competitors and from collusion or combination practices. And I think that your intent—the intent of your original remarks—I think are totally admirable and I compliment you on what you are doing.

Senator SHELBY. The antitrust laws though, Dr. Kahn, are to prevent monopolies from forming, is that correct?

Dr. KAHN. That is correct.

Senator SHELBY. Monopolies that would forestall all competition as we know it. But an administration, this one or any other, will need the will to enforce the antitrust laws first and foremost, will they not?

Dr. KAHN. Absolutely.

Senator SHELBY. And that will not be easy. But if we are going to benefit from deregulation, it will have to be done, will it not?

Dr. KAHN. That is absolutely true. And I do not have any doubt that both the Department of Transportation and the antitrust division now are alert to the problem——

Senator SHELBY. I think so, too.

Dr. KAHN [continuing]. And determined to do what they can about it. But I think we have to keep in mind that the Supreme Court has virtually written predation out of the antitrust laws.

Senator SHELBY. Yes.

Dr. KAHN. And they have got to have—well, first we begin at the district court level and I recognize that. But they have to have their noses pushed into these facts.

CLOSER SCRUTINY FOR PREDATION

And I had duplicated a graph from the testimony of Steven Morrison of a couple of weeks ago, in which he said predation is just too hard to determine and tended to pooh-pooh the attempt to do anything about it.

In his own testimony, he has a graph, a copy of which you have, showing what happened to the fares between Billings, MT, and Denver.

Senator SHELBY. I have it.

Dr. KAHN. That is the one. If you would, just look and see what happened. You see that United's fares were running well above $200. Frontier entered, those are the triangles at the bottom——

Senator SHELBY. Yes.

Dr. KAHN [continuing]. With fares roughly $100. These are averages. United instantaneously went down to $100. Notice the triangles last for only two quarters.

Senator SHELBY. Yes.

Dr. KAHN. Then immediately Frontier is driven out. And look at what happens to United's fares.

Senator SHELBY. They go sky high again, do they not?

Dr. KAHN. Indeed, higher than they were before. And I wrote to Steve Morrison, whom I respect, whose work in this is authoritative.

And I said, "How do you reconcile what you said with what you show in your own graph"?

We have got to combat this essentially ideological statement that "Predation cannot exist because my theory says it cannot exist."

Look at the facts. It clearly is taking place.

Senator SHELBY. But, Dr. Kahn, wouldn't you agree the purpose behind the antitrust laws and its spirit, if not the meaning, aim to make competition work, and from this we all benefit.

Dr. KAHN. Absolutely, absolutely.

Senator SHELBY. In your written testimony, Dr. Kahn, I was struck by the urgency of your call for action by the administration and, to quote, "to draw the line between healthy and predatory competition," two entirely different things. Although you propose your own acid test, those are your words.

The Department of Transportation has recently submitted guidelines toward the same goal of drawing a line between acceptable defensive competition response and competition which threatens to restore monopoly power, of which you have just shown an example.

In the new Department of Transportation guidelines, has the Department created a framework that will permit healthy competition and dissuade predatory activity?

Dr. KAHN. I believe it has.

Senator SHELBY. Yes.

Dr. KAHN. I believe it remains to be seen how administrable its test is. In effect, what the Department is saying is that when the incumbent airlines—the airline, in effect, does what I have said, floods the market with discount seats and thereby incurs the cost of losing all its sale of the full fare tickets——

Senator SHELBY. Yes.

Dr. KAHN [continuing]. And the figures that I have—I have given you show—and those presented by, particularly by the General Counsel of the Department of Transportation, that their sales of the $300 to $350 tickets during the period of putative predation——

Senator SHELBY. Yes.

Dr. KAHN [continuing]. Went down from something like 50,000 to something less than 1,000. They sold less than 1,000 of those full-fare tickets, because they greatly increased the availability of the discount fares.

Then that is really a cost that they are incurring, and the Department of Transportation is saying it would not make any sense for them to incur that cost except as an investment in driving the competitor out, which they then can recoup thereafter.

But how you are going to measure—but how many of those full-fare tickets they would have sold in the face of that competition had they not flooded the market with discount seats is a tough one.

And that is what I know they are working on, and that is what I know the people at antitrust are working on. And I am, in my limited way, trying to help them do that.

Senator SHELBY. Dr. Kahn, do you have an opinion at this point on the lack of competition in certain areas of the market? You know, we are talking about how much that is costing the American people in added fares that ordinarily wouldn't be paid if there was competition.

Dr. KAHN. I have not undertaken——

Senator SHELBY. It is in the billions, is it not? It has to be.

Dr. KAHN. I have not undertaken—I have not taken—undertaken any study.

Senator SHELBY. OK.

Dr. KAHN. I think what you would have to do—you might use as your guidepost the kind of fares that Southwest Airlines is capable of charging and then apply that difference to—now, observe that the Southwest Airlines kind of operation is not feasible between Ithaca and Washington.

It seems to me it is feasible between Syracuse and Washington. And when—which is 60 miles away from me and I would be happy to drive it.

Senator SHELBY. Yes.

Dr. KAHN. But when I got that fare of $616 round trip—and by the way, I was going to have to pay it out of my own pocket. I asked my travel agent, "Well, what if I drive to Syracuse where there are five major carriers?"

She said, "The fares are all $616."

Now, I think that you could at least get a rough approximation by saying what—out of areas in which that kind of operation of Southwest is feasible, what are Southwest's fares?

How does that compare with the unrestricted fares being charged? And apply that to the—I do not know whether it is 5 percent or 10 percent of all travelers who are paying those very high fares. That might give you a notion of the order of magnitude of the cost.

Senator SHELBY. You also, Dr. Kahn, talked about the options between Boston and Phoenix; I believe that was an example.

Dr. KAHN. Yes.

Senator SHELBY. Going from eight to four because of the allowances, is that correct?

Dr. KAHN. That is correct.

Senator SHELBY. Are four options enough to maintain a competitive environment?

Dr. KAHN. Well, I do not think any economist knows the answer to that.

Senator SHELBY. Yes.

Dr. KAHN. You can have markets in which if you have four people, you can have effective competition.

Senator SHELBY. Yes.

Dr. KAHN. But first of all, we are talking about four, which probably means three.

Senator SHELBY. Yes.

Dr. KAHN. Moreover, we are talking about an industry that has already demonstrated their propensity to what is—what is a polite word? The technical economic term is "screw" the person who has to travel on short notice because somebody in the family is sick or the small businessman who cannot negotiate special deals. It has already demonstrated that propensity.

Senator SHELBY. Would exploit be too mild a term?

Dr. KAHN. Thank you.

Senator SHELBY. OK.

Dr. KAHN. Thank you for that more refined—it is not the first that came to my mind. [Laughter.]

And so I—in those circumstances I think that I would regard with real alarm—particularly in the context of not one successful case yet against predation.

Senator SHELBY. Dr. Kahn, you indicate also in your testimony that the combined factors of rapidly escalating unrestricted airfares, incipient efforts to reregulate, and the current status and complaints of many of the low-cost, low-fare new entrants create a recipe for the greatest threat to airline deregulation since we embarked on this path 20 years ago.

Although, I do not believe myself that efforts to reregulate will have many supporters in the final analysis, and I trust they will not, I believe that proper attention now, from the Departments of Transportation and Justice and appropriate attention from the Congress, the House and the Senate, may promote, Dr. Kahn, the continued evolution of deregulation, which is what we want to keep going.

Lack of attention from the administration may increase the pressure for or make possible a reregulation aviation industry that none of us want. Do you share this view at all, or what is your opinion?

Dr. KAHN. Completely and unequivocally, that is my central message.

Senator SHELBY. If so, what should Congress focus on specifically to foster, to bring about a more competitive environment for air travel?

We have used the committee to try to focus on what is going on. Now, how do we go the next step?

Dr. KAHN. Well, I think at the present stage, what is urgently important is that you keep your eye on what the Department of Transportation is trying to do and what the antitrust division is trying to do.

Give them all the support you can, morally and philosophically.

Senator SHELBY. Yes.

Dr. KAHN. To the extent that you can, by your own findings endorse a finding that predation is possible and predation does indeed seem to be occurring, that that may conceivably have some influence on the courts—that, who otherwise seem disposed——

Senator SHELBY. You are creating a competitive environment in a sense, are you not?

PRESERVING COMPETITION

Dr. KAHN. That is exactly right, and to preserve competition.

Senator SHELBY. Right.

Dr. KAHN. And if I may give you another example?

Senator SHELBY. Go ahead. We appreciate you being here.

Dr. KAHN. When I was before the Aviation Subcommittee a couple of weeks ago, there was a representative of Northwest Airlines who was there.

Senator SHELBY. Right.

Dr. KAHN. And when I talked about what happens when the incumbent floods the market with these discount seats, eliminating all restrictions, he said, "Well, you are asking us—you are—you are having the Government—you are proposing that the Government come in and tell us how many discount seats we may offer, rationing the number of discount seats."

And I turned to him and said, "What the hell have you been doing all this time?" That is precisely what you do.

Senator SHELBY. Yes.

Dr. KAHN. You ration the number of discount seats. According to the figures of the General Counsel in this particular route, you allowed only 1,000—less than 1,000 discount seats. Then suddenly, you derationed. And you offered 50,000 of them. After driving the other people out, you reinstated rationing of discount seats.

Senator SHELBY. Yes.

Dr. KAHN. So, again, I think it is at the present oversight and earnest attention that influence the administration agencies, who have been lamentably lax in most of the 20 years since airlines were deregulated, permitting mergers that the Department of Justice itself opposed.

But now they seem to be really anxious to move—eager to move—and supporting them is, at the moment, is all I can think of.

Senator SHELBY. Dr. Kahn, are the days of regional carriers numbered if the current market dynamics continue?

Dr. KAHN. Well, the age of truly independent regional carriers may already have passed.

Senator SHELBY. Yes.

Dr. KAHN. I think all we can do—I am sorry. Perhaps I should finish that idea.

What has happened, of course, is that the major carriers dominating the hubs have already entered into often exclusive code-sharing agreements with regional carriers.

Senator SHELBY. Right.

Dr. KAHN. And I think one aspect of looking at the effect of these alliances that I am eager to see the Department of Justice and Transportation undertake is: What is the status of independent short-haul carriers, who want to enter on some of these spoke markets and their ability to compete with the incumbent regional carriers, who have code-sharing agreements with the dominant carriers?

Now, I know that Frontier presented testimony to you——

Senator SHELBY. Yes.

Dr. KAHN [continuing]. That they were unable to deal with United at the Denver hub and have interlining agreements on the same terms as the United affiliate, United Express.

Senator SHELBY. Yes.

Dr. KAHN. So I think keeping open the opportunities for independent airlines to operate, to join with the hub-dominating carriers ought to be a priority and observe that it is very similar to what we are doing in telecommunications and in the electric power industry.

As we are proceeding to deregulate those industries—and most of my work is in those industries——

Senator SHELBY. Yes.

Dr. KAHN [continuing]. We recognize that we cannot have effective competition unless we make sure that the incumbent monopoly utility companies, which control the access to the market by their competitors because the wires, the transmission lines, and the distribution lines are monopolies.

We have to make sure that the incumbent companies provide equal access by competitors as well as——

Senator SHELBY. Are open——

Dr. KAHN. Open—open to competitors. And it may be that the same analogy ought to be applied to access to interlining agreements at the hubs with the hub-dominating carriers.

Senator SHELBY. Yes; Dr. Kahn, there is a great deal of attention on the monopoly power exercised by the largest players in the airline industry.

At the same time, profit margins in the industry are low by other industry standards. Is a low-profit margin consistent with predatory pricing or monopoly power?

Dr. KAHN. Yes; of course, it is.

Senator SHELBY. Explain.

Dr. KAHN. The—first of all——

Senator SHELBY. You can explain better than we can.

PROFIT MARGINS AND COMPETITION

Dr. KAHN. I will try. We do have to recognize that the airline industry has never been a highly profitable industry.

Senator SHELBY. Yes.

Dr. KAHN. That was true under regulation. It clearly has been true under deregulation. I do remember, however, compiling figures on their profit margins——

Senator SHELBY. Yes.

Dr. KAHN [continuing]. Before in the 10 to 15 years before deregulation. And I am sorry that I do not have the tables at my fingertips, but the average was on the order of 2.0 percent, a very low margin.

Senator SHELBY. Could you furnish that for the record?

Dr. KAHN. I would be happy to.

Senator SHELBY. Good.

Dr. KAHN. Well, will you help me to remember, please? Especially at my age, I need help.

Senator SHELBY. All right. [Laughter.]

[The information follows:]

U.S. Scheduled Airline Industry Consolidated Industry Rate of Return on Investment

	Percent
1955	10.8
1956	8.8
1957	5.1
1958	5.2
1959	6.2
1960	3.2
1961	2.1
1962	5.7
1963	6.5
1964	10.8
1965	11.8
1966	11.0
1967	7.6
1968	4.9
1969	3.3
1970	1.2
1971	3.5
1972	4.9
1973	5.1
1974	6.4
1975	2.5
1976	8.5
1977	10.2
1978	13.3
1979	6.5
1980	5.3
1981	4.7
1982	2.1
1983	6.0
1984	9.9
1985	9.6
1986	5.2
1987	7.2
1988	10.8
1989	6.3
1990	(6.0)
1991	(0.5)
1992	(9.3)
1993	(0.4)
1994	5.2

U.S. Scheduled Airline Industry Consolidated Industry Rate of Return on Investment—Continued

	Percent
1995	11.9
1996	11.5
1997	14.9

Source: Air Transport Association.

Dr. KAHN. The witness from Northwest Airlines said they now are earning only 5 percent margin. Well, that is 150 percent more. That is two and one-half times the average that I found that they earned in the prederegulation period.

But, look, the industry has been through terribly bad times. They lost tremendous amounts of money in the 1990 to 1993 period. It is highly profitable right now. A monopoly is something that exists market by market.

Senator SHELBY. Yes.

Dr. KAHN. First of all, profit margins are not a good measure of profitability.

Senator SHELBY. Yes.

Dr. KAHN. If you look at the margins of retail grocery chains, they are less than 1 percent. The critical thing is what are they as a percentage of——

Senator SHELBY. So you cannot see the margin sometimes?

Dr. KAHN. Yes; that is right. But second, the antitrust laws and the policy of competition never has justified somebody saying, "Well, we are not very profitable; therefore, permit us to cut the throats of some of our competitors."

If the industry is not capable of being viable under competition, then let it make its case to Congress that it should be reregulated and protected from competition, but not let it violate the antitrust laws and take it upon itself——

Senator SHELBY. Yes.

Dr. KAHN [continuing]. To decide that its profits are not high enough and, therefore, it should be permitted to engage in destructive predatory competition.

Senator SHELBY. Dr. Kahn, we appreciate you coming down here. We wish we had had a plane to send after you——

Dr. KAHN. I am——

Senator SHELBY [continuing]. From time to time. And we know that we will be calling on you again. And we appreciate it.

Dr. KAHN. I am very grateful.

Senator SHELBY. We appreciate more than anything—I think the American people do, most of them—what you did to deregulate the airline industry and what you are trying to do to make sure that it works for everybody.

PREPARED STATEMENT

Dr. KAHN. I am proud of it. And I thank you very much, Senator.

Senator SHELBY. Thank you, sir.

Dr. KAHN. Fine.

[The statement follows:]

PREPARED STATEMENT OF ALFRED E. KAHN

I am grateful for this opportunity to testify before you. I do so with a sense of urgency because in my judgment events in the airline industry are moving with such rapidity as to raise what seems to me the greatest threat so far to what we worked so hard to accomplish 20 years ago.

The events to which I refer are the sharp increases over the last year or so in unrestricted fares; incipient efforts to re-regulate, which can only intensify over time, unless the dominant carriers demonstrate greater restraint than they have recently in exploiting non-discretionary travelers; the many complaints of asserted predation that I understand have poured into the Transportation and Justice Departments from the many low-cost, low-fare carries that entered the market around 1994–96; the failures of many of them and the financial plight of those that remain.

The Air Transport Association reports that average airline yields have increased from 8.0 cents per mile in 1976—just before the Civil Aeronautics Board began to permit large-scale discounting, in the initial stages of deregulation—to 13.72 cents in 1997. Since the Consumer Price Index increased during that same interval by 182 percent, the increase in nominal yields of slightly less than 50 percent translates into a decline, in inflation-adjusted terms, of 39.2 percent.

I do not have an authoritative figure for what average full fares were in 1976. Since, however, discount traffic constituted only a very small proportion of the total, I suspect it exaggerates the increase in full fares over the last 20 yeas only slightly to assume that the 8.0 cent average yield in the initial year was not much lower than the average price per mile at which passengers could purchase tickets at the last moment and without having to stay over a weekend. Under that assumption, average full fares increased almost five fold during this period in nominal dollars—from 8.0 to its 1997 level of 39.07 cents per mile—and by some 73 percent, inflation adjusted.[1]

Even though it is of course inherent in averages that the combined weight of the full fares that increased more than 73 percent was exactly offset by the fares that increased less than that, and one of the economically efficient consequences of deregulation has been it has corrected the previous deliberate subsidization of short and thin routes by long-distance travel on dense routes, the legitimate public outrage over what has happened to unrestricted fares, on average, compounded by what has happened on the previously subsidized routes. I cannot refrain from pointing out, for example, that when, recently, the Transportation Department invited me, on short notice, to be present at the Secretary's announcement of their recent policy statement, I was told that the full fare, Ithaca to Washington and return, was $616—over $1 a mile!

In these circumstances, the mounting calls for reregulation are understandable. I do not see how one can object on principle to direct regulation or reregulation to protect consumers from monopolistic exploitation. The phenomenon of hubbing clearly has—along with such accompanying practices as frequent flier credits and override commissions to travel agents—produced situations of real monopoly power, which the carriers are ever more effectively exploiting, at the expense of non-discretionary travelers. But I don't begin to know how, practically, to reregulate one portion of a fare structure, paid by less than 10 percent of travelers. Or, if we tried to do so, how we would take into account all the non-price inducements with which airlines have been competing for traffic—automatic upgrades to first class, separate and shorter lines at the check-in counter, frequent flier credits and so on. Or the indisputably higher cost of offering those non-discretionary travelers the ability to book seats at the last minute.

The theoretically correct basis for such charges to subgroups of customers, advocated by me and other economic witnesses and adopted by the ICC and Surface Transportation Board as the basis for seeing railroad freight charges to captive shippers under the Staggers Act, is stand-alone costs—the hypothetical cost of serving any partial grouping of customers alone. That is the ceiling that would prevail if there were perfectly free entry: in those circumstances rates higher than the current cost of efficiently serving any group or subgroup of customers would be undermined by new entrants. But measuring those costs in the railroad context has proved litigious and expensive, and I suspect it would be even more difficult in the case of the airlines, because of the need to take into account all the dimensions of service quality to which I have already referred.

[1] This estimate is roughly confirmed by the ATA statistics for 1978 to 1997, which show average yields per mile declining 33.8 percent during that slightly shorter period and full fares rising 62.1 percent, both in inflation-adjusted dollars.

Clearly, the best way of ensuring that such a ceiling will prevail is free entry itself; and it was indeed on freedom of competitive entry that we relied for the protection of travelers when we deregulated the airlines. But what seems to have occurred time and again in recent years has been: unrestricted fares are jacked up and up; that induces entry of low-cost, more or less uniformly low-fare rivals, emulating Southwest, who can profitably serve those customers at much lower fares; the incumbents then cut their fares deeply and sharply increase the number of low-fare seats they offer on the routes—and only on the routes—on which they have been challenged; the new entrant departs; and fares immediately go right back up, with no further challenge. That is the kind of scenario that the Department of Transportation says it has seen played out many times in the last few years and that it sees as crying out for remedy.

I agree with it. Confronted with that kind of objective sequence of events, I am prepared to characterize the response of the incumbents—if the Department has accurately described them—as predatory: I see no reason to require any further demonstration. The most grievous governmental failure in recent years has in my opinion been the failure to prosecute a single case against what appear to have been just such cases of flagrantly predatory competition by incumbent major airlines against new competitors; and I applaud the apparent intention of the Department (to whose recent policy statement on the subject I made a modest contribution) now to undertake a vigorous enforcement effort.

The history of the airline industry over the last 20 years clearly demonstrates the great importance of entry by low-cost, uniformly (or much more uniformly than in the case of the major carriers) low-fare carriers in keeping the industry competitive—so long as they survive. As I understand it, many if not most of the recent new entrants have either already been driven out of business or are in danger of being driven out, leaving the surviving major carriers with the power to raise prices once again after their departure. If that happens, I see no way in principle to oppose what I anticipate will be mounting pressure for reregulation.

The antitrust laws prohibit, among other things, price discrimination whose effect "may be substantially to lesson competition or tend to create a monopoly." The Department of Transportation evidently has information strongly suggesting that some carriers have engaged in just such a practice (which Corwin V. Edwards, an eminent antitrust economist, once characterized as "discriminatory sharpshooting"), with precisely that intention and consequence, and that consumers are already paying the price.

I do not suggest it is easy draw the line between healthy and predatory competition—between an acceptable, defensive response by incumbents to new completion and one that threatens to restore monopoly power; but I am convinced that drawing such a line is necessary if we are to continue to have an effectively competitive industry. The recent behavior of unrestricted fares suggests that the need is urgent.

The acid test—whether framed as a test of predatory intent or of the likely objective anti-competitive consequences of such responses—it seems to me, is or should be whether the incumbent airline is deliberately accepting financial losses, in the markets where it is subjected to competitive challenge by the entrants. Such a course of conduct would make no sense except if it regarded those losses as an investment in reestablish its previous position of dominance and, with it, the ability to recoup them in higher prices thereafter. Where the meeting of competition consists merely in offering a sufficient number of discounted fares to fill seats that would overwise be empty, the incremental costs are likely be so low that the traffic retained in this way might well be compensatory. But where, as I understand is often the case, the incumbent carrier responds by flooding the market with discount seats—partly by simply increasing the number of such seats it offers on its previously scheduled flights, but particularly if it also increases the number of its flights on the challenged routes—the incremental cost against which its revenues should be tested (to see if it is indeed deliberately taking losses) are not simply the very small cost of additional fuel, ticketing and baggage handling incurred in filling seats on flights that would otherwise go empty but would properly include the net revenues that those added flights were previously making or could make in other markets. In these circumstances, it seems to me the requisite predatory intent and threat to competition should be demonstrable.

