COMPETITION AND THE ANTITRUST LAWS

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The Competition and Antitrust Laws

- Prohibit collusion between competitors that restrain trade, such as price-fixing.
- Prohibit monopolization through mergers.
- Prohibit monopolization through anticompetitive means, such as predation or abuse of a dominant position.

US Antitrust Laws

- Sherman Antitrust Act of 1890
- Clayton Act of 1914
- Robinson-Patman Act of 1936
- Federal Trade Commission Act of 1938
- Civil Aeronautics Act of 1938 (Federal Aviation Act of 1958)

CONSPIRACIES IN RESTRAINT OF TRADE

It is unlawful in many countries around the world for competitors to agree to fix prices or divide territory. In the U.S., such conduct can result in criminal prosecution by the Justice Department, or a civil suit in which treble damages are potentially recoverable. In the European Union, companies may face a fine of as much as 10% of annual turnover.

Section 1 of the Sherman Act

- Prohibits contracts, combinations, and conspiracies in restraint of trade.
- Airlines seek antitrust immunity to create alliances.
- NW/KLM granted antitrust immunity in 1993.

Jurisprudence

- Section 1 of the Sherman Act prohibits combinations and conspiracies in restraint of trade. To prevail on a claim that a horizontal agreement among competitors restrains trade, the plaintiff must prove the restraint is unreasonable, or in other words, harmful to competition. The purpose of the antitrust laws is to protect competition, not protect individual competitors. Thus, it is not enough to show that the restraint caused the plaintiff economic injury. To determine whether the agreement has an adverse effect on competition, courts examine such factors as reduced output, increased prices and decreased quality.
- *Atlantic Richfield Co. v. USA Petroleum Co.*, 495 U.S. 328, 338 (1990).
- *Virgin Atlantic Airways Ltd. v. British Airways PLC*, 257 F.3rd 256, 264 (2nd Cir. 2001).

Three Tests

The U.S. Supreme Court has identified three methods of assessing whether a horizontal agreement violates Section 1:

1. the *per se* analysis, for restraints which are obviously anticompetitive like price-fixing, territorial allocations, group boycotts, tying arrangements.
2. *quick-look* analysis, for restraints with some procompetitive justification; and
3. the *rule of reason* test, for restraints whose net impact on competition is difficult to determine.

- *California Dental Assn. v. FTC,* 526 U.S. 756, 780-81 (1999). *See Continental Airlines v. United Airlines,* 277 F.3rd 499 (4th Cir. 2002).

Article 81 of EC Treaty

Prohibits “all agreements between undertakings … which may affect trade … and which have as their object or effect the prevention, restriction or distortion of competition . . . .”

Examples:

- Price-fixing;
- Limitation or control of production;
- Shared markets or sources of supply;
- Applying dissimilar conditions to equivalent transactions, placing other trading parties at a competitive disadvantage;
- Making the conclusion of contracts subject to approval by others without commercial justification.

The Air Cargo Antitrust Disaster

- At the end of the first decade of the 21st century, a number of airlines (including Lufthansa, Lan Chile, Air France, British Airlines, Japan Airlines, Korean Airlines, American Airlines, SAS, Asiana Air, Polar Air, Cathay Pacific, Atlas Air, and Cargolux) found themselves in the cross-hairs of government antitrust lawyers in a number of countries for fuel and security surcharges. Some airlines paid fines totaling tens of millions of dollars. The European Union alone imposed fines of €799 million on 11 airlines. British Airways and Korean Airlines paid fines of $300 million each in settlement of a U.S. Justice Department investigation.
- It is unlawful in many countries around the world for competitors to agree to fix prices or divide territory. In the U.S., such conduct can result in criminal prosecution by the Justice Department. In the European Union, companies may face a fine of as much as 10% of annual turnover.