The Department of Transportation's policy statement would add to those opportunity costs the loss of revenue from sales of full-fare tickets consequent on the incumbent carrier's sharply increased offer of discounted seats. While I am not aware that the courts have heretofore recognized this possible component of the temporary losses of a putatively predatory policy, it seems to me correct. When, faced with a challenge to their previous rate structures, with their component of 40 cent per mile charges (the national average) for last-minute, unrestricted fares, the carriers abandon their previous policies of sharply restricting the number of discount fares available—as well as stipulating restrictive conditions that travelers must meet to qualify for them—the consequent diversion of their own traffic from full-fare to discount-fare is one of the costs of their responses—costs that, experience seems clearly to demonstrate, they not only hope to recover after driving the interlopers out of the market but do.

Unfortunately the courts have in recent years virtually defined predation out of the antitrust laws, on the theory—recently repeated in a vapid op-ed article in the Wall Street Journal by a Vice President of the Competitive Enterprise Institute, that "in practice such predatory behavior rarely if ever works. To make the gambit worthwhile, the predator must not only make monopoly profits at the end, but make enough to compensate for its lost revenue—plus interest. That's hard to do, especially since another airline could always enter the market at a later date. In the history of anti-trust law, there have been few, if any, cases of successful predator pricing."[2]

In effect, the Department of Transportation believes that such contentions represent a triumph of theory over fact. So did I: I take the liberty of attaching a copy of my letter to The Journal published just this Monday, accompanied, to my great satisfaction, by a similar letter from Representative Greg Ganske.

Having severely criticized the succession of Administrations over the last 15 years or more for their failure to recognize the importance of antitrust and antitrust-like policies in vindicating the deregulation that was enacted with such broad scale bipartisan support in the late 1970's, I am delighted to have this opportunity to praise the Department of Transportation for its initiative.

This is not a question of ideology; nor am I or the Department proposing "reregulation" of the industry, as the incumbent major airlines are quick to claim. On the contrary, deregulation makes sense and can continue only in the presence of effective competition as the protector of consumers. The scores of competitors that have entered the industry over the last 20 years attest to the widespread eagerness of enterprisers to take the risks of competing that is an essential ingredient of free markets. But the history of their entry and demise also demonstrates the essentiality of vigorous government intervention to keep open the opportunity for that entry, free of the threat—apparently abundantly demonstrated by the actual practice—of predatory responses. The vapid assertion that such responses will not pay because re-entry is always possible in effect denies that the major airlines have done what the Department says it has strong reason to believe they have in fact done. It also denies the logic that my former student, Irwin Stelzer, graphically expounded when he said that a hunter, passing a field posted with a No Trespassing sign, may well ignore that warning; but if he sees the field just beyond the sign littered with the bodies of previous trespassers, he is likely to pay it greater respect.

I urge you to give the Department of Transportation your sympathetic support—and legislative assistance, if necessary—in its effort to forestall or remedy discriminatory sharpshooting by incumbent airlines that restores their ability to charge captive customers fares of 40 cents a mile and more, while posting No Trespassing signs that they have given future would-be challengers excellent reason to respect.

INTRODUCTION OF WITNESSES

Senator SHELBY. Our second panel will be on the subject of airline yield management and ticket pricing practices. We have Prof. Darryl Jenkins, director of the Aviation Institute, George Washington University.

We have Mr. Borden Burr, president, All Seasons Travel Agency in Birmingham, AL; Ms. Lauraday Kelley, vice president, Cruiselink, Hummelstown, PA; and Mr. Larry Darby, president of Darby Associates.

If you folks would just take your seats at the table.

[Pause.]

Professor Jenkins—well, I will say it to all of you, your entire written statement will be made part of the record in its entirety. And I will ask you to come in and proceed as you wish.

Professor Jenkins, you may proceed.

[2] James L. Gattuso, "Don't Outlaw Cheap Airfares," The Wall Street Journal, April 8, 1998.

Dr. JENKINS. Thank you very much.

Senator SHELBY. Pull it a little closer, because we have got a big audience today.

Dr. JENKINS. Is this better?

Senator SHELBY. That is better.

STATEMENT OF PROFESSOR JENKINS, DIRECTOR OF THE AVIATION INSTITUTE, GEORGE WASHINGTON UNIVERSITY

Dr. JENKINS. Good morning, amid the current fury and sound over airline pricing and competition, I welcome the opportunity to provide some facts and background that will help to inform rather than to inflame the debate.

As the author of seven books on airline pricing and service, and as a consultant to just about every major airline, and at least five startup airlines, I bring some modest experience to the current discussion.

I began this industry in 1974 as a travel agent. I am proud to be in it ever since.

PRICING AND YIELD REVENUE MANAGEMENT

Let me start first with airline pricing. It may be instructive to use the example that Prof. Alfred Kahn has already provided with this and in previous hearings.

On very short notice, Professor Kahn booked a flight from Ithaca, NY, to Washington, DC, and paid over $616 round trip for the purchase. It goes without saying that Professor Kahn paid more than he would have liked. But if the fare had been one-half what he had paid, it is likely Professor Kahn would have never been on that flight.

Given the robust economy and the unprecedented demand for air travel, the airline could have sold every seat on that flight weeks in advance for the restricted fare of less than $225.

Instead, the airline sold some of its seats at deep discounts in advance and held some seats back for those wanting to travel at the last minute, like Professor Kahn.

In effect, the airline used price as the means to allocate scarce resources, in this case, an airline seat. To decide exactly how many seats to offer and at what price, airlines use a system called revenue management. Revenue management allows an airline to decide how many seats to sell at which price on each flight at various fare levels; restricted discount fares, unrestricted discount fares, senior discount fares, and most importantly how many seats to hold back for business travelers who buy their tickets at the last minute and change plans frequently.

Revenue management allows airlines to maximize their revenues by making sure that every seat on the airline is full. Revenue management is clearly good for the airline by helping to maximize revenue and most importantly to even out demand.

Revenue management is also good for consumers. It provides a wider range of travel options, availability in fares that a broader group of consumers can afford.

Professor Kahn talks about an increase in the average full fare since deregulation. This is true. Unrestricted airfares are higher. But the number of people who actually pay the full fare is small.

Just to illustrate the point, I have attached a chart that shows the fare distribution on many flights.

[Chart.]

As you can see, less than 10 percent of consumers pay full fare. In fact, over one-half of the plane is flying on a discount of at least 70 percent. And almost 70 percent of passengers on the plane are flying at one-half off.

Certainly, there will always be a group of consumers who are willing to pay a significant premium for added convenience or last-minute service.

Professor Kahn, for example, could have mailed his testimony to this committee for 32 cents if he had finished it 4 or 5 days ago; or he could have paid $10, 31 times as much mailing it today using Federal Express, wildly different prices for a very different service; so too, with airlines where every seat is really different, with different restrictions and different benefits.

Discussions about high fares is important, but should not obscure what is happening at the low-fare side of the equation. While a relatively small number of people will actually fly at the highest fare, the vast majority of Americans are flying at cheap, very cheap fares.

In fact, air travel has never been cheaper in real terms. Check out Sunday's Washington Post. You can fly round-trip from Washington to Atlanta on Delta for $124; Los Angeles for $305 on American and United; or Chicago for $104 on Air-Tran.

Cheap fares are also available on the so-called low fare and new entrant markets. In fact, the market share of these low-fare carriers has reached an historic high, somewhere around 18 percent according to Steve Morrison.

This is good because it provides consumers with low-fare choices and big airlines with competition. What is not good, however, is DOT's recent guidelines on predatory pricing.

These guidelines attempt to protect the new entrants from alleged predatory practices at the hands of the big airlines. But DOT and professor's basic premise about why new entrants fail is fundamentally flawed.

REASONS FOR NEW ENTRANT FAILURE

New entrants, in fact, need no help failing. They do it perfectly good on their own. They have been doing it for years on their own.

I have examined every bankruptcy filing of every airline that has gone out of business since 1978. And they all have one fact in common, not one of them mentions—not one mentions predation as a causation of their demise, not one.

If we—I want to put this in a bigger context now. If we look at all of the routes in the domestic system where predation is alleged, it is not even 1⁄100 of a percent of the total domestic capacity.

This is the problem that we are arguing about today, when out at Leesburg Tracon, they have 30-year-old computers. That is a significant problem. That is a capacity constraint.

Over one-quarter of new restaurants make it through their first 2 years. They fail because of bad service, management miscues, flawed pricing, and inadequate financing, among other reasons.

And airlines fail at about the same rate. As a matter of fact, the rate of failure among new entrants is at its all-time low. During the eighties, between 1983 and 1988, new entrants actually had a shorter lifespan than they do now.

Upstart airlines are notorious for underestimating their costs and miscalculating break-even load factors, consumer demand, and the competitive response.

Vanguard, for example, is constantly changing its route structure. In just 2 years, it has entered and left over 25 different city pairs. I recently called the vice president of marketing at Vanguard and asked him his previous pricing policy.

He said, "We had a bad product and we priced it accordingly."

Since 1995, Vanguard has lost in excess of $25 million.

Successful low-fare airlines like Southwest, on the other hand, are extremely careful about the routes they serve. They do not serve Syracuse for a reason.

In fact, in its 26-year history, Southwest has withdrawn from only a single market after it has launched service. One or two markets is all we could document.

Big airlines do respond to competition by lowering their prices. That is how the marketplace works, "We will not be undersold." It is a fundamental rule.

If the new entrant airlines have legitimate complaints about predation, there are legitimate ways to handle this. I do not see lawsuits being used. If the evidence is clear, then let them bring forth an antitrust issue.

It scares me, Senator, when you have Government regulators who do not have even 1 minute of practice in airline pricing telling those who do this on a day-to-day basis how they should do their job.

Thank you.

Senator SHELBY. Mr. Borden Burr.

STATEMENT OF BORDEN BURR, PRESIDENT, ALL SEASONS TRAVEL AGENCY

Mr. BURR. Good morning, Mr. Chairman and members of the committee. I am delighted to be here this morning to discuss an issue of critical importance not only to my customers and the businesses of Birmingham and the entire State of Alabama, but to all travelers—airline ticketing and competition.

First, Mr. Chairman, on behalf of all of us, we wish to express our gratitude to you for holding these hearings and for all you have done to focus attention on the needs of all travelers, business people, individuals wishing to travel to visit families and friends, and those seeking business opportunities.

Not only have you held hearings that have shed light on the restrictive Wright amendment, but you have taken important action to address other factors that lessen competition that result in higher fares.

I want to emphasize that my company exists today because of airline deregulation. My clients and I are believers in the marketplace. We do not want extensive Government regulation or control over the travel industry.

But if we are going to have a deregulated system, it must be open for all who are willing to compete. Today, we have a system that does not allow all to come into the airline industry. As a result, consumers have fewer choices and in many markets, no choices.

Mr. Chairman, this lack of competition hits small and medium-size communities the hardest. The impacts are enormous. When there are few flights into a city or a State, that State's economic development is jeopardized.

We see less tourism and few companies expanding operations into our communities. Conventions go elsewhere and our residents drive hours to find more reasonable fares.

Imagine having a loved one sick in a distant community and not being able to get a reasonable fare to visit that person or having to drive hours to catch a flight out of another airport. The purpose of deregulation was not only to create—not only create competition in certain communities.

Mr. Chairman, we in Birmingham are fortunate to have some level of competition not enjoyed by other communities. As you know, we have service from a number of hub carriers including Delta and from Southwest. These carriers provide good service but unfortunately to many destinations, reasonable fares are not available.

Moreover, when they are listed they are often not available. In addition, fares are more confusing than ever. In some cases, fare sales are misleading.

ALL SEASONS TRAVEL

Let me tell you something about my company. We have eight offices in Alabama—Birmingham, Dothan, Montgomery, Selma, Tuscaloosa, and Vance, along with satellite ticketing printers in seven States.

Although our primary clients are corporate accounts, we provide service to a number of others, including the University of Alabama and to individuals.

All of our clients are sensitive to price. But as you can imagine, increased fares have a significant impact on the small companies and the educational institutions we serve.

In order to best serve our clients, we have sophisticated computer systems that constantly, 24 hours a day, search for the lowest available fares. Even with that level of sophistication, we are often unable to find seats at fares advertised the previous day.

We frequently get calls from customers who ask us to book a fare that was advertised in the morning newspaper and it is not available for service out of Birmingham, or there are so many conditions attached to it, that it cannot be used.

Of course, the airlines would allow me to book a seat on the same airplane at three to four times the price. In fact, the airline likely has plenty of room on the airplane. However, they have so limited the lower fares that they are not available.

In most cases, the customer books at the higher fare. Our regulators, State and Federal, would not tolerate this practice in other industries.

Imagine if the local Sears store announced the sale of a certain model of shoe at a $50 price and the ad does not say that it only had three pairs that would be sold at that price. Would you accept it if you showed up that morning at Sears—at the Sears store and are told that the shoe is now $75?

NEED FOR PRICE REFORM

Let me give you an example of pricing. Julian Banton, chairman and CEO, Southtrust Bank, America's 26th largest bank, had to go from Birmingham to Greenville, SC. The fare was $615. He could have gone to London for about the same price; and for a little more, he could have gone on to Amsterdam.

He was shocked. He had to take the trip, because it meant business for his bank and for the State of Alabama.

Many business people could not afford that fare. Moreover, he could have paid much more for that seat. We were able to find him the $615 fare by having the computer search the fare records.

Many people would have paid more. Of course, the airlines now have their own websites. We have gotten calls from customers who claim that a fare was shown on the website, but they were unable to get it. We were also unable to find those fares.

Mr. Chairman, is the Government looking at how carriers use the websites?

I frequently get calls from customers who want to visit a relative in another part of the State—of the country, who is sick or want to visit friends. If they can plan trips weeks ahead of time, they can usually get reasonable fares.

Unfortunately, sometimes you do not have several weeks advance notice of illness or the need to help a friend or a family member. What do these people do? In most cases, they drive hours to catch a flight at airports with more affordable service or they do not go.

Fortunately, Mr. Chairman, your actions in regard to the Wright amendment has made travel to Texas and other parts of the Southwest on Southwest Airline more accessible and affordable.

The conditions placed by carriers on fares are complicated. Some fares may only be available in the morning, others in the afternoon, others only late at night. Some require weekend stays. Others require companion travel.

In some cases, a two-for-one sale may be more expensive than purchasing two separate round trips. That confusion multiplies if you have a trip involving multiple stops.

I can think of no other business where you have little choice of suppliers, and the only way an individual may learn the price is to call and ask. In some cases, a fare quoted by the airline is not the lowest.

Mr. Chairman, my concern is that no one is watching over these ticketing issues. As the industry gets more consolidated and as fares become more complex, it is essential that Government officials oversee this pricing deception.

That is not happening. There should be some standards on advertising, on seats available, and on what is told the public.

I am not asking for price regulation, but I am asking that airline tickets, which are a big price item, be held to the same truths in advertising standards as shoes and other consumer goods.

Mr. Chairman, as we sit here discussing problems associated with the air transportation in this country, I am dismayed at the prospect that we may end up with only three air carriers.

The alliance proposals recently announced would bring the U.S. airline industry to a level of concentration that should concern all in Washington.

PREPARED STATEMENT

Thank you very much, Mr. Chairman. I did not see the red light. I will stop.

Senator SHELBY. We appreciate your testimony.

[The statement follows:]

PREPARED STATEMENT OF BORDEN BURR

Good morning Mr. Chairman and members of the committee. I am delighted to be here this morning to discuss an issue of critical importance to not only my customers and the businesses of Birmingham and the entire State of Alabama but to all travelers—airline ticketing and competition.

First, Mr. Chairman, on behalf of all of us, we wish to express our gratitude to you for holding these hearings and for all you have done to focus attention on the needs of all travelers—business people, individuals wishing to travel to visit family and friends, and those seeking business opportunities. Not only have you held hearings that have shed light on the restrictive Wright Amendment, but you've taken important action to address other factors that lessen competition and result in higher fares.

I want to emphasize that my company exists today because of airline deregulation. My clients and I are believers in the marketplace. We do not want extensive Government regulation or control over the travel industry. But if we are going to have a deregulated system, it must be open for all who are willing to compete. Today, we have a system that does not allow all to come into the airline industry. As a result, consumers have fewer choices and, in many markets, no choices. Mr. Chairman, this lack of competition hits small- and medium-size communities the hardest.

The impacts are enormous. When there are few flights into a city or State, that State's economic development is jeopardized. We see less tourism and fewer companies expanding operations into our communities, conventions go elsewhere, and our residents drive hours to find more reasonable fares. Imagine, having a loved one sick in a distant community and not being able to get a reasonable fare to visit that person or having to drive hours to catch a flight out of another airport.

The importance of airline service to small communities has been the subject of a number of forums including the national air service roundtable in Jackson, Mississippi in February, 1998 and in Chattanooga, Tennessee in February, 1997, where State, local, and Federal officials discussed market-based solutions to local air service problems. The genesis for the meeting was the need to provide focus and clarity to the national understanding about local air service problems and to finish "the unfinished business of the Airline Deregulation Act of 1978 by bringing a competitive mix of service to all communities," particularly those that lack adequate airline competition or service quality. The conference recognized the direct linkage between air transportation and job creation, economic growth and quality of life. The significance of airline service to the economic growth of small communities was best summarized by the following conference statement:

"The evolving aviation marketplace in mid-size communities was revealed to have tremendous implications for major employers at the roundtable. For example, testimony delivered by an official from Eastman Chemical, Tennessee's largest employer and exporter, identified substandard local service as an obstacle to: organizing sales meetings; recruiting a talented work force; deploying sales personnel to field locations; and maintaining personal contact with valued clients."

Service to small and medium markets has also been the focus of a number of congressional hearings. An Eastman Company representative—Fielding Rolston, Vice President, Customer Service and Materials Management, elaborated on how critical air service is to business growth when he testified on June 25, 1997 before the House Subcommittee on Aviation that:

"I told you at the beginning that I'm here representing the business community. I say that again because I want to underscore the fact that, as a company in a very competitive and regulated field, we do understand marketplace realities. We do understand how supply and demand works and we do understand the limitations of legislation and regulations in solving societal problems.

"But we also understand that this is a bigger question than whether the airlines need more competition. It's a question of whether this country wants an airline industry that ignores 20 percent of the communities and airports in this Nation. In short, it's a question of whether we're willing to let the small and medium-sized communities—and all of the companies that call those communities home—fall by the wayside as they find it more and more difficult to attract and keep businesses.

"Deregulation has worked for 80 percent of the country. And we're certainly not asking for re-regulation. But we are asking that deregulation be taken one step further. By providing greater access to gates and slots, you can let the market take over and give competition a true chance to flourish. And in doing so you can ensure that small and medium-sized communities again have a seat at the table and a gate at the terminal."

The purpose of deregulation was not to only create competition in certain communities.

The airline deregulation act provides:

—Placing maximum reliance on competitive market forces and on actual and potential competition.

—Avoiding unreasonable industry concentration excessive market domination, monopoly powers, and other conditions that would tend to allow at least one air carrier or foreign air carrier to unreasonably increase prices, reduce services, or exclude competition in air transportation.

—Encouraging, developing, and maintaining an air transportation system relying on actual and potential competition.

Mr. Chairman, we in Birmingham are fortunate to have some level of competition not enjoyed by other communities. As you know, we have service from a number of hub carriers including Delta and from Southwest. Those carriers provide good service but unfortunately, to many destinations, reasonable fares are not available. Moreover, when they are listed, they are often not available. In addition, fares are more confusing than ever. In some cases, fare sales are misleading.

Let me tell you something about my company. We have 8 offices in Alabama—in Birmingham, Dothan, Montgomery, Selma, Tuscaloosa and Vance, along with satellite ticket printers in 7 States. Although our primary clients are corporate accounts, we provide service to a number of others, including the University of Alabama and to individuals. All of our clients are sensitive to price, but as you can imagine, increased fares have a significant impact on the small companies and the educational institutions we serve.

In order to best serve our clients, we have sophisticated computer systems that constantly—24 hours a day—search for the lowest available fares. Even with that level of sophistication, we are often unable to find seats at fares advertised the previous day. We frequently get calls from customers who ask us to book a fare that was advertised in the morning newspaper and it is not available for service out of Birmingham or there are so many conditions attached to it that it cannot be used. Of course, the airline would allow me to book a seat on that same plane at 3–4 times the price. In fact, the airline likely has plenty of room on the plane, however, they have so limited the lower fares that they are not available. In most cases, the customer books the higher fare. Our regulators—State and Federal—would not tolerate this practice in other industries. Imagine if the local Sears store announced a sale of a certain model of shoe at a $50 price, and the ad doesn't say that only 3 pairs will be sold at that price. Would you accept it if you showed up that morning at the store and are told that the shoe is now $75?

There is no industry that sells its products in a more deceptive way. Hundreds of fares for the same commodity—a seat on a plane between Birmingham and a hub airport.

Not only does price depend upon when you bought the ticket but also on where you are flying. Sitting next to each other on a plane may be three people—one going from Birmingham to a hub, one going to the hub and then to London, and one going to another city from that hub. It should not surprise you to learn that the cheapest of these three fares could be the one to London. Why—because there may be some competition in that market.

Let me give you an example of pricing. Julian Banton, Chairman and CEO, Southtrust Bank, had to go from Birmingham to Greenville, SC. His fare was $615. He could have gone to London for about the same price and for just a little more, he could go on to Amsterdam! He was shocked. He had to take the trip because it meant business for his bank and for the State of Alabama. Many business people could not afford that fare. Moreover, he could have paid much more for that seat—

we were able to find him the $615 fare by having the computer search the fare records. Many people would have paid more. Of course, the airlines now have their own websites. We have gotten calls from customers who claim that a fare was shown on the website but they were unable to get it. We were also unable to find those fares. Mr. Chairman, is the Government looking at how carriers use websites?

I frequently get calls from customers who want to visit a relative in another part of the country who is sick, or want to visit friends. If they can plan trips weeks ahead of time, they can usually get reasonable fares. Unfortunately, sometimes you don't have several weeks advance notice of illnesses or the need to help a friend or family member. What do those people do? In many cases they drive hours to catch a flight at airports with more affordable service or they don't go. Fortunately, Mr. Chairman, your action in regards to the Wright Amendment has made travel to Texas and other parts of the Southwest on Southwest airlines more accessible and affordable.