Travel Agent Commission Antitrust Litigation

One Section 1 aviation case that failed to get traction was a suit brought by travel agencies against a number of major airlines alleging that they had conspired to reduce "base commissions" beginning in 1995, when Delta, American, Northwest, United and Continental Airlines each capped travel agent commissions at $25 one-way, and $50 round-trip. By 2002, the major airlines had reduced commissions to zero. The travel agencies alleged that, "defendant's decision to cut, cap, and eventually eliminate its practice of paying travel agencies a base commission would not have occurred without collusion because such action, if taken independently, was contrary to the individual defendant's economic self-interest." The U.S. Court of Appeals for the Ninth Circuit was unconvinced, describing plaintiffs' allegations as "nothing more than a legal conclusion 'masquerading' as a factual allegation." The allegations that the airline executives responsible for setting commissions met on several occasions during the time when commissions were falling, "aver only an opportunity to conspire, which does not necessarily support an inference of illegal agreement." The court instead found the conduct to be no more than "conscious parallelism" which was "more likely explained by lawful, unchoreographed free-market behavior." In opposition to plaintiff's theory of conspiracy, the court found it "just as likely that [the carrier's] commission cap was an effort to reduce its internal commission costs, with the ancillary hope its competitors would follow its lead."

- *In re Travel Agent Commission Antitrust Litigation,* 583 F.3rd 896, 899-900 (9th Cir. 2009).

Delta AirTran Baggage Fees

However, the conscious parallelism defense did not fare well in a case alleging collusion between Delta Airlines and AirTran to fix prices on baggage fees. The court noted, "Plaintiffs need not allege the existence of collusive communications in 'smoke-filled rooms' in order to state a § 1 Sherman Act claim. Rather, such collusive communications can be based upon circumstantial evidence and can occur in speeches at industry conferences, announcements of future prices, statements on earnings calls, and in other public ways. . . . [U]nlawful conspiracies may be inferred when collusive communications among competitors precede changed/responsive business practices, such as new pricing practices."

- *In re Delta/Airtran Baggage Fee Antitrust Litigation,* 733 F. Supp. 2nd 1348, 1360 (N.D. Ga. 2010).

Bankruptcy and Antitrust

In one case, United Airlines argued that creditors conspired in violation of §1 of the Sherman Act to retrieve their aircraft under §1110 of the Bankruptcy Code, which requires return of aircraft unless all delinquent rental obligations are paid. The court found that the allegation that the antitrust laws forbid creditors to coordinate their activities in bankruptcy bordered on the frivolous. "Competition comes at the time loans are made; cooperation in an effort to collect as much as possible of the amounts due under competitively determined contracts is not the sort of activity with which the antitrust laws are concerned. Moreover, business are entitled under the *Noerr-Pennington* doctrine to act jointly when presenting requests to courts and agencies."

- *United Airlines v. The Bank of New York*, 406 F.3rd 918, 921 (7th Cir. 2005), citing *Eastern Railroad Presidents Conference v. Noerr Motor Freight*, 365 U.S. 127 (1961), and *United Mine Workers v. Pennington*, 381 U.S. 657 (1965).

Pre-Merger Notification Requirements

- Approximately 100 States have pre-merger notification legislation;
- Requirements range from simple notification to intensive investigations;
- Typically, jurisdictional thresholds are determined by the size of the transaction;
- Reviews may be suspensory, non-suspensory or hybrid depending upon potential impact of the transaction on the economy; and
- The principal concern is whether merged entity will have market power to increase prices.