The conditions placed by the carriers on fares are complicated. Some fares may only be available in the morning—others in the afternoon—others only late at night. Some require weekend stays—others require companion travel. In some cases a "2-for-1" sale may be more expensive than purchasing two separate round trips. That confusion multiplies if you have a trip involving multiple stops. What if you get off the plane and do some business in the city and then fly to another destination before returning home. The fare quoted by the airline for that multiple stop journey may be higher than if you bought two separate tickets. Of course, the airline doesn't disclose those choices, and it certainly doesn't call the customer back if the fare drops.

I can think of no other business where you have little choice of suppliers and the only way an individual may learn the price is to call and ask. In some cases, the fare quoted by the airline is not the lowest.

Mr. Chairman, my concern is that no one is watching over these ticketing issues. As the industry gets more consolidated and as fares become more complex, it is essential that Government officials oversee this pricing deception. That is not happening. There should be some standards on advertising, on seats available and on what is told to the public. I am not asking for price regulation but I am asking that airline tickets—which are big price items—be held to the same truth in advertising standard as shoes and other consumer goods.

Mr. Chairman, as we sit here discussing problems associated with air transportation in this country, I am dismayed at the prospect that we may end up with only three air carriers. The alliance proposals recently announced would bring the U.S. airline industry to a level of concentration that should concern all in Washington. For an industry that is already concentrated, this would further diminish opportunities for competition and affordable fares. I agree with Herb Kelleher, who has cautioned that these alliances could be devastating to small carriers. I urge you to ask the Department of Transportation to suspend consideration of these alliances until they have fully examined the implications on the entire country—particularly for those of us living and doing business in small and medium communities, have put in place final guidelines to prevent anti-competitive behavior, and have addressed all those issues that limit new entry and competition. To that end, I have included a copy of a letter sent by Ivan Michael Schaeffer, of Woodside Travel Trust, to Secretary Slater on this issue.

To allow competition, I urge you to continue your review of barriers to entry that prevent competition in many business markets, and particularly hit smaller markets and states the hardest. Furthermore, you should also continue to review predatory behavior that prevents new entrants from coming to and staying in smaller cities such as Birmingham, Montgomery and Mobile. Mr. Chairman, it is also essential that steps be taken to improve airline competition. As new carriers enter markets, more discipline is introduced into the market place. A carrier that dominates a market has little incentive to be reasonable.

Thank you, and I am prepared to answer questions.

LETTER FROM IVAN MICHAEL SCHAEFFER, PRESIDENT AND CEO

WOODSIDE TRAVEL TRUST,
Bethesda, MD, April 24, 1998.

Hon. RODNEY B. SLATER,
Secretary of Transportation,
Department of Transportation, Washington, DC.

DEAR MR. SECRETARY: The news that the number of major airlines in the United States decreased by 50 percent overnight was hardly unanticipated. The pell-mell rush of the airlines to consolidate their operations globally has continued, unabated, up to and including yesterday's announcement. Without swift and decisive action by you, all semblance of airline competition will evaporate from the global marketplace.

This further and dramatic consolidation of what Salomon Smith Barney, in their study of concentration at the 50 largest airports shows excessive (more than twice the level that the Department of Transportation considers "highly concentrated"), causes significant problems for the business and economy of the United States. This oligopoly, and in some cases monopoly, if left unchecked, guarantees no low cost carriers will remain. Furthermore, the cost to all travelers will increase, fewer will fly, many more communities will become underserved, all impacting upon the economic well being of those communities as well as upon our economy as a whole.

As we begin the third post-deregulation decade in the United States, it appears that the now well entrenched hub and spoke system will continue to grow stronger and proliferate internationally. However, the alarming and pervasive negative results of this concept (even before yesterday's news), namely, uneven pricing, depending on location and passenger type, and a sharp reduction in service levels for many smaller communities, must be addressed. I would submit that the antidote is for the U.S. Departments of Justice and Transportation, Congress and the European Union to recover and preserve the fundamental tenet of a deregulated environment: the opportunity for competitive entry.

Notwithstanding mountains of pressure from communities, airports and business groups, our governmental entities have spent months and now years wrangling over a number of concerns regarding hub dominance: the competitive response of the "hubbing" airlines to new entry such as predatory pricing and capacity dumping; the failure to make airport facilities, including gates and slots available to new entrants; and issues such as frequent flyer program dominance.

We welcome the guidelines your Department recently released for comment. In the introduction to those Guidelines you recognize not only the "mandate" of DOT to intercede where anticompetitive activity occurs, but also the "obligation" to do so. Mr. Secretary, I would submit to you that "standing pat" with respect to the alliance announcement of American-US Airways and Delta-United (even as the comment period for those guidelines run) would be tantamount to a "breach" of the Department's recognized obligation.

I believe that there are those of us who are so profoundly interested in obtaining a competitive, accessible and fairly priced global air transport system that we must carefully examine the airline industry as it continues to takes shape. The goal, we thought when we embarked upon this effort, was to maintain a strong airline industry that contributes to the growth of the emerging global economy on the one hand, and at the same time fairly and adequately serves the interest of the public operating within that environment.

The domestic airline industry is much different than anyone involved in de-regulation ever anticipate—fewer carriers, steadily increasing fares, airports and areas of the country dominated by one carrier, new levels of concentration, significant barriers to entry and instances of anti-competitive behavior. We now see proposals would allow three air carriers (along with their alliance partners, code-sharing partners, and commuter affiliates) to control U.S. domestic traffic—approximately 82 percent of domestic revenue passenger miles. Their actual and proposed international alliances and ownership with foreign carriers will also allow them to dominate the world.

For years, Government believed carriers would be reluctant to raise fares. However, with the reduction in the number of carriers competing, the dominating carriers fear has gone away. For the founders of deregulation, this rationale served to satisfy the concern over the economies of scale that exist in the airline industry, and justified the excessive market dominance that deregulation might cause. But the DOT and other parties now seem to acknowledge that such competitive pressure does not exist in fortress hubs, and in many other major markets and as a consequence there is no stabilizing pressure on airfares.

Prior to yesterday's announcement, and according to a Salomon Smith Barney report, measures of concentration at the 50 largest airports showed an unprecedented degree of concentration or market lack of competition than at any other time in the history of the airline industry. The "weighted" average of airline market shares at each of the 50 largest airports in the United States demonstrate that the concentration for the industry is at excessive levels.

As a result, concentration in the U.S. airline industry is an all time high; there are fewer carriers operating than at any time since deregulation; and there are few applications on file at DOT for air carrier certificates. The alliances announced yesterday and previously by Northwest and Continental are but a prelude to mergers that will irrevocably change the scope of global airline competition.

Because the major carriers have responded so strongly to protect their turf, and the rumblings of discontent from the public is getting louder, DOT has decided to give the public fair opportunity to comment. The airlines obviously favored that approach, as it gave them time to mount a concerted public relations and lobbying effort and, of far greater significance, the space to unabashedly take these dramatic new initiatives to drive the nail in the coffin of the anticipated fruits of deregulation.

Although your proposed anti-competitive guidelines address one of the factors that has decreased competition, barriers to entry and marketing practices utilized by large carriers block the growth of new entry. As Herb Kelleher, in commenting on the Department's proposed guidelines recently stated, he: "found it inconsistent for the government to set guidelines to protect new entrants while advocating airline alliances. More consolidation * * * makes it tougher for startups to compete with big carriers that can make enough in their monopoly markets to subsidize losses in competitive markets."

Mr. Secretary, these issues and their impact on all are so significant that we call upon you to suspend consideration of all alliances (including, but not limited to Northwest-Continental, American-US Airways and United-Delta)—domestically and internationally—until the impact of these alliances and existing alliances can be fully evaluated and definitive measures are put in place that will ensure future competition and choice for all Americans.

It is high time for debate and reflection to end and for our Government to undertake its duty to protect the travelers of this country.

Sincerely,

IVAN MICHAEL SCHAEFFER,
President and CEO.

STATEMENT OF LAURADAY KELLEY, VICE PRESIDENT, CRUISELINK

Senator SHELBY. Ms. Lauraday Kelley, CruiseLink.

Ms. KELLEY. Good morning. Mr. Chairman, members of the subcommittee, I am Lauraday Kelley, vice president of CruiseLink, a travel agency consortium. In addition, my husband and I have been Pennsylvania travel agency owners for over 20 years.

I have summarized my testimony but ask that the full text be submitted for the record.

Senator SHELBY. It will be, without objection.

Ms. KELLEY. Thank you. I would like to thank you for holding this very important hearing on the issue of airline ticketing practices and antitrust enforcement.

I am here today representing the Coalition of Travel Industry Parity [CTIP], a coalition comprised of 23 travel agency co-ops, consortia, and franchise organizations with approximately 17,000 travel agency members.

I also represent views strongly shared by the American Society of Travel Agents [ASTA], the world's largest travel trade association with 27,000 members in 170 countries.

CTIP and ASTA are closely allied in support of legislation, Senate bill 1977, the Consumer Access to Travel Information Act of 1998 just introduced by Senator D'Amato and Senator Reid that we believe is needed to address the decline of competition as well as other problems in our Nation's air transportation system.

This morning, I would like to briefly talk about the spate of anticompetitive practices recently undertaken by the major airlines and the effect of these anticompetitive practices on both the air traveler and thousands of small businessowners that comprise the travel agency industry.

For the past 3 years, major U.S. airlines have begun trying to neutralize or eliminate the travel agent ticket distribution system. They are doing this for a very simple reason, to force consumers to purchase tickets directly from the airlines.

Individual airlines currently do not and will not provide information about competitors' services, even if they offer better value and meet the consumer's needs.

By eliminating consumers' access to an unbiased source of fair information, we believe that the airlines intend to achieve the effect of additional fare increases. As a result, the consumer loses.

As the committee is aware, the major airlines now control hubs, fares, schedules, routes, slots, and small city services. And with this latest round of joint marketing agreements, that stranglehold over the air transportation system may be tightened even further.

The major airlines would have us believe that they need to reduce expenses so that they can pass savings on to the consumer.

As you know, Mr. Chairman, airline ticket practices have steadily increased with no recognizable benefits or improved services for the consumer. Airlines are posting record profits, while many consumers are paying some of the highest airfares in history.

However, there is an additional threat to consumers. Mr. Chairman, the typical travel agency is a small business enterprise. Many times, we serve as the only ticket distribution system available to small, regional and new startup airlines.

Without it, Mr. Chairman, the likelihood of a regional or startup airline surviving greatly diminishes.

AIRLINES' THREATS TO TRAVEL AGENTS

Mr. Chairman, I would like to describe some examples of how airlines are squeezing travel agents and thus hurting the consumer. One recent example of this absurd practice has to do with consumers who purchase round-trip tickets for one-way travel.

In the strange world of airline fares, round-trip fares are sometimes less than one-way fares. So savvy consumers who purchase a round-trip ticket, simply throw away the return portion of the ticket and can thereby save hundreds of dollars.

In response to this practice, one airline now states that it will at its own discretion collect the difference between the round-trip fare and the one-way fare from any travel agent involved in a transaction where the consumer does not use the return portion of their planned trip.

Other examples of anticonsumer practices include: One, offering fares through the Internet that are not available for sale elsewhere, while advertising that the airline itself can give the consumer the lowest fare, thus penalizing the consumer who does not have access to the Internet; two, penalizing travel agents for granting refunds on so-called nonrefundable tickets while the airlines routinely make such refunds when contacted directly by the consumer; and three, punishing travel agents for issuing back-to-back and "hidden city" tickets, even though they may represent the lowest airfare for the consumer.

One of the most stunning developments, Mr. Chairman, is that the major airlines have a computer—computerized system of obtaining a travel agent's proprietary consumer and sales data. In other words, one carrier may be able to look at the keystrokes of one particular agent to see if they are bringing up the schedule of a competing carrier over their own schedule.

Senator SHELBY. How do they do that?

Ms. KELLEY. They do that through a report that they receive through the data base of all the other airlines.

Senator SHELBY. OK.

Ms. KELLEY. I cannot think of another business where the supplier is allowed to do, actually, an unauthorized audit of the books of their distributor.

Mr. Chairman, let me emphasize that the travel agent's livelihood depends on the U.S. consumer. We are in business to offer the U.S. travel consumer the most complete travel information in the travel industry, as well as to assist them in securing the very best airfares available.

This is not just a case of one entity battling in the marketplace with another to provide the best service. This is about several large entities engaging in anticompetitive practices, with the intent of limiting information and competition for their own benefit.

All we ask is that Congress preserves our ability to compete. If we are prevented from doing so, the American consumer will be the big loser.

PREPARED STATEMENT

Mr. Chairman, on behalf of the 250,000 travel agents across the United States, thank you for providing me this opportunity to testify before you today.

Senator SHELBY. Thank you, Ms. Kelley.

[The statement follows:]

PREPARED STATEMENT OF LAURADAY KELLEY

Mr. Chairman and Members of the Subcommittee: I am Lauraday Kelley, Vice President of CruiseLink, a travel agency consortium. My husband I have been Pennsylvania travel agency owners for 20 years. I appreciate the opportunity to appear before you today to explore the broader issue of competition in the aviation industry and in particular the anti-competitive ticketing practices of US airlines.

I am here today representing the Coalition for Travel Industry Parity (CTIP), a coalition comprised of 23 travel agency co-op, consortia, and franchise organizations, with approximately 17,000 travel agency members. I also represent views strongly shared by the American Society of Travel Agents (ASTA), the world's largest travel trade association, with 27,000 members in 170 countries. CTIP and ASTA are closely allied in support of legislation that we believe is needed to address the decline of competition and growing array of problems within our nation's air transportation system.

Since airline deregulation in 1978, it became apparent that the travelling public preferred to complete their flight arrangements with travel agents. The reason is simple: travel agents are the only source of complete, accurate and unbiased travel information and services available in the marketplace. Individual airlines currently do not, and will not provide information about competitor's services, even if they offer better value and meet the consumer's needs. Today, between 70 and 80 percent of US air travelers depend upon travel agents to provide an accurate and complete selection of schedules, fares, and ticketing services for all airlines, both domestic and foreign, large or small. Travel agency sales of air travel currently exceeds $70 billion annually and continues to grow, despite competition from the airlines' 800 numbers and the Internet.

For the past three years, major U.S. airlines have tried to neutralize or eliminate the travel agency ticket distribution network, in order to force customers to purchase tickets directly from the airlines. By eliminating access to an unbiased source of information, we believe the airlines expect to greatly improve their profitability through the fares consumers pay for air travel. Consider that if airlines increase the average fare paid by one-half of travel agents' clients by a mere five dollars, they would reap an additional $455 million in revenue per year.

In 1978, airline deregulation was enacted with the belief that an unregulated marketplace would foster competition in prices and services and that consumers would benefit from lower fares and improved services. Today however, we see that four major airlines, United, American, Delta and Northwest effectively control pricing and distribution policies of the US air transportation system. These airlines also have considerable influence in the international marketplace. And with this latest round of joint marketing agreements, their stranglehold over the air transportation system may be tightened even further.

Simply, we believe that the major airlines intend to wrest complete control over consumer access to information, reservations and ticketing services, much in the same manner they now control hubs, fares schedules, routes, slots and small city services. These airlines do not want consumers to continue to have the same ready access to comparative schedule and fare information that they enjoy today through the travel agency distribution system.

The airlines are using a variety of techniques to achieve their goals. Twice in the past three years, they have initiated reductions in travel agent commissions on the sales of air travel, effectively reducing the commission below the agent's costs. As a result, travel agencies have been forced to levy transaction fees to offset the reductions in commissions. Although many consumers have elected to pay the fees to travel agents, other consumers who are unwilling or unable to pay these fees have only one viable option: to contact airlines directly and forfeit the comparative price shopping travel agencies provide. This puts the consumer right where the airlines want them, bereft of an unbiased source of information to deal with a bewildering array of complex airfares and rules.

The major airlines have generally misrepresented the reason for travel agency commission cuts. They would have us believe that they need to reduce expenses so that they can pass savings on to the consumer. As you know, Mr. Chairman, airline ticket prices have steadily increased, with no recognizable benefits or improved services for consumers. Airlines are posting record profits while many consumers are paying the highest airfares in history.

There is an additional threat to consumers, Mr. Chairman. The typical travel agency is a small business enterprise. We are often the only ticket distribution system available to small, regional, or new start-up airlines. Internet sites posting air travel information and offering ticket-purchasing mechanisms are already tightly controlled by major airlines. Any individual who has attempted to book a flight on the Internet learns quickly that the process can be very difficult and tedious. Further, major airlines have severely impaired Internet competition orchestrated by travel agents by adopting discriminatory and non-compensatory commission policies for travel agent bookings that originated through the Internet.

For many years, airlines have threatened and harassed travel agents by unilaterally imposing a wide variety of penalties for alleged ticketing practices that often benefit consumers. These ticketing procedures are sometimes suggested by travel agents, but often are at the request of customers.

One recent example of this absurd practice of the airlines has to do with consumers who purchase round-trip tickets for one-way travel. In the strange world of airline fares, round-trip fares are usually less than one-way fares, therefore consumers who purchase a round-trip ticket simply throw away the return portion of the ticket and thereby save often hundreds of dollars. In response to this practice, one airline has now stipulated that it may, at its sole discretion, collect the difference between the round-trip fare and one-way fare from any agent involved in a transaction where a customer does not use the return portion of their planned trip.

Other examples of anti-consumer practices include: (1) offering fares through the Internet that are not available for sale elsewhere, while representing that the airline itself can give the consumer the lowest fare; (2) penalizing travel agents for granting refunds of so-called non-refundable tickets while making such refunds when contacted directly, and, (3) punishing travel agents for issuing back-to-back and "hidden city" tickets, even though they may represent the lowest fare for the consumer.

The agent, of course, has no control over the customer once the ticket is sold. Nonetheless, as absurd as it sounds, under the current system, a travel agent has neither the right of appeal, nor any legal recourse against an airline that levies a penalty, for any reason, justified or not, against any travel agent. The travel agent must pay the penalty or the airline may terminate the agent's right to sell tickets on behalf of that airline. Any agent who loses the right to write tickets on a dominant hub carrier, has just been awarded a one-way ticket of his very own—to bankruptcy court.

Other examples of pressure tactics by carriers include dominant hub carriers that withhold benefits from agents who do not support the dominant airline. Major airlines have a computerized system of obtaining proprietary travel agency customer and sales data and worse, we have recently learned that some dominant carriers are now able to analyze the computer reservations keystrokes of travel agents to determine the order in which a travel agent, sitting at his or her own desk, accesses airline schedules. In other words, one carrier may be able to look at the keystrokes of a particular agent to see if they are bringing up the schedule of a competing carrier, over their own schedule.

Two weeks ago, Senator D'Amato and Senator Reid introduced S. 1997, the Consumer Access to Travel Information Act, which addresses some of the problems I have highlighted. Representative Mike Forbes has introduced identical legislation, H.R. 3704, in the House. CTIP, ASTA and 250,000 travel agents support this legislation, as well as most of the other legislation that has been introduced in Congress this year to restore competition in the air transportation industry.

Mr. Chairman, let me emphasize that the travel agent's livelihood depends on the U. S. consumer. We are in business to offer the United States travel consumer the most complete travel information in the travel industry as well as to assist them in securing the very best airfares available. We are not afraid to compete with airlines; we have competed with them for 50 years. We are however, deeply troubled with actions taken by the major airlines in the last several years, which, if unchecked, will make it impossible for us to compete.

This is not just a case of one entity battling in the marketplace with another to provide the best service. This is about several large entities engaging in anti-competitive practices, with the intent of limiting information and competition for their own benefit. We believe the marketplace should determine who is the best provider of information and other consumer services, and that the marketplace should not be influenced by sheer size and magnitude of several competitors who stand to benefit from these anti-competitive practices. All we ask is that Congress preserve our ability to compete. If we are prevented from doing so, the American consumer will be the big loser.

Mr. Chairman, on behalf of the thousands of small business people across the United States who are travel agents or run travel agencies, I thank you for holding these important hearings.

This completes my prepared statement. I will be pleased to respond to any questions you may have at this time, or submit for the record at a later date. Thank you.

STATEMENT OF LARRY DARBY, PRESIDENT, DARBY ASSOCIATES

Senator SHELBY. Mr. Larry Darby, president, Darby Associates. Mr. Darby, welcome to the committee.

Mr. DARBY. Thank you, Mr. Chairman. I am happy to have the opportunity to be here this morning and thank you for that bubbly-blast. It is not often I get a free lecture from the dean of regulatory economists, Professor Kahn.

You have asked me to summarize commercial arrangements called resale——

Senator SHELBY. Right.

Mr. DARBY [continuing]. In the telecommunication sector and to reflect a little bit on what that might mean in the airline——

Senator SHELBY. Draw the analogy if you can.

Mr. DARBY [continuing]. In the airline business. Let me sort of give a cautionary note. I am probably more qualified on the first than on the second.

My background for the past 20 years is in the telecommunication side and less on surface and air transportation, although we do some business from time to time.

Senator SHELBY. That was an area where there was little, if any, competition.

Mr. DARBY. And I hope to bring out that issue——

Senator SHELBY. Go ahead.

Mr. DARBY [continuing]. As a possible differentiating characteristic.

Senator SHELBY. Yes.

Mr. DARBY. I have submitted a longer statement for the record, and I appreciate your——

Senator SHELBY. Your written statement will be made part of the hearing record in its entirety.

Mr. DARBY. And I appreciate that. And I also, in response to counsel, submitted a much longer statement on communications resale that I wrote in 1995 and——

Senator SHELBY. That will also be made part of the record in its entirety. This is the analysis statement?

Mr. DARBY. Yes, sir; and I will refer to that from time to time.

Senator SHELBY. OK.

[The information follows:]

ANALYSIS OF AT&T MARKET POWER IN THE RESALE MARKETPLACE

EXECUTIVE SUMMARY

The purpose of this report is to characterize and evaluate elements of AT&T's tariffing strategy in a market where some of its largest customers, resellers, are also a source of growing competition to it and other facilities based carriers in the end user market.

The paper reports the results of a review of (a) the economics literature on matters related to the incentives of vertically integrated firms in its dealings with specialized rivals, (b) contract tariffs entered by AT&T under the authority granted them by the FCC in Docket 90–132, and (c) practices related to their negotiation, implementation and AT&T business practices in general in relationship to resellers. The paper interprets key provisions of those contracts in the context of our current understanding of the economics of vertical relationships and strategic pricing practices under partial regulatory constraint.

The overall objective of the study is to determine whether, how and to what extent the business relationships entered with different users by AT&T and other interexchange carriers are marked by identifiable and systematic differences among user classes. The more specific goal is to determine whether such differences are consistent with Commission competitive policies and its goals with respect to providing a market environment congenial to the effective operation of the resale sector.

The study commences with a review of the regulatory underpinnings of the development of the reseller industry and the Commission's goals in protecting and promoting resale. It turns then to a review of the current market structure of the interexchange marketplace; the nature of AT&T's ratemaking incentives, pricing discretion and strategy in the interexchange marketplace. This analysis is followed by a discussion of some economic principles and concepts relevant to the current market structure, which principles are brought to bear in an analysis of the terms and conditions attached to services offered to resellers compared to the terms and conditions offered by AT&T to end users.

The results of our analysis indicate that AT&T has the ability and incentive to structure its general commercial relationships and to differentiate the terms offered in different contract tariffs in ways that conflict with the Commission's basic policies respecting resale and the Commission's broader goals for promoting competition in the interexchange marketplace.

The analysis shows that because of its vertical integration of production, wholesale and retail of network services and its power in each of those markets, AT&T defines its relationships with resellers in ways consistent with economic theories of anticompetitive behavior designed to suppress competition by raising competitors' costs and by other means.

The principal conclusion of the analysis is that market forces alone, given the current structure and incentives in the marketplace, are not clearly sufficient to assure continued evolution of competition to facilities-based carriers from the resale sector in conformance with long established Commission policies.

COMMISSION POLICY TOWARD RESELLERS

Resellers make important contributions to achievement of the goals of the Commission's competition policies. The Commission has attempted generally to foster regulatory conditions congenial to the development of a healthy telecommunications resale sector, to complement its other procompetitive, deregulatory policies in interstate telecommunications.

The telecommunication reseller industry was borne in 1976 with the FCC's decision holding that longstanding AT&T tariff prohibitions on sharing and resale of private line services were unjust, unreasonable and unlawfully discriminatory.[1] Until that time, with limited exception, AT&T tariffs prevented users from sharing the services or reselling tariffed services, whether or not they added value before reselling, and limited customers to using the services in the conduct of its own business.

The Commission found that elimination of the provisions in AT&T tariffs preventing resale of private line services would bring about several public benefits of an economic nature and emphasized the role of resellers in rationalizing the rate structure; forcing it more closely into conformance with the overall cost structure; and providing for more efficient use of underlying network capacity.[2]

In various orders since the original resale order, the Commission has consistently reiterated its belief that the public's interest is served by the existence of a healthy resale industry and has adopted measures expanding the scope of resale and opportunities for reseller growth. A key factor came five years later when the Commission permitted resale of AT&T's MTS and WATS services, thereby making it possible for resellers more easily to acquire the ability to offer universal connections. The equal access requirements of local exchange companies contained in the Modified Final Judgment extended to resellers and permitted them, along with other competitors, to offer one-plus dialing comparable to that offered by AT&T. The emergence of U.S. Sprint as a major facilities based competitor and its decision to use resellers to expand its market share contributed to growth of resellers and the emergence of Sprint as a viable facilities based competitor to AT&T.

In a recent restatement of its views of the economic role of resellers in the interexchange marketplace, the Commission has emphasized again the importance of resellers in helping to bring about cost-based rates and efficient use of underlying carrier capacity.[3]

"The Commission has a long-standing requirement that all common carriers must permit unlimited resale of their services. The Commission has found that unlimited resale promotes the public interest by creating competitive pressures on carriers to provide service at rates near the cost of service and by stimulating demand for such service."[4]

Commission policy has been to eliminate tariff prohibitions on resale. "Because of these benefits from resale of communications services, the Commission has rejected

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[1] Regulatory Policies Concerning Resale and Shared Use of Common Carrier Service and Facilities, 60 F.C.C. 2d 261 (1976), (Resale and Shared Use Order) recon. 62 F.C.C. 2d 588 (1977), *aff'd sub nom. American Telephone and Telegraph Co.* v. *F.C.C.,* 572 F. 2d 12 (2nd Cir. 1978); see also Regulatory Policies Concerning Resale and Shared Use of Common Carrier Domestic Public Switched Network Services, (Switched Network Resale Order), 83 F.C.C. 2d 167 (1980), *aff'd sub nom. Southern Pacific Communications Company* v. *F.C.C.,* 683 F. 2d 232 (D.C. Cir. 1982).

[2] The Commission specifically noted four expected benefits: a. the provision of communications services at rates more closely related to costs; b. better management of communications networks, and the provision of management expertise by users and intermediaries to the carriers; c. the avoidance of waste of communications capacity; and, d. the creation of additional incentives for research and development of ancillary devices to be used with transmission lines.

Significantly, the Commission held that tariff restrictions on resale and shared use were not justifiable on grounds that such restrictions protected carrier revenues or rate structures.

[3] While both cost based rates and effective capacity utilization contribute to economic welfare, the contribution of resellers to expanding the size of the market and hence capacity utilization for underlying facilities carriers is especially important. Given the considerable excess capacity of the industry and the substantial elasticity in end-user demand, a healthy resale industry is especially valuable in expanding capacity utilization by lowering the average level of rates through what is essentially an arbitraging function. The Commission's initial resale decision, combined with subsequent ones expanding the bounds of permissible resale, is the foundation of the development of competition in the interexchange marketplace. The ability to resell capacity obtained from AT&T has been instrumental in the survival and growth of MCI, Sprint and other facilities based carriers who used resale to win market share and to generate cash flow to underwrite facilities expansion.

[4] In the Matter of AT&T Communications: Apparent Liability for Forfeiture and Order to Show Cause. Adopted: December 30, 1994; Released: January 4, 1995 (mimeo) at p.2. (Hereafter, "Apparent Liability"). While both cost based rates and effective capacity utilization contribute to economic welfare, the contribution of resellers to expanding the size of the market and hence capacity utilization for underlying facilities carriers is especially important. Given the considerable excess capacity of the industry and the substantial elasticity in end-user demand (as documented in the Interexchange Order), a healthy resale industry is especially important in contributing to efficient utilization of fixed network facilities from which services are available at very low costs at the margin.

See also, In the matter of Competition in the Interstate Interexchange Marketplace, Report and Order, CC Docket No. 90–132, 69 RR 2d 1135 at 1160 (1991). Hereafter, "Interexchange Order".

the restrictions on resale . . ."[5] Thus, outright prohibition is an unreasonable restriction on resale. And, the language of several orders indicates that it is also Commission policy to disallow tariff restrictions on resale, inasmuch as previous Commission holdings declare unlawful "de facto" tariff restrictions which fall short of outright prohibition of resale.[6]

CONTRIBUTIONS OF RESELLERS TO COMMISSION'S GOALS

The reseller industry is an important contributor to achievement of the Commission's competitive goals in the interexchange marketplace. It has done so in several ways. Resellers have contributed toward conforming the structure of costs more closely with the underlying structure of costs, thereby advancing one of the Commission's principal underlying competitive policy objectives. Resellers have lowered the average rate for small and medium sized users to an extent that would not otherwise have been possible.

Resellers provide a variety of services to end users. The industry can be separated into three main categories, which differ according to asset ownership and principal business function. Resellers may or may not own either switches or transmission lines, and they may or may not provide billing or other ancillary customer services.[7] The principal sources of value added are: sales and marketing to end users, customer management, billing and collecting, and, more generally, provision of a full array of customer services.

Resellers have contributed to capital formation in the interexchange marketplace. By providing an outlet for capacity from facilities based carriers—new entrants in particular—resellers have helped capitalize the development of fibre networks by competitive, underlying facilities based carriers.

A consortium of regional long distance resellers, the National Telecommunication Network (NTN), was initiated as a means of providing a nationwide interconnected network of individual resellers of intercity communications capacity. The NTN is a product of agreements among resellers to interconnect networks; to share traffic; and, to terminate traffic for each other.

A number of resellers have recently been innovators in providing detailed, analytical billing statements which users have found helpful in planning communications requirements and for monitoring and assuring efficient use of limited facilities.

Resellers provide a cost effective distribution channel for carriers and frequently are able to offer customized services with value added features to end users whose particularized needs might otherwise be ignored by the underlying carrier. Resellers can reduce costly (to the underlying carrier) customer churn, by assuring them access to the best available value.

Resellers are advancing the Commission's competitive agenda by their adaptation to user requirements and rate/service innovation in the interexchange market environment. In addition to bringing about greater rate competition, the reseller sector is diversifying its service offerings and entering new markets. New products include E-mail services, data services, new features on calling cards, prepaid cards (for residential callers, travelers, affinity groups and people without phones) and international callback services for U.S. based companies and foreign businesses. These represent significant additions to the traditional 1+ outbound and 800 services traditionally marketed to small and medium-sized businesses.[8]

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[5] Ibid. "Apparent Liability", p.2. See also, MCI Telecommunications Corporation, 81 F.C.C. 2d 568, 572–73 (1980); American Telephone & Telegraph Co., 84 F.C.C. 2d 158, 1867–87 (1980).

[6] See, *Public Services Enterprises of Pennsylvania, Inc.* v. *AT&T Corp.,* File No. E–93–09, FCC 95–169 (released May 5, 1995) and accompanying references.

[7] The simplest form of resale business entity is an "aggregator". An aggregator, as the name suggests, simply gathers different customers together, aggregates their traffic for purposes of getting lower rates reflecting quantity discounts from the underlying carrier and order services from the relevant tariff. End users are billed the tariff charges by the facilities based carrier and they pay the aggregator a commission. Aggregation and marketing are the simplest forms of reseller value-added. Aggregators have declined in number and volume in favor of more complex forms of resale. The next level reseller has no facilities but does provide billing services. These "rebillers" (or switchless resellers) may provide other customer services in addition to billing. They are compensated by billing end users amounts that reflect a markup over the rate they receive from the underlying carrier. The most sophisticated resellers own facilities—switches and/or transmission lines. These companies provide a wide array of services, including billing, and set their own usage rates. They may sell to end users or to other smaller resellers. They have their own Primary Interchange Carrier (PIC) codes and pay access fees to interconnecting local exchange carriers.

[8] For a detailed accounting of the evolution of reseller services and plans for the future, as indicated in responses to a questionnaire, see ATLANTIC—ACM; 1994 Competitive Telecommunications Reseller Report; June, 1994 (section 2).

ECONOMIC FRAMEWORK FOR ANALYZING AT&T BEHAVIOR TOWARD RESELLERS

The economic structure of the markets within which telecommunications services resale takes place is rather complex. For present purposes, the key characteristic of the market is the dual nature of AT&T's relationship with resellers who are both customers and competitors. This duality of resellers—as customers, whom it is very much in AT&T's interest to please, and as competitors, whom it is very much in its interest to thwart—creates contradictory incentives for AT&T's managers. These contradictory incentives create tensions between alternative patterns of market behavior—a pushing and pulling between cooperative and rivalrous behavior.

These tensions in turn lead to questions about the extent to which pursuit of shareholder interests in dealing with resellers is consistent with the Commission's statement of the public interest in promoting resale.

The purpose of this section is to clarify the nature of these tensions, their implications for AT&T's market conduct and the extent to which market forces will satisfy the public's interest in fostering a market climate conducive to resale and consistent with the Commission's purposes and policies.

The structure of markets within which telecommunications network services are made available for resale to end users is characterized by three distinct vertical stages: network ownership and services production, sale of bulk capacity on a wholesale basis, and retail sales to end users. Some companies are fully integrated across all three phases, while others are only partially integrated or completely specialized in one phase. There are differential degrees of competition, market power and regulation within these segments and with respect to different services. The factual circumstances are not closely replicated, so far as we can tell, anywhere else in the domestic economy.[9] The structure of the market and the relationships among various participants are illustrated in the graphic in Appendix 1, which maps various market participants with the stage(s) of the market in which they participate.

Stage 1—Facilities Ownership and Provision of Communications Capacity. AT&T is one of several suppliers at this level—carriers who provide services (on retail and/or wholesale basis) from facilities they own. While AT&T is the dominant provider of underlying network capacity and network services, it is joined at this primary level of production by several other facilities-based carriers, including, principally MCI and Sprint, but several other smaller ones as well. Even the largest facilities based carriers (other than AT&T) have at one time or another supplemented their offerings by reselling capacity obtained from other facilities based carriers. Most facilities based carriers continue to do so.

AT&T is the dominant supplier of services to both end users and for resale. The other major facilities-based interexchange carriers—MCI, Sprint, and WilTel—provide services to both resellers and end users. Most smaller facilities-based, interexchange carriers fill out their networks with services obtained from the major carriers for resale. Some resellers have limited investment in switches, which provide linkages among circuits obtained from facilities based carriers. The line between small interexchange carriers and facilities-based resale carriers is not in principle a bright one, inasmuch as both segments are substantially dependent on the facilities of others.

Stage 2—Provision of Service on a Wholesale (for Resale) Basis. AT&T and the large facilities based carriers provide capacity on a wholesale basis to intermediaries who in turn resell to end users. Some of the larger resellers also sell capacity to other smaller resellers thus assuming the role of both wholesaler and retailer. And, in fact, some of the larger users who obtain service either under contract or Tariff

[9] The market here has many of the characteristics of what has been studied under the broad rubric of the "theory of the sale of intermediate goods", which examines the contractual relationship between parties at successive vertical stages in the chain of value added. The similarities may be appreciated by considering the description of such markets written in a recent review and consolidation of the literature on vertical contractual relations: "There are several important respects in which intermediate goods markets differ from final good markets and thus merit independent study. First, intermediate goods markets often involve large transactions made by sophisticated buyers. Second, the products being sold may possess very complex bundles of attributes, making problems of moral hazard more severe, or at least more complicated. Third, the buyers' demands for an intermediate good are interdependent when the buyers are product-market competitors with one another. Fourth, the buyers of an intermediate good typically are involved in a game in the downstream product market, and the sales contract for the upstream product may affect the equilibrium of this downstream game. Lastly, buyers of intermediate goods often can credibly threaten to integrate backward into supply of the intermediate good."

Michael L. Katz, "Vertical Contractual Relationships", Handbook of Industrial Organization, vol. 1 (edited by Richard Schmalansee and Robert D. Willig), North Holland: Elsevier Science Publishers B.V., 1989, p. 656.

12 may provide wholesale capacity to other smaller resellers or to end users in the retail market.

Stage 3—Provision of Service on a Retail Basis to End Users. Facilities based carriers and resellers compete in the retail market by providing service to end users. They are joined in that competition by a handful of large users who buy under one or several volume discounted tariffs, then sell some of that capacity to smaller end users.

Resellers are set apart from facilities based carriers by the fact that most, and in many cases all, of their revenue comes from the sale of minutes provided from the physical network of another carrier. Resellers may or may not own switches, and they may or may not bill their customers. These distinctions provide the basis for the three types of resellers identified in the table. The capital intensity of resellers varies from those that have significant investment in both switching and transmission facilities, to those that invest in switches only, to those that have no plant investment (pure resellers). Pure resellers may be further divided into aggregators and rebillers. Aggregators merely sign up users and arrange with the facilities based carrier(s) to provide and bill for service. Like aggregators, rebillers sign up multiple users and order service from the facilities-based carriers. In addition, however, the rebiller also bills the end user.

The key points to emerge from this classification of various types of entities in the interexchange market are (a) AT&T is the dominant facilities provider and source of most capacity obtained by resellers, (b) AT&T and other major facilities based carriers are fully integrated through the entire vertical value chain from facilities provision, through wholesaling, to the end user retail market and (c) resellers are both competitors of the major facilities providers in the retail market and customers in the wholesale market.

The analysis below will be concerned mainly with the implications of these differential degrees of vertical integration, market rivalry and market power.

AT&T HAS INCENTIVES TO SUPPRESS RESALE

The structure of these markets belies simple characterization of the incentives and likely market behavior of firms generally and AT&T in particular. The foregoing sketch of the firms and markets involved in different phases of the value chain is complicated further by the details of different firms' day-to-day operations. The markets are characterized by incomplete and asymmetric regulation, different degrees of rivalry and market power, and widely varying degrees of vertical integration and market staying power. Thus, even a reasonably complete characterization of the incentives of firms in the sector would require consideration of several strands of contemporary economic analysis—behavior of the firm under different regulatory constraints; the economics of vertical integration and price discrimination; oligopoly pricing models under different assumptions about information, and others.

While a full analysis is beyond our scope here, examination of the incentives and market opportunities of the fully integrated suppliers creates doubt whether the "invisible hand" is at work, bringing into conformance the private interests of the carriers and the broader public interest which the Commission undertakes to promote and protect. Because of the vertical structure of the market and the fact that sales to different buyers make different contributions to the company's bottomline and to the success of its overall market strategy, AT&T has a clear incentive to favor some classes of customer over others.

AT&T is a publicly held and traded corporation. As such, its managers must be responsive to, and their decisions systematically reflect, the need to create value for AT&T shareholders. Thus, there is no reason to doubt that AT&T attempts to structure its tariffs and to price its various services, including those made available under contract, in ways that will create maximum value for its shareholders. It will have the incentive to do so even when such market behavior comes up against the constraints imposed by policies and rules of the Federal Communications Commission.

AT&T has revealed its preferences about the resale market structure on several occasions in the past. It has almost without exception opposed the expansion of the types of services that may be resold, while resisting relaxation of the conditions governing resale.[10] While several different reasons have been cited in AT&T argu-

[10] Prior to the Commission's Order in Docket 20097, AT&T tariffs quite consistently and uniformly forbade resale and shared use. In the Docket 20097 proceeding, and again in the WATS resale proceeding, AT&T argued against relaxation on resale restrictions on various "economic

Continued

ments, the principal and recurring ones relate to economic harms (of a public nature) alleged to follow from initiation or expansion of resale.[11]

We can best identify and characterize the conflicts between the public interest as identified by the Commission and AT&T's corporate self-interests by considering the value of AT&T minutes or capacity sold to different customers or customer classes. For simplicity, consider minutes sold as a surrogate measure of shareholder value. Other things equal, AT&T prefers larger margins and contributions to earnings to smaller ones. In this context some minutes are more valuable than others, as measured by the differences in margins expected to be generated by different services. Different types of minutes also contribute differentially to the success of AT&T's overall market strategy.

Recall that AT&T competes in two of the vertical markets in the value chain. First, it provides capacity to resellers on a wholesale basis, in competition with MCI, Sprint and other facilities-based carriers. Second, AT&T also competes with these resale carriers and with other facilities based carriers for the business of end users in the retail market. Thus, an interstate, interexchange minute of use by an end-user can be categorized from AT&T's point of view according to (a) which underlying carrier provides the capacity and (b) which carrier interfaces with the customer. This situation is characterized in the accompanying two by two characteristics matrix which divides interstate minutes into four discrete categories. Differences in value created for AT&T by different types of minutes—as measured by expected earnings—provides the basis for very strong preferences among them.

The best case from AT&T's point of view is to sell minutes of use of its network directly to end-users. In this case AT&T garners whatever average cost reductions or other advantages of scale and scope that may be associated with producing and distributing those minutes; it earns on, or contributes to the overhead cost of, the resources used in both the production and distribution of minutes; and, it denies its competitors both those advantages in cost economies and earnings or overhead contributions.

Selling directly to end users also maintains customer contact and control. As AT&T continues its evolution into a more diversified, multiservice market environment, maintaining direct contact with end users—"customer control"—becomes more and more valuable.

Thus, dealing directly with the end user is preferred by AT&T from an earnings point of view, from the point of view of improving its cost competitiveness and market share in the sale of capacity, and as a means of maintaining contact with end users.

AT&T has clearly revealed the strength and value of this preference in its persistent opposition to the Commission's resale initiatives.[12]

The second best case for AT&T is to sell minutes of use of its network to a reseller, who in turn sells to end users who would otherwise buy minutes, directly or indirectly, from another facilities provider. In this case, AT&T earns on its provision of capacity, but not on its retailing organization. It reaps the cost advantage associated with selling minutes of use of capacity, but loses contribution to the cost of its marketing organization. It also loses contact with the customers.[13]

FIGURE 1.—COMBINATIONS OF FACILITIES AND SERVICES PROVISION

	Facility provider sells to end user (retail)	Facility provider sells to intermediary (resale)
AT&T Provides Facilities	Best Case—Q_T	Second Best Case—Q_{TR}
Others Provide Facilities	Worst Case—Q_F	Third Best Case—Q_{FR}

harm" grounds. Thus, the company has generally signalled that it regards resale as counter to its own economic interests.

[11] Frequently the argument has taken the following form: Resale will reduce the revenue contribution of certain customers to overhead, thereby shifting the responsibility for recovering such overhead to other customers, whose rates will have to be increased.

[12] In subsequent sections we will explore the extent to which this aversion to resale and preference for bypassing resellers to get to end users is reflected in its market behavior toward resellers.

[13] This preference is clearly expressed by AT&T in the contracts it negotiates with resellers. Minutes sold by resellers to customers of AT&T's rivals are cheaper than rates for reseller services sold to AT&T's own customers. AT&T's desire to get these customers back on its own network is clearly expressed in the favorable pricing differential applied to "Winback" minutes in contracts negotiated with resellers.

The worst cases from AT&T's point of view involve end users buying minutes of use made available on a wholesale basis from the networks of its competitors, either directly from a competitive facilities provider or indirectly via an intermediate reseller. Assuming that direct contact with the end user has some value to facilities providers, AT&T probably has a mild preference that minutes of capacity sales lost to competitors be provided to end users by an intermediary reseller rather than directly by the facilities provider. These possibilities are illustrated in the accompanying graphic, Figure 1 above.[14]

Given the different value to AT&T of these different types of minutes, we can reasonably expect that these preferences will be expressed in its commercial relationships. AT&T wants to sell as many minutes as possible, but it would prefer to sell them directly. And, in cases where it cannot sell them directly, it prefers having its own network resold to a situation in which its competitors networks are resold.