Source: United Airlines

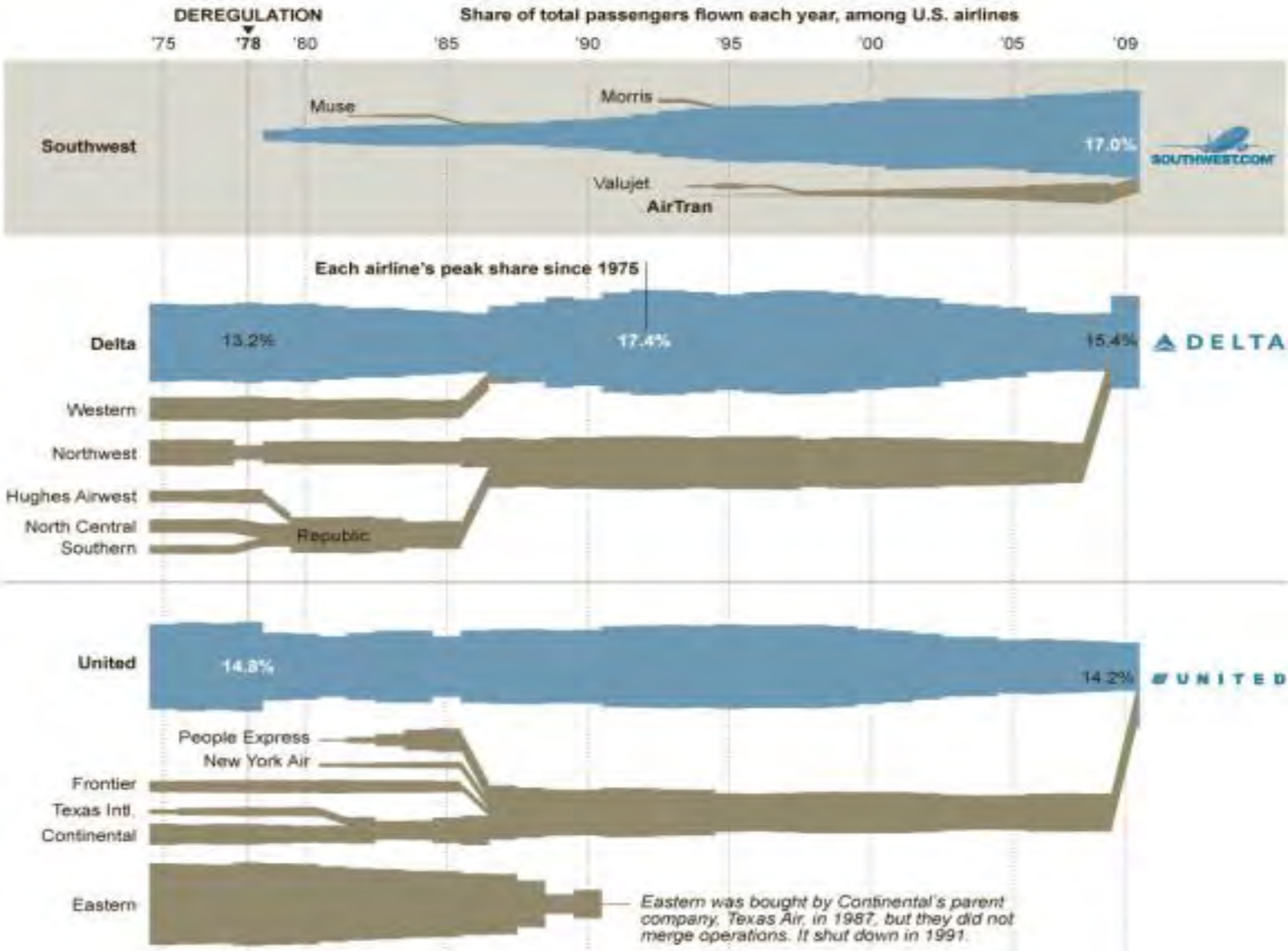
Mergers

- Prior to 1985, airline mergers and acquisitions required approval from the Civil Aeronautics Board. Approval conferred antitrust immunity. Between the sunset of the CAB in 1985, and 1989, airline mergers were regulated by the U.S. Department of Transportation.
- USDOT never met a merger it didn’t like, and approved each of the 21 merger applications submitted to it, even those to which the Department of Justice vigorously objected (i.e., Northwest-Republic and TWA-Ozark).
- Since 1989, airline mergers have been subject to section 7 of the Clayton Act.
- 15 U.S.C. § 18.

Major US Airline Mergers

(acquired company of left/acquiring company on right)

1979	National-Pan Am
1980	Seaboard-Flying Tigers
	Hughes Airwest- Republic
1982	Continental-Texas International
1985	Frontier-People Express
	Muse-Southwest
1986	Pan Am-United
	Republic-Northwest
	Ozark-TWA
	Eastern-Texas Air
	People Express-Texas Air (Continental)
	Western-Delta
1987	Air Cal-American
	Pacific Southwest-USAir
	Piedmont-USAir
1988	Flying Tigers-Federal Express
1997	AirTran-ValuJet
1998	Reno Air-American
2001	TWA-American
2004	US Airways-America West
2008	Northwest-Delta
2009	Midwest-Republic
	Frontier-Republic
2010	Continental-United
2011	AirTran-Southwest



DEREGULATION
Share of total passengers flown each year, among U.S. airlines
'75
'78
'80
'85
'90
'95
'00
'05
'09
Southwest
Muse
Morris
17.0%
SOUTHWEST.COM
Valujet
AirTran
Each airline's peak share since 1975
Delta
13.2%
17.4%
15.4%
DELTA
Western
Northwest
Hughes Airwest
North Central
Southern
Republic
United
14.8%
14.2%
UNITED
People Express
New York Air
Frontier
Texas Intl.
Continental
Eastern
Eastern was bought by Continental's parent company, Texas Air, in 1987, but they did not merge operations. It shut down in 1991.