The foregoing should help clarify the existence and nature of the ambiguity in AT&T's attitude toward resellers. On the one hand, the Commission's policy and rules direct AT&T to treat resellers as any other customer. This policy is re-enforced by market incentives when resellers are diverting minutes from AT&T's facilities based rivals. In this case, resellers are viewed by AT&T as good customers. On the other hand, AT&T is not so favorably disposed to resellers when they are diverting minutes from customers being served directly by AT&T. In this case, resellers are viewed not as customers but as rivals and AT&T's market incentives are inconsistent with the regulatory imperative to treat them as customers. The structure of the market, where some firms are fully integrated and some are not, dictates this tension between the cooperative (with downstream customers) and competitive (downstream rivals) forces operating on the firm in control of facilities.[15]

AT&T's ability to differentiate its rate and service offerings, and if it should so desire, to discriminate among different users and user classes, is conditioned in part by its ability to suppress resale of its services. While it is foreclosed by regulatory admonition from preventing resale in its tariffs, it may nevertheless find advantage

[14] The discussion in this section can be summarized succinctly. The total volume of minutes sold in the interstate, interexchange market can be expressed as the sum of these various combinations of minutes. The following expresses this relationship. Total minutes sold (Q) equals the sum of those sold directly by AT&T (Q_T), plus those produced by AT&T but sold by resellers (Q_{TR}), plus those produced by other facilities providers, either directly (Q_F) or indirectly (Q_{FR}).

$$Q = Q_T + Q_{TR} + Q_{FR} + Q_F$$

The contribution to fixed costs and earnings are different. Minutes sold directly to end users are more valuable than minutes sold through resellers. And, minutes sold by other facilities-based carriers have no value to AT&T, but some of these are probably less "harmful" than others, inasmuch as minutes sold directly by AT&T's facilities based competitors make them a stronger competitor than minutes sold indirectly through resellers. These considerations are summed up in the rankings below:

$$Q_T > Q_{TR} > Q_{FR} > Q_F$$

The task faced by a vertically integrated facilities provider in its transactions downstream is to maximize the contribution of total minutes, recognizing that some minutes are more valuable than others. The contracts negotiated by AT&T and the nature of their other commercial relationships very clearly confirm this ranking.

[15] Professor Robert E. Hall makes this point differently but forcefully in another context comments on the consumer welfare implications of eliminating line of business restrictions in the Modified Final Judgment and thereby permitting the Regional Bell Operating Companies to enter the interexchange business and thereby integrate it with their local exchange businesses. Declaration of Robert E. Hall; Attachment H, AT&T Ex Parte Presentation (CC Docket No. 79–252), April 24, 1995. Professor Hall states: "Absent vertical integration, upstream firms cooperate with their downstream customer. On the other hand, horizontal rivals in the same market do not usually cooperate with each other. Cooperation is the antithesis of competition. Once an upstream supplier integrates vertically into the downstream market, it becomes the rival of its downstream customers. Accordingly, it is unrealistic to expect the upstream firm to cooperate with its rivals in the downstream market." (p. 2)

In addressing the economic effect of permitting the RBOC's to integrate into the long distance market, Professor Hall's arguments are applicable here. He concludes: "The strain between cooperation and rivalry is greater the larger the role of the vertically integrated firm in the upstream market". (p. 2) Further on, he concludes: "Two general principles emerge from this analysis: First, vertical integration into a downstream market merits scrutiny whenever the upstream seller has a significant role in the upstream market. Second, the social costs of the degradation of cooperation with the downstream rivals that will inevitably accompany vertical integration needs to be reckoned against any efficiencies that may result from the vertical integration." (p. 3)

Professor Hall considers three policy options: allow the dominant upstream firm to dominate the downstream market; prohibit vertical integration of upstream and downstream activities; and, finally, force cooperation through regulation or litigation, thereby forcing firms to "act contrary to their shareholders' interests by providing downstream rivals with information and products." (pp. 4–5) The latter is of course the current Commission approach that is being reconsidered.

in discouraging resale by pushing the limits of the Commission's regulations. Thus, to the extent that AT&T is attempting to differentiate rates and services from one customer to the next, its ability to do so is thwarted by a healthy resale sector. Resale is a check on AT&T's ability to discriminate.[16]

AT&T HAS THE ABILITY TO SUPPRESS RESELLERS' COMPETITION

The Commission has on numerous occasions in recent years declined to deregulate AT&T's interstate operations, finding on each occasion that AT&T has market power and exercises dominance in portions of the interstate, interexchange marketplace. Thus, notwithstanding the Commission's open entry policies, the expansion in the number of competitors and the decline in AT&T's market share, the Commission has repeatedly found that AT&T has the ability to suppress competition in this market and declined completely to deregulate fully its interstate offerings.[17]

There is no question that AT&T has considerable market power, even after more than twenty five years of competition, substantial increases in rivals' capacity and dramatic reductions in its own market share in recent years. Whether its market power has diminished to the point where it is insufficient to warrant pervasive regulation of the type traditionally practiced for dominant telephone common carriers is a separate question—and the Commission should keep it separate—from questions about AT&T's ability to suppress competition from resellers.

While AT&T's market power may have declined sufficiently to warrant modification, relaxation, or elimination of many of the Commission's traditional regulatory programs and rules, it is less certain that increased in rivalry in the interexchange marketplace has been sufficient to eliminate AT&T's ability to suppress resale competition through exercise of its considerable remaining strength in the marketplace.

There is compelling historical evidence that the services of other facilities based carriers have been imperfect substitutes for those of AT&T, even though they may be similarly configured and priced. Thus, it appears that AT&T has garnered over the years a substantial amount of brand loyalty from both large and small users. These facts imply that most buyers are willing to pay a premium price for AT&T services above comparable bundles offered by competitors.[18]

AT&T's ability to suppress competition from resellers through exclusionary or discriminatory conduct is attested to by two recent decisions by the Commission and judicial findings.

ABUSE OF MARKET POWER—COMMERCIAL PRACTICES THAT SUPPRESS COMPETITION

In the previous two sections we have examined the nature of AT&T's incentives with respect to resellers. The facts presented support a conclusion that AT&T has

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[16] Conditions necessary for discrimination are well known. Hal Varian, "Price Discrimination", Handbook of Industrial Organization, p. 599 states them as follows:

a. the firm must have some market power;

b. the firm must have the ability to sort customers into classes with different demand elasticities; and,

c. the firm must have the ability to prevent resale.

However, in the present context, the (re)phrasing of the third condition by Bonbright, et al. is of considerable relevance: "The resale by those buyers who pay a low price to those who would be charged a higher price must be *deterred*." (Emphasis added). Thus, the weaker condition of "deterring", as opposed to "preventing" resale is sufficient to permit some price discrimination. See James C. Bonbright, Albert L. Danielsen, and David R. Kamerschen, "Principles of Public Utility Rates," 2nd ea., Arlington: Public Utilities Reports, Inc. (1988) p. 520. Thus, inasmuch as AT&T has an incentive to practice "de facto" discrimination among different users as a means of increasing revenues, it has an incentive to "deter" or suppress resale. It is clear that AT&T's ability to discriminate by putting in place "Ramsey Prices"—a strategy advocated by some—by establishing rates proportional to the inverse of demand elasticities would be advanced by market conduct designed to "deter", if not "prevent" resale. Indeed, Ramsey pricing and related strategies requiring demand-based rate variations are not sustainable in an environment open to resale and shared use.

[17] See, "Policy and Rules for Dominant Carriers," CC Docket No. 87–313, 4 F.C.C. Rcd. 2873 (1989); see, also the Interexchange Order.

[18] Much of the evidence to our knowledge is now somewhat dated, but not necessarily without evidentiary value. The best and most recent survey on user preferences was submitted over five years ago. See Steven C. Salop, Steven R. Brenner and Gary L. Roberts, "Market Power in the Supply of Long-Distance Services", Appended to Comments of Competitive Telecommunications Association (CC Docket #90–132). While we are not aware of any more recent evidence of customer preferences for AT&T services, and hence of more recent measures of "brand loyalties", neither are we aware of any rebuttal to that evidence; nor, of more recent evidence of any kind on point. Given the large proportion of customers in all classes who preferred AT&T services and the strength of intensity of those preferences, there is a strong intuitive basis for concluding that substantial preferences for AT&T among relatively large numbers of users still exist in the marketplace. (See Tables 1–15 in "Market Power", Salop, et al.)

both the incentive and ability to treat resellers differently from its other similarly situated customers; and, to do so in ways that will limit the scope and intensity of competition from the resale sector.

Given the ability and incentive to do so, it is reasonable to expect AT&T will adopt marketplace strategies designed to buttress its market position and limit the growth of its rivals—including resellers. AT&T's shareholders expect it to do so. Given the incentive, the ability, and the opportunity to do so, the question is not whether they have been exercising that power in pursuit of long term market objectives, but whether the tactics adopted are within the gambit of acceptable competitive market behavior, or fall instead into the realm of so-called "predatory" conduct, or unacceptable anticompetitive behavior more generally.

Let us be very forthcoming at the outset. From a public policy perspective, it is sometimes difficult to distinguish between acceptable and unacceptable competitive behavior; to separate healthy competitive activity from efforts to foreclose rivals; and, to differentiate aggressive rivalry from predatory behavior. Particular aspects of market conduct may be any of these, depending on the market context. The realm of generally accepted business practice changes from time to time and from market circumstance to market circumstance. The Commission's own rules reflect the fact that market conduct acceptable for one class of carrier (nondominantones) is not acceptable from others.

Furthermore, the incentive of carriers with market power—including AT&T—is to abstain from blatantly discriminatory, patently unacceptable and clearly unlawful behavior, in favor of more subtle forms of market misconduct that arguably are in the realm of acceptable business rivalry. And, the more clever regulatory gamesman will tend to practice forms of anticompetitive conduct that can be cloaked in colorably legitimate business practices.[19]

Until fairly recently, much of the discussion of abuse of market power has focussed on strategic and pricing practices adopted by dominant firms (those with market power) as predatory means for eliminating competitors or for discouraging new entry through limit pricing.[20] A firm's market power may be exercised not only over the price it charges, but in some circumstances it may also be exercised by taking measures that will diminish the attractiveness to consumers of its rivals offerings by either raising rivals' cost and/or reducing rivals' service quality.[21] A variety

[19] Professors Willig and Bernheim address the problem of identifying anticompetitive conduct and separating it from the type of market conduct encouraged in a market economy in their discussion of the behavior of the Regional Bell Operating Companies (RBOC's). The analysts are so widely and deservedly respected and their analysis so clear and on point here, that it is worthwhile to quote them at length.

"Since it is extremely difficult to assess an RBOC's true costs and technical capabilities, regulators are not always able to distinguish discriminatory acts from legitimate business practices, especially in the absence of extensive hearings and review of the evidentiary record. This implies that aggrieved parties must often seek the help of regulators and the courts through protracted and costly litigation, the outcome of which is usually highly uncertain. (p. 74)

"Even in cases where discriminatory practices are eventually disallowed, the RBOC's can rely on their colorably legitimate business explanations to argue that, since they acted in good faith within the grey areas of the law, legal or regulatory responses should be confined to prospective relief. Thus, the RBOC's can impose enormous costs on competitors even if regulators eventually detect and restrain discriminatory activities . . . The clear lesson is that the mere threat of discrimination can chill competition even in the presence of active regulatory oversight. B. Douglas Bernheim and Robert D. Willig, "An Analysis of the MFJ Line of Business Restrictions"; December 2, 1994. (p. 75)

"As we have discussed at length above, we believe that the RBOC's will manipulate the terms and technical conditions of network access so as to create noticeable price and/or quality advantages for their own products, while cloaking this manipulation in the guise of colorably legitimate business practices. When competitors and/or regulators complain about observable differences in market offerings, the RBOC's will claim that apparent self-preference arises from unavoidable technical problems, considerations of cost, or competitive necessity. And, they will provide testimony . . . that unintegrated firms simply cannot achieve the same efficiencies, or provide the same innovative offerings, as integrated firms. Bernheim and Willig." (p. 80)

[20] Economic theory of predatory pricing behavior has been characterized as falling into three general categories: those dealing with asymmetric financial constraints and "deep pockets" of dominant incumbents; those involving the development of a reputation as a "tough" competitor willing to offset and disarm any competitive incursions; and, those associated incumbent's use of price to "signal" predatory intent and ability. These models are reviewed in Ordover and Saloner, pp. 546–62. See also, J. Roberts, "Battles for Market Share: Incomplete Information, Aggressive Strategic Pricing, and Competitive Dynamics", Working Paper, Graduate School of Business, Stanford University, (1985) and J. Roberts, "A Signaling Model of Predatory Pricing", Oxford Economic Papers, (Supplement), New Series, 38:75–93 (1986).

[21] The academic literature addressing these kinds of questions begins formally with the work of Salop and Scheffman. See, S.C. Salop and D.T Scheffman, "Raising Rivals Costs", American

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of cost increasing/demand impairing activities have been explored in the literature.[22] These evolving views of aggressive, anticompetitive pricing conduct indicate less likelihood of naked predatory pricing, but greater reliance on more moderate, and more difficult to detect, pricing methods designed gently, but unambiguously, to discourage competitors or entrants and to persuade them ". . . that their resources would be better spent elsewhere."[23]

Just as the focus on predatory pricing has shifted to more subtle forms of pricing misbehavior that undermine competition without driving competitors out of business, there has been a companion shift of attention to other nonprice forms of strategic market activities that are less draconian than destroying competitors or foreclosing their entry, but which nevertheless may be regarded as anticompetitive behavior by firms with market power.[24]

Firms use a variety of techniques to place rivals at a relative disadvantage in the marketplace. Some of the most prevalent forms and instances of such market behavior of dominant firms are the very essence of market competition and, as such, they are encouraged by regulatory policies—reducing rates as a result of improved efficiency, improving various dimensions of product quality, introducing new products and the like. These accepted forms of market rivalry share a common characteristic inasmuch as they represent efforts by the initiating firm to improve the price/performance characteristics of its own market offerings. But these forms of market rivalry are quite different from market strategies and activities by a firm with market power that acts in the first instance on the price/performance characteristics of its rivals' market offerings and, thereby, handicaps them in ways that benefit the initiating firm, but do not lead to greater economic welfare.

The goal of these market strategies by dominant firms is to suppress rivals' expected growth and to dampen their earnings prospects. The result of the successful exercise of such strategies by incumbents with market power is suppression of capital formation and capacity to serve by competitors either from elimination of rivals, reduction of the growth of smaller incumbents, or suppression of the rate of new entry.[25] Each of these results can be shown to increase the expected earnings and shareholder value for incumbents.[26]

Rivals' profits and earnings potentials may be suppressed in a variety of ways. Earnings are the difference between revenues and costs and will be influenced by market tactics that impact either. The principle nonprice market tactics that suppress competition are those that reduce a rival's earnings or profit prospects by reducing expected revenue and or increasing expected or realized costs. Let's consider these in turn.

Reducing Resellers' Revenue.—Rivals' revenues depend on the prices paid and quantities purchased from them. Market tactics by dominant firms may influence them in a variety of "revenue suppressing" ways. These tactics are particularly apt when, as is the case with resellers, the dominant firm is also the supplier of an im-

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Economic Review, 73:267–271 (1983). See also Salop and Scheffman, "Cost-Raising Strategies", working paper no. 146, Federal Trade Commission, Bureau of Economics, Washington, D.C., Journal of Industrial Economics, 36:19–34, (1987). This literature is summarized and fully referenced by Ordover and Saloner in "Predation, Monopolization, and Antitrust", Handbook of Industrial Organization, vol. 1, pp. 565–70.

[22] See Ordover and Saloner, pp. 568–9. They note that the development of the theory lags potential applications of the theory. Also, they report that most of the work has been done on cost increasing activities and less done on demand impairing activities, at 370.

[23] Ordover and Saloner, p. 566.

[24] Ordover and Saloner call the most aggressive of these practices, "nonprice conduct aimed at eliminating competitors" (p. 562), while reserving the less opprobrious "putting rivals at a disadvantage" and "muscling out rivals" (p. 565) for the less aggressive and less obvious anticompetitive practices.

[25] As indicated above, much of this behavior and results are resemble market conduct associated with healthy competitive processes and conceding the difficulty of determining clear dividing lines between the two. Thus, for example, elimination of a competitive firm and absorption of its output and customer base may have positive or negative welfare implications, depending on the circumstances. Note however that the preponderance of the literature indicates "guarded support" for the proposition that constraints on dominant firm behavior will frequently increase economic welfare. See Ordover and Soloner at pp. 538–9. In their words: "In the context of strategic interactions, it is difficult to distinguish between those actions which are intended to harm actual (and potential) rivals that stifle competition, and thereby reduce economic welfare, and those actions which harm present rivals and discourage future entry but which, nevertheless, promote economic welfare. . . . Thus, it may be difficult to assess strategic behavior for purposes of determining impacts on economic welfare or conformance with broad public interest considerations."

[26] Katz ("Vertical Restraints") notes that sales, market share, profits and related measures of corporate objectives are positively related in the general case with the level of a rivals costs. (p. 706)

portant input (telecommunications capacity) to its competitors in the downstream market (retail telecommunications sales).

First, a vertically integrated, dominant firm may force its rivals to charge higher prices or it may otherwise reduce the differential between the prices of its competitors prices and the dominant firm's own price. The dominant firm may do this by selling to end-users at rates below those it offers comparably situated resellers. While much of the literature on this point discusses the incentive of a dominant firm to increase its dominance by integrating into downstream markets, the firm that is already integrated has the same set of incentives, vis-a-vis its downstream rivals, and may reasonably be expected to manifest similar types of market conduct.[27] This type of conduct has been written about expansively and described generally as implementing "price squeezes".[28]

Second, the dominant, vertically integrated firm can lower the quantity its rivals may sell at a given price by suppressing the quality of the inputs or intermediate products/services it provides to its downstream rivals, thereby reducing rivals' service quality. For this to happen, the inputs provided by the upstream supplier must be an important component of the downstream rivals production process or service—a condition that clearly holds in the relationship between integrated facilities providers and the resale industry.[29]

Finally, the dominant, vertically integrated firm can lower expected and actual sales of its downstream rivals by "locking in" customers through long term contracts and by otherwise increasing customer "switching" costs.[30] End-users of telecommunications services, business users in particular, may have to incur direct costs as a result of switching from one supplier to another. Long term contracts often have a variety of conditional requirements and associated forfeiture clauses that have the practical effect of increasing costs to the purchaser in the event that certain conditions are not met. While costs of switching are clearest in the case of "requirements contracts" they are also important where different complementary goods or services are required to be used with the products or services or different vendors. But, even where specialized, complementary inputs are not required, end users generally experience switching costs of various types and magnitudes.[31]

Raising Resellers' Costs.—A very direct way of reducing the threat of rivals in the marketplace is to take measures to raise their costs. As suggested above, there is an important and growing strain of the "predatory behavior" literature that explores the ability and incentive of dominant firms to engage in market behavior that raises rivals' costs.

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[27] For a good exposition of the incentives and types of firm conduct predicted by standard economic models, see J.A. Ordover, A.D. Sykes and R.D. Willig, Non-Price Competitive Behavior by Dominant Firms toward the Producers of Complementary Products, in "Antitrust and Regulation: Essays in Memory of John McGowan," Cambridge, Mass.: M.l.T. Press, pp. 315–330.

[28] For a good summary, see Martin K. Perry, "Vertical Integration: Determinants and Effects", Handbook of Industrial Organization, vol. 1, pp. 192–96 and references cited there. See, in particular, D.L. McNicol, "The Two Price System in the Copper Industry", Bell Jouma/of Economics, 6:50–73 (1975) for an analysis of the circumstances under which an integrated supplier can increase its profit by "rationing" quantity to its downstream rivals. He calls this "quantity" discrimination, which like price discrimination results in a "supply squeeze" that handicaps downstream rivals.

[29] It should be noted that providing downstream or potential competitors inferior services has frequently been alleged in the telecommunications industry. In the context of local exchange communications there is the problem of access to bottleneck facilities. In principle there is no difference between that kind of discriminatory access and the kind under review here, in which the dominant supplier uses its market power to diminish the quality of its competitors offerings by degrading the intermediate services it provides. Also, we note that offering inferior services to competitors might be regarded as an effort to raise competitors costs, inasmuch as there is, at least in principle, some quality enhancing, but costly, activities the downstream firm might make to compensate for the inferior service. The activities of dominant, vertically integrated firms designed to increase rivals' costs are discussed more fully below.

[30] For a brief overview of the importance of switching costs, see Robert J. Reynolds, "Aspects of Dominant Firm Behavior", Appendix G of Sprint Comments in (Interstate Interexchange) Docket No. 90–132, p. 11. See also, P. Klemperer "Entry Deterrence in Markets with Consumer Switching Costs", Economic Journal, 97 (Supp.) 99–117 (1987). While Klemperer focuses on end users and entry deterrence, many of the points made there can find ready interpretation in the context of the behavior of a vertically integrated firm that sells to a specialized retailing firm with which it competes in downstream markets. See also, P. Aghion and P. Bolton, "Contracts as a Barrier to Entry, American Economic Review, 1987, 338–40.

[31] See Richard J. Gilbert, "Mobility Barriers and the Value of Incumbency", Handbook of Industrial Organization, pp. 506–508 (section on switching costs); see also, R. Schmalansee, "Brand Loyalty and Barriers to Entry", Souem Economic Joumal, 40:579–91 (1974) and R. Schmaiansee "Product Differentiation Advantages of Pioneering Brands", American Economic Review, 72:349–365 (1981).

Perhaps the most severe cost raising tactics involves denying competitors access to indispensable inputs through exclusive dealing arrangements or by otherwise gaining control of such inputs. However, a variety of less exclusionary practices fall short of outright prevention of access to resources, but merely makes them more expensive. Such practices can increase rivals costs in different ways and by amounts of differing relative importance.

The structure of the communications resale market, with the largest firms integrating facilities provision with wholesale/retail distribution and selling to their (resale) competitors, gives rise to several different opportunities for integrated suppliers to increase the costs (and sustainable rate levels) of their specialized rivals who merely resell to end users.

Raising Reseller Costs by Inflating Input Prices.—Resellers are critically dependent on the rates charged them for underlying capacity by integrated, upstream facilities providers like AT&T.[32] The discussion in previous sections indicates that integrated, dominant carriers have a strong economic incentives to attempt to control the spread between the rates they charge end users and those they charge to intermediate resellers who will compete with them in the end user market.