The Clayton Act

- The Clayton Act prohibits a person “engaged in commerce or in any activity affecting commerce” from acquiring “the whole or any part” of a business if the acquisition may substantially “lessen competition or tend to create a monopoly.” To prevail, the plaintiff must define the relevant market and prove that the merger will create a danger of anticompetitive consequences.
- The relevant market is the geographic and product market, using reasonable interchangeability or cross-elasticity of demand analysis.
- Although market share and concentration levels are relevant, they are not conclusive. Instead, courts examine the market’s structure, history and future, the characteristics of the customers, trends toward concentration or concentration, the existence of competitors and barriers to entry.
- *Brown Shoe,* 370 U.S. 294, 344-45 (1962).
- *U.S. v. Philadelphia National Bank*, 374 U.S. 321, 362 (1963).

Major Mergers Outside the U.S.

(acquired company of left/acquiring company on right)

- Canadian-Air Canada
- JAS-Japan Airlines
- KLM-Air France
- Austrian/Swiss/BMI/Brussels-Lufthansa
- Iberia-British Airways

Proposed Mergers that were Blocked

(acquired company on left/acquiring company on right)

- USAirways-United
- Air Lingus-Ryanair
- Aegean-Olympic


UNITED


Bloomberg
Businessweek
FACEBOOK'S IPO: FRIENDS WITH BENEFITS
Continental
UNITED
Let's Get It On
Continental and United have undeniable corporate chemistry, but is it a love built to last?

RATIONALE FOR THE UNITED-CONTINENTAL MERGER

Creates a Better and More Efficient Network

– Combines highly complementary networks to create a broader, deeper network

– Provides new destinations, including merger-enabled route expansion and additional "single carrier" connections

– More competitive cost structure

– Significant merger-specific synergies which provide a higher level of benefits than codeshare or ATI

Sustained and Enhanced Network Reach

– **A merger creates a more efficient carrier better able to sustain service to small communities**
  - **Network reach, particularly to small communities, has been reduced in the last decade due to various factors, including Low Cost Carriers ("LCCs")* siphoning off traffic from dense routes**
  - **Network carriers'** business model provides critical network reach / breadth, including service to numerous small communities nationwide**

Few Network Overlaps

– **Few network overlaps; overlapping routes have strong competitors and often logical new entrants**

– **Consumer benefits, synergies, and merger-specific cost savings swamp any potential competitive concerns**

Industry Landscape Has Fundamentally Changed Since 2000

– **LCCs have significantly increased presence**

– **Enables better competition with rapidly growing international carriers that are benefiting from mergers**

* LCCs refers to: AirTran, Allegiant, Frontier/Midwest, jetBlue, Southwest, Spirit, Sun Country, and Virgin America. Use of the term "LCCs" is for convention only. The parties do not agree that the term "LCC" accurately differentiates these airlines from network carriers.

** "Network carriers" are defined as Alaska, American, Continental, Delta, United and US Airways.

Source: United Airlines

United-Continental

The merger of United and Continental Airlines drew antitrust fire from a number of concerned citizens. Their expert witnesses identified three alternative relevant markets:

- (1) network carriers competing for business travelers;
- (2) airport-pairs; and
- (3) the U.S. airline industry as a whole.

As to the first category, the court concluded, “because the plaintiffs have failed to show why LCCs should be excluded from a market for business passengers . . . network carriers catering to business passengers simply does not fly as a viable relevant geographic and produce market for purposes of Section 7 analysis.”

As to airport-pairs, the court found that “competition from adjacent airports disciplines pricing and must be considered when defining the relevant market. . . . [G]iven the substantial evidence suggesting city-pairs [may be the appropriate market], plaintiffs’ effort to establish anything else never leaves the gate.”

As to the third alternative proffered by plaintiffs (the “national market”) the court noted that it was unclear how a flight from San Francisco to Newark competed with a flight from Seattle to Miami.

- *Malaney v. UAL Corp.* 2010 U.S. Dist Lexis 106049 (N.D. Cal. 2010)., at *30.
- Id. at *41-2.
- Id. at *42.