Nonprice Means of Raising Costs.—In addition to raising competitors costs directly by charging excessive rates, there are several nonprice means for an integrated supplier to gain competitive advantage in downstream markets by imposing handicaps on their customers/competitors that will have the effect of raising their costs. A variety of these means have been reported and their theoretical implications explored.[33]

AT&T CONDUCT TOWARD RESELLERS—CONTRACT TARIFFS

The previous section summarized relevant parts of the economics literature as it may apply to the behavior of AT&T vis-a-vis the resale sector of the industry. That literature basically holds that firms situated like AT&T—vertically integrated and dominant in both upstream and downstream markets—have an incentive and the ability to behave in the marketplace in ways that may be anticompetitive. The analysis identified a variety of potential anticompetitive practices that might be present in the long distance marketplace. We turn now to a discussion of some of the terms of contracts entered by AT&T and their competitive implications, preceded by a brief analysis of the status of the Commission's evaluation of the impact of contract tariffs on resellers.

Background.—AT&T and other interexchange carriers have only fairly recently been authorized to offer services pursuant to the terms of individually negotiated contracts. In 1990, the Commission undertook an examination of the state of competition in the interstate, interexchange business in Docket 90–132. On completion of its investigation, the Commission concluded that most AT&T business services were subject to substantial competition and, on that basis, it further streamlined regulation of most AT&T business services. In addition, the Commission found competition sufficiently robust to warrant permitting AT&T and other interexchange carriers to offer certain business services pursuant to terms individually negotiated with particular customers. As a condition of offering service under individual contract, the Commission required AT&T and other IXC's to make those contract terms generally available to other similarly situated customers.[34]

Impact on Resellers.—The Commission has not fully reviewed the impact of contract tariffs on resellers. In the Interexchange Order, the Commission undertook

[32] The proportion of total reseller costs made up of the cost of obtaining capacity from an integrated facilities provider will vary from one reseller to another. For those merely reselling, or rebilling in the limiting case, the proportion may exceed ninety percent. For other resellers who have facilities of their own—switches and/or transmission—and add value in other ways, the share of the total of outlays for capacity will be less. In all cases, however, the substantial dependence of resellers on underlying capacity providers is manifest in high proportions of reseller costs accruing to providers of the underlying facilities.

[33] The cases in the economics literature involve exercises of market power in both horizontal and vertical market contexts. Even though our interest here is principally in the vertical market context, it has been instructive to review summaries of the relevant literature from three different perspectives. See Katz, p. 706; Ordover and Saloner, pp. 565–70; and, R.J. Gilbert, especially pp. 499–503 (*Handbook of Industrial Organization*) for three different perspectives—predatory behavior, vertical restraints, and barriers to entry—on strategies to raise rivals costs.

[34] The Commission cited language from Sea-Land Service, Inc. v. ICC, 738 F.2d. 1311 (D.C. Cir. 1984) to the effect that, ". . . [a]lthough one normally regards contract relationships as highly individualized, contract rates can still be accommodated to the principle of nondiscrimination by requiring a carrier offering such rates to make them available to any shipper willing and able to meet the contract's terms."

very briefly to analyze the effects of contract carriage on resellers. It concluded: "Nor do we believe that contract carriage will have an adverse effect on resellers."[35]

The Commission's analytical support for this comforting conclusion is quite limited and in substantial proportion simply incorrect:

". . . The fact that AT&T's competitors have been making contract offerings and still provide service to resellers indicates that contract rates would not adversely affect this segment of the market."[36]

This is a non sequitur. It does not follow, first of all, that AT&T will emulate the behavior of its competitors. Nor, is it true that simultaneous provision of service under contract and to resellers equates to no adverse effect on resellers. At best this observation suggests that the opportunity to offer service under contract will not lead to cessation of service, but it has no probative value at all on the question of lesser impacts on resellers.

"Moreover, resellers, like other users, are valued customers—in fact, they are large customers. It is not reasonable to assume that AT&T will refuse to present them with viable service options at reasonable rates."[37]

Indeed, there is no rationale for assuming any AT&T tariffing behavior simply on the basis that resellers are large customers. There is a substantial basis for supposing that AT&T's tariff practices are designed to impose costs on competitors, and that the incentive to impose such costs is greater for larger customers than for smaller ones.

The Commission concludes its analysis of the effect of contract carriage on resellers by restating its resale policy and the general terms of its contract tariff decision.

"In any event, as noted above, the terms of AT&T's contracts must be filed with the Commission and made available to all similarly situated customers, including resellers. *Moreover, our longstanding policy barring restrictions on resale applies with full force to contract carriage.*"[38]

This is the context in which the contract tariffs filed by AT&T should be considered and the standard against which the principle provisions in reseller contracts, and the differences between those comparable provisions in corporate contract tariffs, ought to be evaluated.

We have reviewed the principal provisions of the majority of the more than 2,000 contract tariffs entered by AT&T since it was granted the necessary authority by the Commission. It goes without saying that these are complex agreements that spell out sometimes in excruciating detail, but sometimes with exasperating vagueness, a wide and rich range of privileges conferred and obligations imposed on buyers.

A typical contract tariff contains restrictions and conditions that appear to vary with the likely cost of providing the service and with the likely "value of the service". Some provisions are inexplicable on either grounds. Restrictions are placed on the number of sites; services are tied together, so that rates depend on the total volume of all services; rates are bundled; minimum commitments are required and rewarded with lower rates, but penalized if not achieved; rates vary with the proportion of traffic (a) that is switched, (b) that is "won back" from another facilities-based carrier, (c) that is dedicated usage, (d) that is switched, etc., etc., etc. Users are "locked in", but they are compensated with lower rates for agreeing to such arrangements. These are the most apparent conditions; the fine print is even more vexing.

The conditions found in the contract tariffs are in many cases clearly designed to separate resellers from corporate users—to discourage resellers from taking service under "corporate" contracts and, reciprocally, to discourage corporate users from taking advantage of benefits designed for resellers. As such they conform to one of the necessary conditions for practicing effective price discrimination—separation of different classes of buyers and those with differing demand elasticities.

We have identified conditions that appear to us to be on the margin of economic discrimination between resellers and corporate users, but which, to be quite candid, probably cannot be proved one way or the other without a sharper definition and sense of the strength of the public policy commitment to nurturing a market environment conducive to resale. As indicated above, what is good business practice in one context will be impermissible in another public policy context.

We cited above the Commission's view of the sustainability of resale in a contract tariff environment. We are less confident that resale will thrive, as envisioned by the Commission, in an environment in which AT&T contracts are not subject to re-

[35] Interexchange Order, p. 1160.
[36] Ibid.
[37] Ibid.
[38] Interstate Interexchange Order, p. 1160; Emphasis added.

view under a broad public interest standard. Indeed, without such a regulatory constraint, the strength of AT&T's incentives and the latitude of its opportunity would most certainly lead to a less robust resale sector.

AT&T CONDUCT TOWARD RESELLERS—COMMERCIAL PRACTICES

The tensions in AT&T's incentives toward resellers, and its understandable preference to deal directly with end users without intervening agents, are reflected frequently in AT&T's market conduct, which conforms generally to theoretical constructs that predict the behavior toward downstream rivals of vertically integrated firms with market power. Several of these practices are consistent with market strategies designed to suppress competition by raising rivals' costs; by reducing or rendering uncertain their revenues; by undermining various dimensions of rivals' service quality; and, otherwise handicapping its downstream, less diversified, resale rivals.

Some examples of this type of behavior will be instructive. Consider first the longstanding and systematic use by AT&T of one of the most valuable assets a reseller possesses, information about its customer base. Customer proprietary network information (CPNI) routinely includes data about location, calling patterns, rates, payment histories, services preferences and other valuable marketing information. As the underlying facilities provider, AT&T has access to this information. And, if the information becomes available to AT&T marketing personnel, it provides a valuable marketing tool permitting selected, high-margin, or otherwise preferred customers of resellers to be targeted.

Successfully employed, abuse of CPNI by AT&T clearly increases reseller marketing costs, reduces the value to resellers of their proprietary information, reduces their expected revenue and significantly increases their market risk—all of which make resellers less effective competitors to AT&T and less able to fulfill the role foreseen for them in consistent restatements of Commission competition and resale policies.

Resellers are of course critically dependent on the reliability, timeliness, regularity and general quality of service provisioning by AT&T and to a much lesser extent the other underlying facilities-based carriers. It is difficult for a reseller to compensate for delays, uncertainties, missed schedules and commitments, mistakes and oversights committed the underlying carriers. Provisioning problems originating with AT&T can for the most part only be passed through to end users by resellers, who must take final responsibility for the degraded service. Any degradation of AT&T provisioning to resellers will suppress the quality and vigor of reseller competition by raising reseller cost, reducing their revenue and frequently both.

There is no good purpose served here by repeating the full litany of abuses alleged by the resellers and other large buyers against AT&T. Those are a matter of record, and they are gradually being resolved through regulatory and judicial processes. The purpose here is to provide a basis for interpreting the anticompetitive nature of actions taken toward resellers. It is important to have a framework for understanding the impact of AT&T market conduct on reseller competitiveness through its impact on reseller costs, revenues, risk, growth expectations and other parameters of performance important to the survival and growth of the sector as competent competitors to facilities-based carriers.

CONCLUSION

The results of our analysis indicate that AT&T has the ability and incentive to structure its general commercial relationships and to differentiate the terms offered in different contract tariffs in ways that conflict with the Commission's basic policies respecting resale and the Commission's broader goals for promoting competition in the interexchange marketplace.

The analysis shows that because of its vertical integration of production, wholesale and retail of network services and its power in each of those markets, AT&T defines its relationships with resellers in ways consistent with economic theories of anticompetitive behavior designed to suppress competition by raising competitors' costs and by other means.

The principal conclusion of the analysis is that market forces alone, given the current structure and incentives in the marketplace, are not clearly sufficient to assure continued evolution of competition to facilities-based carriers from the resale sector in conformance with long established Commission policies.

APPENDIX 1.—RESALE MARKET STRUCTURE, MARKET FUNCTIONS AND PARTICIPANTS

	AT&T	Large IXC's	Small IXC's	Resale carrier—		
				Type 1 [1]	Type 2 [2]	Type 3 [3]
Facilities provision	X	X	X	X	....	....
Switching	X	X	X	X	X	....
Transmission	X	X	X	....	....	....
Wholesale	X	X	....	....	....	....
Retail	X	X	X	X	X	X

[1] Type 1 (facilities-based) resellers have investments in lines and/or switches.
[2] Type 2 (switchless) resellers have no investment, but perform billing functions.
[3] Type 3 resellers (aggregators) have no facilities and do not bill customers.

DEREGULATION AND TELECOMMUNICATIONS

Mr. DARBY. In the time you have given me, I want to talk about four questions quickly.

One: How, why, and when did resale come about in the telecommunication sector?

Two: How did it develop over time?

Three: What have been its effects to date?

And four, the last question: What might be expected if resale were extended to the airline section?

Resale describes a common practice in many lines of commerce, normally called wholesaling. Somebody breaks bulk, buys from the underlying manufacturer, breaks the bulk, passes along part of the discount to retailers and to consumers.

In surface transportation, it was called freight forwarding. And in telecommunications, it is called resale. But effectively, it interjects a new economic entity between the producer and the consumer.

Senator SHELBY. It is basically buying wholesale and then retailing it, is that the——

Mr. DARBY. Precisely. It combines two of those functions.

Senator SHELBY. Sure.

Mr. DARBY. And I take great pains in my earlier paper to walk through what those pieces are.

Senator SHELBY. OK.

Mr. DARBY. To understand why it was introduced, I urge you to recall, if you can, the days when AT&T was a monopoly.

AT&T had a monopoly in both the production and the distribution of services, long-distance and local. Its tariffs forbid resale. They simply said, "You buy, you use it. Do not share it. Case closed."

Second, the tariffs also had substantial bulk discounts for large users. And the net effect of two of those effects was to prevent arbitrage by a third party, by buying low and subsequently selling high.

Senator SHELBY. Explain that. Explain that, just so——

Mr. DARBY. The business as it has——

Senator SHELBY. We have a big audience here.

Mr. DARBY. Sure. The business as it has developed permits some users and some new business institutions to buy service from the underlying facilities carriers, to buy large volumes at low cents per minute—or low cents per circuit——

Senator SHELBY. Yes.

Mr. DARBY [continuing]. And then reenter into the market in competition with the facilities-based carriers at the retail level, by breaking bulk and reselling that.

So I might buy dozens and dozens of private line circuits from AT&T and then break those down and offer switch telephone service, let us say from Dothan, AL, to Indianapolis, IN.

The net effect of that is that I am both a customer of AT&T or the underlying facility carrier, and a competitor. And that dual role provided some ambiguity, which I will get into, if you would like.

The purpose for the FCC's rationale, Federal Communications Commission rationale for implementing resale was that it was a quick and easy way to introduce fare competition or rate competition into an industry that was tightly held by a single monopolist.

Recalling that communications is very capital intensive, it has taken MCI over 25 years to assume—to get its current size. Resale provided a means for the FCC quickly to introduce rate competition into the sector.

Its purpose was to increase user choice, which it did; to intensify price and service competition, which it did; and to do so very quickly by increasing the number of competitors.

The FCC, I should point out, rejected a variety of claims of economic harm and technical harm that were advanced by AT&T. Those were never proved and they have not subsequently materialized.

How was resale developed quickly since 1976? It is grown. It now has roughly 800 practitioners, some of which are facilities based; some of which have no facilities whatsoever. Some have more facilities than others.

It currently accounts for about 15 percent of the revenue of this approximately $80 billion intercity telecommunications business. Initially, it began as pure resellers of long-distance service. The industry has subsequently migrated into other services. They now resell international services, local services, wireless services. Some provide one-stop shopping. They have also expanded from sort of pure resellers into value-added carriers. They provide a number of additional services that were not otherwise available.

I mentioned the ambivalence of the incumbents toward resellers. The ambivalence is reflected in the fact that resellers are both customers and competitors of the facilities-based carrier.

So the best of all possible worlds if I am a facilities-based carrier and you are a reseller is that you buy my services and then steal away customers of MCI, so that I effectively serve those customers.

The worst case is if you use my facilities to take away my customers, because that reduces my yield.

Most economists' expectation of the resale sector have been realized. The sector has forced rate structure toward a structure of cost. It has identified and served niche customers. It has lowered the communications bills for millions of small- and medium-size businesses and residents as well.

It has intensified the market discipline on the incumbents and required them to emulate the successful practices of resellers. And it has improved the rate of capacity utilization for underlying carriers.

LESSONS FOR AIRLINES

Introduction of resale into the airline environment would completely disrupt the current ticketing practices and airline yield management pricing by introducing resellers as new customers and competitors, with entirely different pricing opportunities and objectives.

The direction of the first order effects are straightforward. Resale of the variety experienced in telecommunications in my view would: create a new class of competitors; require incumbent carriers to design entirely new fare-setting algorithms; reduce spreads between the lowest and highest rates; shift revenue from carriers to resellers and customers; reduce average fares and stimulate demand; put pressure on carriers to reduce operating expenses; and increase the risk and cost of capital to incumbents, and you should realize that.

In sum, resale would tend to reduce incumbent carrier revenue; increasing revenue for resellers; change the structure of fares, higher for some, lower for others; and forcing carriers to adjust in a variety of ways to the changes in their cash flow.

That requirement would bring into play considerations, it seems to me, of quality of service, wages and employment and, indeed, the full range of carrier operating practices.

PREPARED STATEMENT

I will be happy to answer your questions and thank you again for asking me.

Senator SHELBY. Thank you.

[The statement follows:]

PREPARED STATEMENT OF LARRY F. DARBY

Mr. Chairman, members of the Subcommittee, thank you for the opportunity to be here this morning. You have asked me to summarize key elements of commercial arrangements called resale in the telecommunications business and how that experience might inform your efforts to define the future role of government regulation in the airline industry.

I am Larry Darby. I conduct a telecommunications economics consulting practice here in Washington, D.C. I have participated in a variety of ways in the development of Federal Communications Commission (FCC) policies toward telecommunications resellers, beginning with an analysis of the practice incorporated in an Office of Telecommunications Policy petition to the FCC in 1975.

In addition to my statement this morning, I agreed to submit for the record a longer and more detailed paper on telecommunications resale I wrote for other purposes some time ago, but which, nevertheless, should help the Committee understand the role and impact of telecommunications resale in principle and in practice.

I cannot in the time allotted this morning convey the full richness and detail of the history and performance of telecommunications resellers. I will, though, try to answer four questions:

1. How, why and when did resale come about in the telecom industry?
2. How did resale develop?
3. What have been its effects?
4. What might be expected, if resale of airline capacity were permitted?

How, why and when did resale come about in the telecom industry? Resale, as the name suggests, describes the practice common in many lines of commerce of buying in large quantities at prices reflecting volume discounts, then breaking bulk, marking up the rate and reselling in smaller volumes. In the general trade the practice is called wholesaling. In surface transportation it was called freight forwarding. In telecommunications it is called resale, a practice that took a variety of forms which I will describe after providing some context.

While AT&T enjoyed a monopoly in the provision of both long distance and local telephone services, its tariffs forbid resale and shared use of company facilities or services. The practical effect for users was straightforward. You buy a telecom service, you use it. Don't sell it; don't share it. Case closed.

AT&T tariffs also provided volume discounts. While most users paid by the month, or according to call distance or call setup and holding time, large users, principally business or institutions, could lease private lines or otherwise obtain bulk capacity at lower unit costs to accommodate their high volume requirements.

After decades of prohibition by AT&T and its regulators, resale was first permitted in the late sixties as a means of assisting new facilities-based entrants into the long distance telecommunications business. MCI and others complemented the facilities they constructed and owned with lines they leased from AT&T and then resold. The practice permitted entrants to offer services, and thereby compete with AT&T, in geographic areas where they had no, or insufficient, facilities. While MCI and Sprint and others today have nationwide facilities networks, each originally relied on AT&T facilities to "fill out" their geographic service offerings and national coverage, pending build-out of their own networks.

The FCC first licensed MCI in 1969, then generalized and expanded that pro-competitive decision on several occasions in the early 1970's. However, it was not until 1976 that the Commission completely set aside AT&T tariff restrictions and thereby permitted unlimited shared use and resale. It was five more years before the decision was extended to permit resale not only of private lines, but also of basic switched services like simple long distance connections (message toll services or MTS) and wide area telephone services (WATS).

The rationale for the resale decisions was straightforward. Put simply, the FCC wanted to increase user choice among both carriers and services; to intensify price and service competition; and, to do so by quickly increasing the number and market strength of new competitive rivals. Each purpose was served by reducing the very substantial barrier to entry posed by the enormous threshold capital requirements of constructing new and duplicative common user telecommunications networks. Resale made it possible for new entrants to mushroom literally over night and to provide service of comparable scope and quality to that offered by incumbent facilities-based carriers.

The FCC anticipated that elimination of AT&T tariff provisions prohibiting resale would bring about a variety of benefits to the using public. These included rationalizing the rate structure; forcing rates more closely into conformance with the overall structure of costs; stimulating demand; lowering rates and diversifying service for some users; and, providing for more complete and efficient use of existing network capacity.

It is important to note that the FCC rejected a variety of AT&T claims of harm to the network and allegations of assorted economic harms to other users and to itself. It is equally notable that none of these harms actually materialized.

The FCC recently reviewed and reaffirmed its resale policies and observed that: ". . . unlimited resale promotes the public interest by creating competitive pressures on carriers to provide service at rates near the cost of service and by stimulating demand for such service."

How did resale develop? Since 1976 the resale industry has grown, matured and diversified. Today there are over 800 resellers serving pretty much the full spectrum of the business community, especially small and medium sized firms, as well as millions of households. Resellers have captured more than fifteen percent of the $80 billion domestic intercity telecommunications business. In addition to revenue growth, the two decade transition has been marked as well by expansion of the scope of services offered by resellers to include international services, local exchange services, wireless services, specialized billing services and a variety of "bundled" services customized to individual user needs.

Reseller growth and diversification was gradual and episodic. Though the resale sector was first given life by a 1976 FCC decision declaring unlawful AT&T tariff prohibitions of resale, the decision had important antecedents in earlier "procompetitive" FCC decisions, not the least of which launched MCI, today's second largest long distance carrier. Subsequent FCC decisions have loosened restrictions and otherwise enlarged the domain for resale activity.

Pure resale has been distinguished by the FCC from shared use of capacity by members of a common organization or institution and from value-added carriage, in which the reseller not only disaggregates and resells circuits, but also improves on their quality or value before repackaging them for resale. Early resellers were also value added carriers. Most today add value to the basic circuits and services they provide, in addition to offering lower rates.

Resellers perform a variety of functions. They may own and operate their own facilities—particularly switches—and many do. Facilities-based resellers link their own lines and switchers to transmission and distribution lines leased from larger, more diversified companies. Other resellers provide no facilities and merely buy, repackage, market, resell and bill for the facilities or capacity they obtain from others.

Finally, some resellers do not provide billing, relying instead on an underlying facilities carrier to do the billing. These companies are called "aggregators", which describes their role of combining traffic from several users in order to obtain bulk discounts. Aggregators look quite like commission sales agents for the underlying facilities carriers whose capacity they market. (I have discussed these categories and their implications more fully in the accompanying paper.)

I suspect that this form of resale—the "aggregator" mode—would be the one most likely to emerge in the airline industry.

Facilities-based carriers are ambivalent toward resellers, and that ambivalence is reflected in their conduct toward resale generally and toward particular resellers. Depending on circumstances, a particular reseller can help, harm or have little impact on a given underlying facilities-based carrier. (These outcomes are also developed in greater detail in my paper.)

The ambivalence to resellers of incumbents is traceable to the fact that a reseller is both a potential customer and a potential competitor to the vertically integrated, underlying facilities-based carriers that operate as both wholesalers and retailers. In the best of circumstances from, say, AT&T's point of view, a reseller would take capacity from it, then market the capacity to customers of one of its competitors—say, MCI. The worst circumstances for AT&T are the obverse, wherein a reseller takes capacity from MCI, then markets to AT&T's customers. The middle case is one in which a reseller uses AT&T capacity to take away some of AT&T's retail customers. This ambivalence is most clearly manifest in the industry wide practice of giving greater discounts for capacity that is used to supply so-called "win back" customers—that is, those previously served by ones competitor(s).

What have been its effects? It is probably fair to say that most of FCC's expectations of the resale sector have been subsequently realized in the marketplace. The theory of resale accurately anticipated the facts emerging from actual practice.

In my previous detailed review of the resale sector, I found several important general contributions of resellers to the FCC's overall competitive policies. At that time I concluded that the market conduct of resellers had contributed to improved market performance in several ways, including:

—Forcing the rate structure toward the structure of costs by arbitraging the volume discount spreads;

—Identifying and serving "niche" customers and needs that might otherwise be overlooked by industry majors;

—Contributing to lowering the average telecommunications bill for millions of residential users and numerous small and medium-sized businesses and institutions;

—Intensifying market discipline on incumbents and forcing them to emulate successful rate and service innovations of resellers; and

—Stimulating demand and improving the rate of capacity utilization of the underlying carriers, while also providing capital support to migration by underlying carriers to fibre optic and other high capacity facilities.

Most resellers do more than simply arbitrage the volume discount structure of underlying carrier tariffs. While that is an important function, resellers may also add value for users in a variety of ways. In addition to passing along part of the bulk rate discounts they receive by virtue of their volume purchases, resellers today frequently provide an array of value-added services and customer support services, including customized billing, customer consultation and network planning assistance to users. Some bundle a variety of services for "one-stop" shoppers.

What effects might be expected, if resale of airline capacity were permitted? I understand that current yield management techniques have many characteristics of what economists call Ramsey pricing. That is, prices are set according to the elasticity of demand for individual passengers, a practice that in an earlier time was called charging what the traffic would bear. The pricing scheme is intended to maximize revenue per aircraft by systematically differentiating the fare in ways designed to fill the aircraft, while exacting the maximum from each passenger.

The introduction of resale into this environment would completely disrupt the current system by introducing resellers as new customers and competitors with entirely different pricing opportunities and objectives. The current scheme is not sustainable in a resale environment.

The direction of the first order effects of introducing resale are fairly straightforward. Resale in the current environment would in the first instance undermine the ability of carriers to differentiate rates according to current ticketing and revenue yield management practices. More particularly, permitting resale of the variety experienced in telecommunications would:

—Create a new class of competitors;
—Require incumbent carriers to design entirely new fare setting algorithms;
—Increase the intensity of rate competition;
—Reduce spreads between the lowest and highest rates;
—Shift revenue from carriers to resellers and passengers;
—Reduce average fares and stimulate demand;
—Put pressure on carriers to reduce operating expenses; and
—Increase risk and the cost of capital to underlying carriers.

The impact of these first order effects suggests some good news and some not so good news. Determining the balance will require far more analysis than I have undertaken for purposes of this hearing. Conceptually though, it is clear that the net effect will depend, first, on the relative magnitudes of these contradictory effects and, secondly, on the direction and magnitude of a variety of distant and collateral second order effects that I have not had the occasion systematically to analyze, nor even identify.

In sum, resale would tend to reduce incumbent carrier revenue, increase revenue for "resellers", change the structure of fares—lowering some, but raising others—and forcing carriers to adjust in a variety of ways to reduced cash flow. That requirement would bring into play considerations of quality of service, wages and employment and, indeed, the full range of carrier operating practices.

YIELD MANAGEMENT BENEFIT

Senator SHELBY. Professor Jenkins, I want to thank you for your summary of the yield management. At least I know, superficially, anyway, why everyone on the flight has a different fare when we fly. And people do wonder about this everywhere.

Who are the winners, professor, and the losers in a yield management environment as opposed to the period before yield management became the standard pricing strategy of the network airlines?

Dr. JENKINS. Well, the winners clearly are the majority or the— or clearly the overwhelming plurality of leisure travelers, those who have some flexibility in their travel plans. I do not know necessarily that there are——

Senator SHELBY. Lead time, in other words.

Dr. JENKINS. Yes; lead time. Some flexibility. If Professor Kahn had had flexibility in coming here, his fare need not have been $616. It could have been $380, if he had had 1 day flexibility on it; or if he could have taken a different flight and at a different time. I checked out the fares to find some of these things out myself on his testimony. I hear anecdotes all the time.

Senator SHELBY. Yes.

Dr. JENKINS. As a mathematician, they drive me a little crazy. When I started out in this business in 1974 as a travel agent—and I have been a travel agency owner ever since then and still am——

Senator SHELBY. Yes.

Dr. JENKINS. We did not book leisure travel. The people like my parents could not fly. They could not afford it. People like myself, outside of the discounts that I got for being a travel agent, did not fly.

BUSINESS TRAVEL PRICING PRACTICES

The only people who flew then were business travelers and very wealthy people. So I think overall the net has been positive for both leisure and business.

Now, on the business side, the fares are at an all-time high. But some of these city pairs that you have been looking at, I have gone back and I have checked the records since 1978. Even those prices at their highest level have not yet still kept up with inflation rates.

Senator SHELBY. Let me ask you a question. Part of the high fare—and we have heard some testimony to this effect—of a business traveler's fare is last-minute booking, is that it? By the nature of business itself——

Dr. JENKINS. Well, it is. Business travelers and all of us who have been travel agents know that these guys will book and rebook at least two or three times on average. All right?

Senator SHELBY. It depends——

Dr. JENKINS. And then they may or may not show up.

Senator SHELBY. It depends on their business line.

Dr. JENKINS. It depends on your business line. That is to be sure. And it depends on routes that you are going on, so——

Senator SHELBY. Have not a lot of businesses—I know a few myself, small, medium-size businesses—working with their travel agencies have reexamined their travel expenses and call Mr. Burr, Ms. Kelley, or others to say, "Look, we have to save some money. How do we do this, you know. You are the professional. We have got so much traveling to do. We know this. How do we do it?"

Is that a fair question, Mr. Burr or Ms. Kelley?

Ms. KELLEY. Absolutely.

Dr. JENKINS. Do you want to comment?

Ms. KELLEY. I would like to comment on that. Several things have taken place. One is that the small and large companies have reduced the amount of travel. They are doing a lot more teleconferencing, because they cannot afford to send their businessmen out as often. They do not send two or three. They may just send one.

But some of the practices that they are using, particularly in my own area, and using Harrisburg, PA, as the airport, for me to come to Washington, the airfare is $503, because I am only coming today, going home tomorrow.

However, if I was to stay over Saturday night, which would encompass a couple more hotel nights, obviously the rate would be a lot cheaper. But what the business travel——

Senator SHELBY. Do the hotels subsidize the airlines on that? Is that——

Ms. KELLEY. Yes; I believe the hotels do subsidize the airline. [Laughter.]

But what is happening with the business community is that the employer is giving incentives now for perhaps a Saturday night overstay. If a gentleman or a woman has to go on a trip on a Friday to some city they will offer an incentive for them to spend Saturday night away from the family, thus cutting into the quality family time that is limited as it is.

The second thing that they are doing is offering to drive by car to alternate airports. Again, going back to my area, if I was to fly out of Harrisburg anywhere on a business trip, because all I have is four major airlines, my fares are outrageous.

If I was to advise my consumer to drive to Baltimore or to Philadelphia, both of them about a 2-hour trip, then they can save over one-half most of the time of what their airfare is, because there is

Southwest, Air-Tran, and some of the low-cost airlines in these areas.

Senator SHELBY. Professor Jenkins, I want to get back to you on a question. What other industries that you know about use pricing strategies similar to the yield management as evidenced in the airline industry?

Dr. JENKINS. The stock market.

Senator SHELBY. The stock market.

Dr. JENKINS. Yes.

Senator SHELBY. OK.

Dr. JENKINS. Let me just answer your—your previous question also——

Senator SHELBY. OK.

Dr. JENKINS. Three years ago, the airlines tried in the fall, tried to push through some very high fare increases on your unrestricted tickets.

At that time, the consumers basically voted the fare increase down, and nobody booked for 3 days unrestricted tickets at all.

The economy has been so robust in the last couple of years, growing at 4.5 percent that literally during rush hour, every seat on every plane is full.

Now, when you have a scarce commodity, how do you allocate that scarce commodity? And this is no surprise to Professor Kahn. It should not be any surprise to him why unrestricted fares are so high.

The commodity is scarce and the price is high. This will change when two things happen: When the economy goes into the—goes south or when we have thousands of new airplanes, which we do not have right now. There is no new capacity in this system whatsoever.

Senator SHELBY. Are we going to get it?

Dr. JENKINS. Well, 5, 10 years from now.

Senator SHELBY. OK. Lead time?

Dr. JENKINS. Yes; lead time.

Senator SHELBY. Mr. Darby, what similarities, if any, do you see between the state of competition at the moment in the airline industry and the state of competition in the telecommunications industry before telecom deregulation——

AIRLINE COMPETITION VERSUS TELECOM COMPETITION

Mr. DARBY. The similarities—let me just quickly spell out my view of the current market structure of each, and a little bit about market conduct.

Before the introduction of competition, as I indicated before, there was AT&T and only AT&T.

Senator SHELBY. Yes; a total monopoly.

Mr. DARBY. A total monopoly, with the exception of a few small or retailers on the side, but effectively a monopoly.

There is competition among airlines today, but that competition is becoming increasingly constrictive, it seems to me, as the industry becomes more concentrated. So——

Senator SHELBY. More consolidated?

Mr. DARBY. More consolidated. So there—I would characterize as an economist the market structure of telecommunications as a virtual monopoly in contrast to the market structure of airlines in what would be called a tightly held oligopoly and apparently becoming even more tightly held.

And the pricing practices, as it becomes more tightly held, pricing practices of a tightly held oligopoly approach of those of a monopoly. So in that sense, the structure is similar.

There was very little pricing coherence in telecommunications. AT&T's tariffs sort of grew up like topsy, willy-nilly.

You know, you sort of try to figure out if there is any rhyme or reason to why some people pay more, some people pay less. It was mainly historical accident.

And whether you like current airline rate structure or not, it is coherent. It is understandable. It is driven, you know, by an understandable motive which is to maximize the fare yield. So introducing resale into that environment would dramatically change the rate structure in ways that, you know, are not clear to me. It depends on the structure of resale.

LARGE VOLUME DISCOUNTS

Senator SHELBY. Professor Jenkins, one last question: Do airlines engage in ticket discounting for large volume purchasers? And if so, who would be a typical candidate that an airline would discount for?

Dr. JENKINS. Well, we have corporate discounts.

Senator SHELBY. Yes.

Dr. JENKINS. I do not know that even the airlines know the answer of how many of their flyers are flying on corporate discounts, or even who their corporate flyers are——

Senator SHELBY. OK.

Dr. JENKINS But most likely, one-half of all business travelers fly on some type or other corporate discount. Clearly for a major corporation like Ford——

Senator SHELBY. Yes.

Dr. JENKINS Ninety percent of the city pairs that they fly on a lot, those will have corporate discounts on. There will be some flights that they take that, you know, where they might only use once or twice a year. They will not have discounts on them, but on other major routes, they have discounts on those.

Senator SHELBY. OK.

Dr. JENKINS. And they will vary. They might do them like a group fare, where you can book at any time during the middle of the week.

Senator SHELBY. All right.

Mr. Burr, would you as a travel agent—and, I guess, Ms. Kelley, I can ask the same question in your—would you like to get the same price for tickets that the airlines give to their largest customers? And if so, how would that work?

Ms. KELLEY. You may answer that on my behalf. [Laughter.]

Mr. BURR. Well, of course, yes. To dwell on that a little bit, I would say that the pricing structure is so complicated out there now——

Senator SHELBY. Very.

Mr. BURR. That I do not know how to define that to you. As a professional in the business right here, I find it hard to explain the price of your ticket to you.

Senator SHELBY. Yes.

Mr. BURR. And it changes daily.

Senator SHELBY. Yes; all the time.

Mr. BURR. Minute by minute.

Dr. JENKINS. Well, let me make a suggestion to Mr. Burr then. Since he does not understand the system and I am a professor, I will explain it to him at his leisure. It is certainly not complicated at all. It is just fundamental supply and demand. And I will be happy to teach him how to get better fares for his corporate accounts.

Senator SHELBY. Well, you all do that outside the room in a minute. [Laughter.]

YIELD REVENUE MANAGEMENT

Professor Jenkins, is yield management used only by the network airline, or do some point-to-point airlines like Southwest use it as well?

Dr. JENKINS. Southwest uses it as well, because they have walk-up fares——

Senator SHELBY. OK.

Dr. JENKINS. And they have advanced purchases. Those who have not used yield—revenue management is the correct term—would include Eastern Airlines, Pan Am Airlines and just about every airline that is no longer with us.

Senator SHELBY. Do the point-to-point airlines use yield management to the same degree as the network airlines? And if not, why not?

Dr. JENKINS. They use it. They do not have the same fare structure though.

Senator SHELBY. Why?

Dr. JENKINS. Vanguard, for example, recently initiated a revenue management system. The people that they are attracting is way down on the demand curve, and so the consumer is very, very price elastic.

Senator SHELBY. Ms. Kelley, as a travel agent of, what, 20 years experience?

Ms. KELLEY. Thirty-three.

Senator SHELBY. Thirty-three, excuse me. In your testimony, you indicate that the Internet air travel sites are severely impaired by the airlines adopting discriminatory and noncompensatory commission policies for travel agent bookings originating through the Internet.

Ms. KELLEY. Two things——

Senator SHELBY. Would you describe some examples of those discriminatory or noncompensatory policies for the committee today?

Ms. KELLEY. Two things that have happened on the Internet with the air carriers—we are willing to compete. We feel our services are superior to any services that an airline would offer.

Senator SHELBY. Yes.

Ms. KELLEY. However, we want to be able to compete with the same airfares that they are offering other people. And many of the airlines have recently posted fares that are available only to the consumer if the fare is purchased via the Internet. They have blatantly put disclaimers on that these fares are not available through travel agents.

Senator SHELBY. Yes.

Ms. KELLEY. And in many instances, if the consumer elects to purchase the airfare on the Internet, the travel—and then go into their travel agency to pick up the ticket, the travel agent is not compensated by commission or if they do receive commission, it is a reduced rate, less than what we have already been reduced to.

And so that is some of the situation that is happening with the Internet and the discrimination that the airlines are putting on us.

Senator SHELBY. Professor Jenkins, I am not picking on you, but you——

Dr. JENKINS. I enjoy it. [Laughter.]

THE STOCK MARKET VERSUS THE AIRLINE INDUSTRY

Senator SHELBY. How does the stock market use yield management? You alluded to that earlier.

Dr. JENKINS. Well, if you go in——

Senator SHELBY. Is it——

Dr. JENKINS. If you look at a price of a stock right now, its price is a function of its supply and demand.

Senator SHELBY. That is right.

Dr. JENKINS. If you go in and look at it tomorrow, the price is different. Nobody complains. And it is the same basic commodity. You get a piece of paper that says you own a certificate of stock in that industry.

Senator SHELBY. Are you telling us that the airline industry is run like the stock market?

Dr. JENKINS. Well, basically, yes. It is——

Senator SHELBY. How? How?

Dr. JENKINS. Airline seats are, in fact, a commodity. And they are sold like a commodity in real time.

That is why you have CRS's. That is why you have travel agents. That is why travel agents have exploded in numbers since deregulation because there are more fares and there are more options available.

Senator SHELBY. Mr. Darby, do you want to comment on that?

Mr. DARBY. I basically disagree that pricing of stocks and pricing of airline passenger seats are the same. I mean, they have some similar characteristics, but basically the stock market is an example of a circumstance in which you have a large number of buyers and a large number of sellers coming together to create what is an intensely competitive market, with free entry and exit, frictionless entry and exit, in sharp contrast, it seems to me, to the airline industry, which is highly concentrated, tightly concentrated with fares essentially administered by the major carriers.

There is no analogue to administered fares at the New York Stock Exchange.

Senator SHELBY. I appreciate your coming today. We appreciate your comments here and also your written testimony for the record and your candor. Thank you very much.

Ms. KELLEY. Thank you.

Mr. DARBY. Thank you.

Dr. JENKINS. Thank you.

Mr. BURR. Thank you.

DEPARTMENT OF TRANSPORTATION

STATEMENT OF PATRICK V. MURPHY, DEPUTY ASSISTANT SECRETARY, AVIATION AND INTERNATIONAL AFFAIRS

INTRODUCTION OF WITNESS

Senator SHELBY. Our third panel will be Mr. Patrick Murphy. He is the Deputy Assistant Secretary, Aviation and International Affairs, U.S. Department of Transportation.

Of course, this will be dealing with the subject of the administration's enforcement policy here.

Mr. Murphy, again, welcome to the Committee. We always appreciate you coming, your participating. And your written testimony will be made part of the record in its entirety. And you may proceed as you wish.

Mr. MURPHY. We, at the Department of Transportation, Mr. Chairman, take the view that deregulation of domestic air travel 20 years ago was one of Congress' best efforts to bring powerful economic forces to bear on behalf of travelers, shippers, and the airlines themselves.

Deregulation in the United States has expanded the pie for everyone and has been for the benefit of everyone.

Traffic is up. Fares are down. And profits are at record levels. However, deregulation can only work in the long run if the airlines compete fairly with each other.

A COMPETITION PROBLEM

In the past few years, the Department of Transportation has received an increasing number of complaints by smaller airlines that the largest airlines are using unfair tactics to keep them from getting a foothold in many markets at hub airports. Others have echoed these complaints—Members of Congress, local communities, travel agencies, business and leisure travelers. These complaints, Mr. Chairman, are especially troublesome at a time when new entry has virtually stopped, low-fare airlines are struggling financially and the number of markets with competition have now declined for 6 straight years.

Mr. Chairman, we have not moved precipitously in response to these complaints. The department undertook a detailed analysis of the complaints brought to us. Our experts spent countless hours studying extensive company records, identifying patterns of behavior and analyzing industry data. We conferred with expert staffs at the Department of Justice and the Federal Trade Commission.

As a result of these efforts, we are concerned that unfair exclusionary practices by some major network airlines are preventing needed competition at hub airports, effectively denying more reasonable fares and affordable access to tens of millions of passengers across the country.

Senator SHELBY. And how much money, billions of dollars perhaps, costing——

Mr. MURPHY. I could not really quantify that. We know that 40 percent of the country has the benefit of low fare competition.

Senator SHELBY. Yes.

Mr. MURPHY. We have 60 percent without that benefit at this time.

Senator SHELBY. But it would be a big dollar item, would it not?

Mr. MURPHY. We believe it would be a very large item, yes, sir.

Senator SHELBY. OK.

Mr. MURPHY. Under the statutory mandates, we have to preserve and foster competition in air travel, we concluded that we have an obligation to act. We considered enforcement action against the airlines, but in the end, we concluded the best approach was to set forth policy guidance on what the Department's views would constitute unfair exclusionary conduct warranting Federal action.

We have shaped a policy that targets only the most egregious conduct. We will apply a final policy prospectively so that the airlines are fully aware and on notice in advance of what conduct will be found to be unfair exclusionary conduct.

And the Secretary determined that we would put out for public comment a proposed policy so that we could engage in the very kind of dialog we are having today. I might add that we put that policy out 1 month ago.

We have no intention of reregulating the airline industry as some have charged. Rather, we want to assure that effective competition, which is the linchpin of deregulation, is preserved.

PROPOSED ENFORCEMENT POLICY

Our proposed policy statement identifies the behavior that we will consider to be unfair exclusionary practice. If in response to new entry into one of its hub markets, a major carrier pursues a strategy of price cuts and capacity increases that either, one, results in substantial self-diversion of revenue or, two, results in substantial worse short-term operating results than would be a reasonable alternative competitive strategy, we propose to find this unlawful.

We do not wish to stifle legitimate competitive responses to new entry. We are not proposing a policy to protect competitors, but to promote competition.

STATUTORY AUTHORITY

Some have contended that the Department has exceeded its authority in issuing the proposed enforcement policy. It is our view that an enforcement policy of this kind is a proper use of our statutory authority to define and prohibit unfair methods of competition and a proper discharge of our statutory mandate.

Section 41712 of our statute tasks the Secretary, when he or she considers it to be in the public interest, to "decide whether an air carrier is engaged in an unfair or deceptive practice or an unfair method of competition" and to take appropriate action to end any such abuse.

Furthermore, Congress deemed our exercise of this authority to prevent unfair competition essential to the successes of deregulation.

While Congress eliminated many of our regulatory provisions governing the airline industry as part of deregulation, Congress' review of the operation of deregulation 6 years after deregulation, caused it to conclude that the statute must maintain DOT's authority to prohibit unfair methods of competition.

As Congress recognized and the courts have held, the Department's authority to prohibit unfair competition allows us to prohibit anticompetitive conduct that does not violate the antitrust laws.

Our proposed enforcement policy falls within the language of our statute, is consistent with the court's interpretation of the scope of our statutory authority and carries out Congress' determination.

ALLIANCES

I would now like to comment for just a moment, if I may, Mr. Chairman, about alliances and the possible competitive implication of increased concentration in the airline industry.

Let me first note that the recently announced alliances between the six largest U.S. airlines—Continental and Northwest, the fifth and fourth largest carriers; American and USAir, the second and sixth largest airline; as well as Delta and United, the third and largest airlines, represent the first combinations among domestic airlines in the past several years.

I might add also that these three alliances would account for 80 percent of the U.S. airline industry.

There was a wave of mergers in the airline industry 10 years ago in the mideighties, but no major domestic airline transactions in recent years. These recent transactions represent a new form of alliance. In the past, alliances were between regional airlines and large carriers promoting feed traffic or U.S. and foreign airlines building cross-border networks. These newly proposed linkages present very different issues. They represent nothing less than a major transformation of the airline industry.

We have heard concerns about these transactions. Now, let me assure you that we and the Justice Department have the tools and the willingness to investigate whether such transactions would lead to a significant loss of competition, and if necessary, to prevent such harm.

The potential size and scope of these proposed alliances warrant our close scrutiny. Consequently, we have recently requested that the carriers provide us with full details of their alliances.

We intend to examine carefully the potential effects of these large arrangements. In particular, we will consider whether they may reduce competition, either in specific markets or overall.

We will consider the potential impact of these alliances on the competitive capability of other major airlines and of new entrants.

In conclusion, Mr. Chairman, the Department of Transportation is working hard to preserve the benefits of competition and to protect the interests of consumers. The administration is committed to ensuring competition in domestic and international airline business. That is why we have worked hard in recent years to secure 30 Open Skies agreements.

We have issued our proposed competition policy. We have recently granted 85 slot exemptions to provide valuable new air service and competition. And we are now beginning to review whether new airlines have been thwarted in various markets due to an inability to obtain adequate airport facilities on reasonable terms. We are also just beginning to review the big three proposed domestic alliances.

Thank you, Mr. Chairman.

PREPARED STATEMENT

Senator SHELBY. We appreciate your remarks and also your continuing to appear before this committee and many others. We will insert your complete statement in the record.

[The statement follows:]

PREPARED STATEMENT OF PATRICK V. MURPHY

Mr. Chairman and Members of the Committee: I welcome the opportunity to be here today and applaud you for bringing together individuals to undertake an open and serious discussion about a matter important to all of us—competition in aviation across the United States.

When Secretary Slater recently called for a dialogue on airline competition, he knew that Congress would be an essential voice. I am pleased to be a participant in your discussion today.

We have seen over the years that we accomplish far more in aviation by engaging in constructive give-and-take and by working together. Witness the birth of airline deregulation itself. That landmark event in the history of domestic air travel in the United States would not have come about without the concerted efforts of many—inside government and out.

More recently, Government, airline management, and labor worked together successfully to overcome the recession that gripped the industry at the time President Clinton took office.

SUCCESS OF DEREGULATION

This same cooperative spirit can pay equal or greater dividends as we grapple with today's issue—forging appropriate measures to preserve and foster a competitive climate in the air transportation industry. Let no one mistake our view—deregulation of domestic air travel in 1978 was one of Congress' best efforts to bring powerful economic forces to bear on behalf of the traveler, the shipper, and the airline industry itself. This view is widely shared, and is confirmed by all of our studies at the Department.

Deregulation in the United States has expanded the pie for everyone and for the benefit of everyone. U.S. airlines carry about 270 million more passengers a year than under regulation. On average, domestic consumers pay a third less (in constant dollars) than they did twenty years ago. And, airline operating profits are also at record levels—totaling $20 billion in the last three years.

Airline deregulation works when the airlines compete fairly with each other. Consumers benefit when the airlines compete because, to win business, they have to offer more attractive service and fares. In fact, one airline—Southwest—has established itself as one of the nation's larger and stronger airlines by offering consumers both low fares and good service.

In response to deregulation, the major airlines developed hub-and-spoke networks and have created twenty hub airports around the country. Hubbing creates advantages for many travelers, since it gives travelers at the hub cities many more flights and enables airlines to offer more service in markets without enough traffic to sustain non-stop service. On the other hand, hubbing has the disadvantage of making effective competition in the hub's local markets very difficult, thereby allowing the hub airline to charge higher fares in such markets. A hub airline has competitive advantages in those markets because it operates the most flights and can offer travelers a more attractive frequent flyer program and travel agencies more attractive incentive commission programs. As a result, most hub markets have little competition, and the passengers in those markets pay relatively high fares. New service by a low-fare airline is likely to be the only way that many hub markets will ever benefit from competitive airline service.

A low-cost airline's entry into a hub market can produce enormous consumer benefits. For example, the Department's April 1996 study of low-cost airlines examined the effects of the low-fare service offered by Morris Air and Southwest, which acquired Morris, in a number of Salt Lake City markets. Average fares in those markets dropped by about fifty percent, and traffic in those markets tripled when fares in other Salt Lake City markets were increasing somewhat. As a result, by late 1995 the average fares in the markets served by Morris and Southwest were only one-third the level of fares in other Salt Lake City markets.

A COMPETITION PROBLEM

In the last few years, however, the Department has received an increasing number of complaints by smaller airlines that the largest airlines are using unfair tactics to keep them from getting a foothold in many markets at hub airports. Others have echoed these complaints—Members of Congress, local communities, travel agencies, and business travelers. These complaints are especially serious at a time when the number of markets with competition have declined for six straight years, new entry has virtually stopped and low-fare airlines are struggling financially.

Let me give you one example of what we have heard and what we have found.

When a new entrant started operation in one major city-pair market, the dominant hub carrier initially did not slash its fares and increase capacity in response to the new service. However, after a few months the hub carrier matched the newly offered $49 one-way fare and added more seats. Before this move, thirty percent of the hub carrier traffic—about 13,000 passengers—paid fares of $325 to $350, while fewer than 1,500 passengers paid fares of $75 or less, during a three-month period. After the hub carrier dropped its fares and increased capacity, it carried almost 50,000 passengers who paid no more than $75 and less than 1,000 passengers who paid fares of $325 to $350. In a three-month period after the new entrant left the market, the hub carrier sold fewer than 1,000 seats at fares under $75, carried only about 3,000 passengers paying fares of $325 to $350, but carried over 12,000 passengers paying fares of $350 to $375.

Mr. Chairman, we have not moved precipitously in response to this type of complaint. The Department undertook a detailed analysis of the complaints brought to us. Our airline experts spent countless hours studying extensive airline company records, identifying patterns of behavior, and analyzing industry data. In developing our proposed policy, we conferred with expert staffs at the Department of Justice and the Federal Trade Commission. As a result of these efforts, we are concerned that unfair exclusionary practices by some major network airlines are preventing needed competition at hub airports, effectively denying more reasonable fares and affordable access to tens of millions of potential passengers across the country.

Under the statutory mandates Congress has enacted to preserve and foster competition in air travel, we concluded that we are obligated to act. We considered enforcement action. But in the end, we concluded (in fact at the suggestion of some of the airlines) that the best approach was to set forth policy guidance on what, in the Department's view, constitutes unfair exclusionary conduct warranting Departmental action.

Reviewing the continuum of carrier behavior over several years, we have shaped a policy that targets only the most egregious conduct—when a combination of factors occur in carrier behavior that cannot be adequately explained as good economics. We will apply a final policy prospectively, so that carriers are fully aware in advance of what conduct will be found to be unfair exclusionary conduct. And the Secretary determined that we would put out for public comment a proposed policy so that we could engage in the kind of dialogue we are having here today. We have no intention of reregulating the airline industry, as some have charged. Rather, we want to assure that effective competition—which is the linchpin to the success of deregulation and the benefits it brings to consumers—is preserved.

PROPOSED ENFORCEMENT POLICY

Our proposed policy statement identifies the behavior that we will consider to be an unfair exclusionary practice. If, in response to new entry into one of its hub markets, a major carrier pursues a strategy of price cuts and capacity increases that either (1) sacrifices more revenue than all of the new entrant's capacity could have diverted from it or (2) results in substantially worse short-term operating results than would a reasonable alternative strategy for competing with the new entrant, we propose to find this unlawful. Any strategy this costly in the short term is economically rational for the major carrier only if it forces the new entrant from the market, after which it can readily recoup the revenues sacrificed to achieve this end.

It's one thing for an established airline to match the prices of a competitor's new service. That is legitimate competition. It's another thing entirely for an airline to not only match that price, but to also sell ten times as many seats as the new entrant at the low fare, thereby ensuring that both the new entrant and the established airline will lose money or forego profits . . . but only until the new entrant is driven from the market. Then, the established carrier slashes the amount of service, raises fares, and recoups its losses or lost profits—all at the cost of much higher prices to the consumer. This, under our policy, is unfair competition.

To provide guidance we have set forth three types of obviously suspect responses to new entry that will normally trigger an enforcement proceeding to determine whether a violation has occurred:

(1) when the major carrier adds capacity and sells such a large number of seats at very low fares that the resulting self-diversion of revenue results in lower local revenue than would a reasonable alternative response;

(2) when the major carrier carries more local passengers at the new entrant's low fares than the total number of seats that the new entrant offers, resulting, through self-diversion, in lower local revenue than would a reasonable alternative response; and

(3) when the major carrier carries more local passengers at the new entrant's low fares than the new entrant does, again resulting, through self-diversion, in lower local revenue than would a reasonable alternative response.

To summarize, before we undertake any formal investigation, at a minimum we will ask these three questions: first, did the major carrier cut its fares to effectively match those of the new entrant; second, did the major carrier also significantly increase the capacity it offered at low fares; and third, did the decrease in fares coupled with the increase in low-fare capacity result in considerably lower local revenue than the major carrier would have realized under a reasonable alternative strategy.

We do not wish to stifle legitimate competitive responses to new entry, which provide the lasting benefits to consumers that deregulation should bring. We recognize that this can involve a delicate balance, and that is one of the reasons we are eager to get the views of all interested parties. We are not proposing in this policy to protect competitors, but to promote competition. We are carrying out our statutory responsibilities to ensure that if a low-fare airline's entry into a major carrier's hub markets fails, it fails on the merits, not due to unfair methods of competition.

STATUTORY AUTHORITY

Some have contended that the Department has exceeded its authority in issuing the proposed enforcement policy. It is our view that an enforcement policy of this kind is a proper use of our statutory authority to define and prohibit unfair methods of competition and a proper discharge of our statutory mandate to promote competition.

Section 41712 of our organic statute (formerly section 411) tasks the Secretary, when he or she considers it to be in the public interest, to "decide whether an air carrier . . . is engaged in an unfair or deceptive practice or an unfair method of competition" and to take appropriate action to end any abuse. Nothing in the terms of that section excludes any type of unfair competitive conduct from its reach.

In addition, other provisions of the statute make it clear that Congress expected us to take action when major airlines engage in conduct that unreasonably threatens competition in airline markets. The statute's policy section specifically directs the Secretary, in carrying out his responsibilities, to consider that the public interest requires "preventing unfair, deceptive, predatory, or anticompetitive practices." The statute also directs him or her to consider in the public interest "avoiding unreasonable industry concentration, excessive market domination, monopoly powers, and other conditions that would tend to allow [a carrier] unreasonably to increase prices, reduce services, or exclude competition. . . ." 49 U.S.C. 40101(a)(9) and (13).

Furthermore, Congress deemed our exercise of this authority to prevent unfair methods of competition essential for the success of deregulation. While Congress eliminated many of the other regulatory provisions governing the airline industry as part of deregulation, Congress' review of the operation of deregulation in 1984 caused it to conclude that the statute must maintain our authority to prohibit unfair methods of competition. And it did not carve out any area of airline operations from the scope of that authority. As the House committee stated, H.R. Rep. No. 98–793, 98th Cong., 2d Sess. (1984) at 4–5:

> There is also a strong need to preserve the Board's authority under Section 411 to ensure fair competition in air transportation . . . Although the

> airline industry has been deregulated, this does not mean that there are no limits to competitive practices. As is the case with all industries, carriers must not engage in practices which would destroy the framework under which fair competition operates. Air carriers are prohibited, as are firms in other industries, from practices which are inconsistent with the antitrust laws or the somewhat broader prohibitions of Section 411 of the Federal Aviation Act (corresponding to Section 5 of the Federal Trade Commission Act) against unfair competitive practices.

As the House recognized then, and as the courts have held, the Department's authority to prohibit unfair methods of competition allows us to prohibit both conduct that violates the antitrust laws and anticompetitive conduct that does not violate the antitrust laws. Congress gave us that authority (and the FTC comparable authority over other industries) because Congress believed that businesses could engage in practices that unreasonably and unfairly threatened competition without violating the antitrust laws and that the Department should have the power to prohibit such conduct.

The unfair exclusionary behavior we address in our proposed policy is analogous to, and may in some cases amount to, predation within the meaning of the federal antitrust laws. A major airline's use of large fare cuts and capacity increases and sacrifice of revenues in the short run in order to eliminate competition in hub markets, after which it can cut capacity and raise fares to at least their original levels and recoup losses or lost profits, closely resembles conduct prohibited by the Sherman Act. In any event, the authority given us to prohibit unfair methods of competition is not confined to practices that violate the antitrust laws.

In sum, our proposed enforcement policy comes within the language of our statute, is consistent with the courts' interpretation of the scope of our statutory authority and, most importantly, carries out Congress' determination that the success of deregulation requires us to preserve competition and stop anticompetitive behavior.

As Secretary Slater has said: "Our responsibility at the Department of Transportation is to ensure that every airline—large or small, new or established—has the opportunity to compete freely. That is what deregulation is supposed to be all about—a fair chance to compete."

ALLIANCES

I would also like to address another issue affecting competition in the aviation industry—the possible competitive implications of increased concentration in the airline industry.

Let me first note that the recently-announced alliances between the six largest U.S. airlines, Continental and Northwest (the fifth and fourth largest U.S. carriers), American and USAir (the second and sixth largest airlines) as well as Delta and United, (the third and first largest) represent the first combinations among domestic airlines in the past several years. There was a wave of mergers in the airline industry in the 1980's, but no major domestic airline transactions in recent years. These recent transactions represent a new form of alliance. In the past, alliances were between regional airlines and large carriers to promote feed traffic, or U.S. and foreign carriers to build cross-border networks. These newly proposed linkages present very different issues. They represent nothing less than a major transformation of the industry.

We have heard concerns that the three recently announced transactions will reduce competition in the domestic airline industry. Let me assure you that we and the Justice Department have the tools and the willingness to investigate whether such transactions would lead to a significant loss of competition, and if necessary, to prevent such harm.

The potential size and scope of these proposed alliances warrant our close scrutiny. Consequently, we have requested that the carriers provide us details about their alliances. We intend to examine carefully the potential effects of these large arrangements. In particular, we will carefully consider whether they may reduce competition, either in specific markets, or overall. We will consider the potential impact of these alliances on the competitive capabilities of other major airlines and of new entrants.

Our focus on the impact on other major airlines will be on whether competition will decrease or be eliminated.

The proposed alliances also raise concerns about the continued ability of new airlines to enter underserved or overpriced markets.

CONCLUSION

Mr. Chairman and members of the Committee, the Department of Transportation is working hard to preserve the benefits of competition and to protect the interests of consumers. This Administration is committed to ensuring competition in the domestic—and international—airline business. That is why we have worked so hard to secure 30 Open Skies agreements; we have issued our proposed competition policy; we have recently granted 85 slot exemptions to provide valuable new air service and competition. And we are now beginning a review into whether new airlines have been thwarted in various markets due to an inability to obtain adequate airport facilities on reasonable terms. We are also just beginning to review the big three proposed domestic alliances. We look forward to working with Congress to ensure that the aviation system continues to grow and that consumers continue to benefit.

Thank you Mr. Chairman. This completes my prepared statement, and I would be pleased to respond to your questions and those of the Committee.

ENFORCEMENT POLICY

Senator SHELBY. Mr. Murphy, the Department of Transportation has recently issued guidelines, which you've alluded to, as to what constitutes unfair exclusionary practices.

In the statement of enforcement policy to the request for comments on these new guidelines, a carrier is placed on notice that it will be considered to be in violation of the guidelines if it pursues a strategy of price cuts, capacity increase, or both, that: one, either causes it to forgo more revenue than all of the new entrants' capacities could have diverted from it or, two, results in substantially lower operating profits or substantially greater operating losses in the short run than would a reasonable alternative strategy for competing with a new entrant.

To enforce these guidelines would seem to require a great deal of analysis or second guessing business strategy to carry out either of those tests, especially when determining whether a reasonable alternative strategy for competing with a new entrant would result in higher operating profits or lower operating losses.

The guidelines seem to me to be subject to a great deal of interpretation by the Department in the course of enforcement. Would you disagree with that assessment? And if so, does the Department have the authority and the staff ability to make such assessment?

Mr. MURPHY. I would first respond that we believe we have the authority.

Senator SHELBY. OK.

Mr. MURPHY. As far as the difficulty in the enforcement, I would say this is a complex area. Everybody who has looked at it agrees that defining precisely what is unfair exclusionary behavior is difficult.

Senator SHELBY. But just because something is complex, just because it is difficult, just because it is hard to do is no reason to ignore it, is that right?

Mr. MURPHY. That is our view, Senator, and that is why we worked so long with the Justice Department Antitrust Division, the Federal Trade Commission, people like Professor Kahn to develop these standards. I might add, we also developed in our document for comments the tests or the triggers that we would use before we would open an investigation.

Senator SHELBY. Yes.

Mr. MURPHY. And we put those out there in an attempt to alert the carriers, even more precisely what it is we would look for before we would open an enforcement case.

And those are an increase in capacity, a substantial increase in capacity, a substantial lowering of price and that this would not be a reasonable alternative response. We put those additional measures out there.

Our guidelines are now out for comment. They have been out for a month. The comments we have received to date have been very supportive. We have another month of comment and then a month of responses. Then we will move to finalize our guidelines.

DETERMINING PREDATORY ACTIVITY

Senator SHELBY. Mr. Murphy, there are no really bright lines in the guidelines that we can point to and say "If an airline is doing that then it is clearly engaging in predatory activity," are there? And finding those bright lines seems to be very, you know, much of a challenge, as you have said.

Would you comment on why that is the case? In other words why it is so tough——

Mr. MURPHY. I think one of——

Senator SHELBY But not impossible?

Mr. MURPHY. I think one of the reasons it is tough is that we do not want to get into the business of drawing very firm lines. We want the airlines to compete. We want them to have the ability to respond in an appropriate way——

Senator SHELBY. Yes.

Mr. MURPHY And compete very vigorously with these new entrants. We are not trying to shelter anyone from vigorous competition. We are only trying to eliminate the most egregious behavior.

Senator SHELBY. Yes.

Mr. MURPHY. And based on our investigations, this was not really, I might add, Mr. Chairman, an academic exercise. We went out and investigated and looked into the books of the large airlines and saw how they were moving against these small companies.

We are trying to eliminate some of the behavior that we think we could have started an enforcement case right then and there. But rather, we felt it was more productive to set out guidelines so people prospectively would know that we were watching this behavior.

LEVEL OF COMPETITION

Senator SHELBY. Mr. Murphy, Dr. Kahn has spoken about how quickly the industry is changing, and some of the other witnesses have described how technology has and will have an impact on the industry. Given the pace of change in the industry, do we risk doing more damage to, rather than improve, competition with the uncertainty inherent in vague guidelines? In other words, guidelines, I think, ought to be specific. They should not be vague, indefinite, and uncertain in any way. And if you have guidelines to promote competition, that is great. But if it will not do anything to promote competition, it is a problem, is it not?

Mr. MURPHY. One response I would give, Senator, is that the level of competition in the airline industry is already declining.

Senator SHELBY. Sure.

Mr. MURPHY. It has been declining for 6 to 8 years. New entry has come to a virtual stop.

Senator SHELBY. Yes.

Mr. MURPHY. The smaller carriers are in difficulty financially. They are the companies that bring the low-fare pressure on the airlines. We want to make sure we continue to have a stream of good low-fare competitors out there to keep the big airlines and perhaps these big alliances competitive.

Senator SHELBY. Basically, in America, don't we want competition to work? And for it to work, you cannot have regional monopolies or other monopolies, is that correct?

Mr. MURPHY. And clearly that is our concern——

Senator SHELBY. Yes.

Mr. MURPHY Especially at these dominated hub airports.

Senator SHELBY. OK. Senator Kohl.

Senator KOHL. Thank you, Senator Shelby.

MIDWEST EXPRESS AIRLINES

Mr. Murphy, I am from Wisconsin. And Midwest Express Airlines is an outstanding airline operating out of Milwaukee.

Mr. MURPHY. Sure.

Senator KOHL. And I am concerned about your having placed them into the so-called major category. By comparison to the other companies in the major category, they are not only the smallest, but by comparison, they cannot be considered to be comparable.

Mr. MURPHY. OK.

Senator KOHL. Their sales are about $350 million a year, whereas the others are in the billions of dollars. They basically operate out of one city, Milwaukee, with a minor hub in Omaha.

And they are not in a position to compete with the majors. They do not try to. They operate, as you know, a different kind of a business.

If a major wanted to come into Milwaukee and compete with them and put them out of business, it would not be difficult. And I am concerned about the categorization, because that categorization, as you know, has inferences and has direct consequences.

And I would like to hear from you why you have decided at this point to put them in that category.

Mr. MURPHY. Yes, sir; I would be happy to comment on that. First of all, I agree with your characterization of Midwest Express as an outstanding newer airline that does a fine job.

When we put this definition in our proposed—and I will underline proposed guidelines—we were really responding to what we had observed with regard to the very large airlines going after the very small low-fare airlines, the newest low-fare airlines.

That is how we came up with this definition. I must say that the definition has probably received as much comment as any other part of our proposal.

And with just your suggestion that we were too rigid in how we characterized carriers, we are going to take another look at that. This is a proposal. We have heard comments from other carriers who feel they were left out.

And I can assure you we will be looking at that definition again, Senator.

Senator KOHL. Yes; well, you say major carriers versus low-fare. They are not low fare either.

Mr. MURPHY. I know that, Senator.

Senator KOHL. So they are neither major, nor are they low fare.

Mr. MURPHY. Yes.

Senator KOHL. Maybe there is another category you are looking for entirely that describes Midwest Express, you know, because they are fairly unique. Their percentage of the domestic market is 0.3.

Mr. MURPHY. Yes.

Senator KOHL. I do not know how much smaller you can get.

Mr. MURPHY. Well, I appreciate——

Senator KOHL. They only have 26 airplanes. So again, I do appreciate what I think I hear you saying, which is that you will be looking at that categorization and attempting to be as fair as you can.

Mr. MURPHY. Yes, sir.

Senator KOHL. And I do appreciate that. That is very good to hear. I thank you.

Senator SHELBY. I want to thank you, Senator Kohl.

I want to thank each one of the participants here today. We have had a lively hearing and several different points of view. But I want to thank everyone for participating here.

These aviation competition hearings we have been having, I believe, have played an important role in helping us on the committee and in the Senate understand what can and what should be done, Mr. Murphy, to help foster competition and improve air service for all Americans.

I am convinced that this is an area, which deserves continued congressional scrutiny and also scrutiny by the administration——

Mr. MURPHY. Yes, sir.

Senator SHELBY Particularly in the light of the newly announced code-sharing allowances and the new DOT guidelines.

This subcommittee will do whatever it takes to ensure a level playing field in the aviation industry and ensure that the American people have affordable, timely access to air service.

CONCLUSION OF HEARINGS

This hearing now will be recessed subject to the call of the Chair. Thank you. That concludes these aviation competition hearings.

[Whereupon, at 10:50 a.m., Tuesday, May 5, the hearings were concluded, and the subcommittee was recessed, to reconvene subject to the call of the Chair.]

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