United-Continental


Rejected new name for
merged UNITED/CONTINENTAL
AIRLINES...
INCONTINENT
UM
NO
MARSHALL RAMSEY THE CLARION-LEDGER ©2010 CREATORS.COM

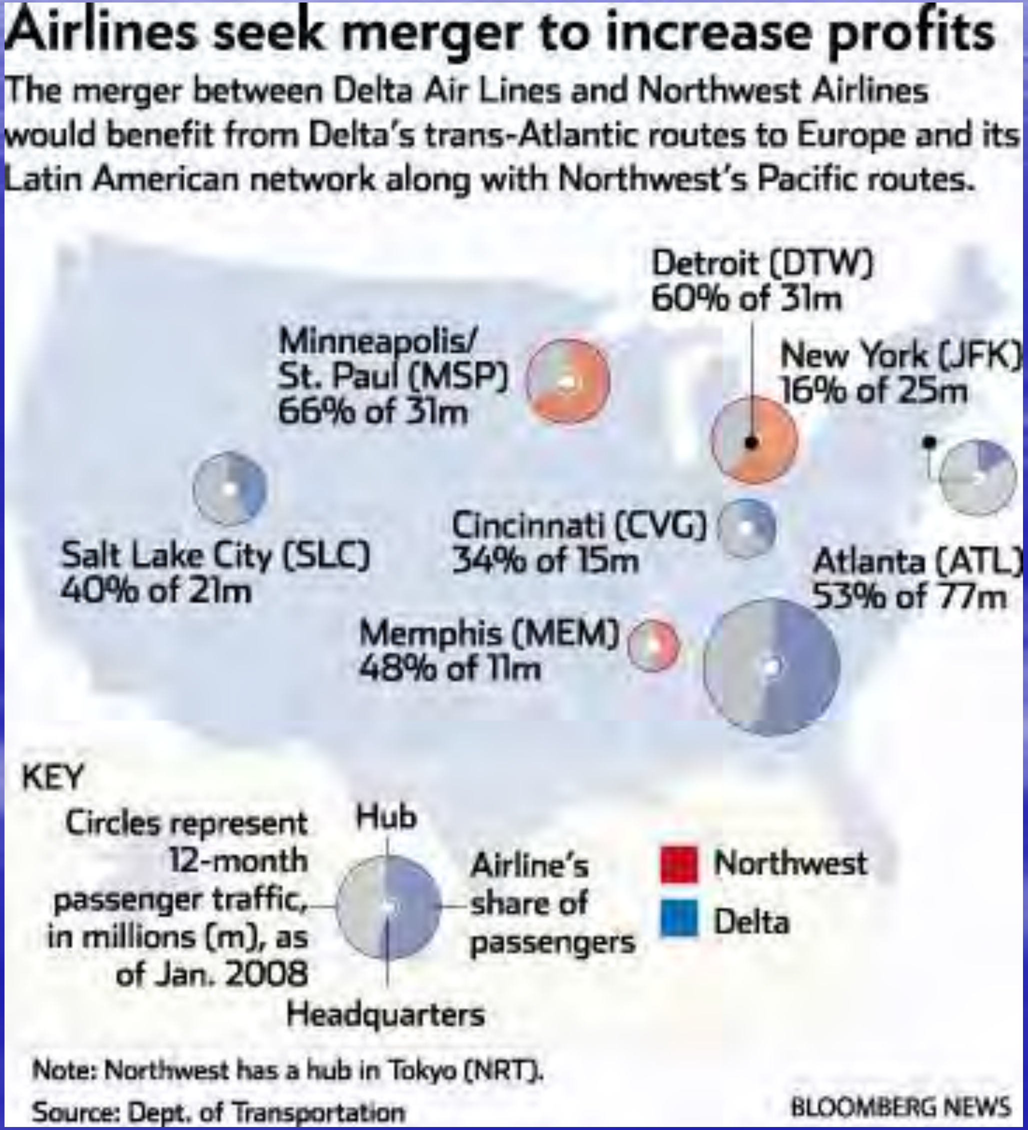
Northwest-Republic

- A challenge to Northwest's acquisition of Republic Airlines, brought 11 years after the merger, failed on different grounds – the statute of limitations. Suits under the Clayton Act must be brought within four years. Rejecting the plaintiff's allegation of a "continuing violation", the court noted that a challenge to the acquisition of a company accrues at the time of the merger or acquisition.
- The court noted that a typical "continuing violation" situation exists in a price-fixing conspiracy where the participants continue to fine-tune their cartel. "[T]o apply the continuing violation theory to non-conspiratorial conduct, new overt acts must be more than the unabated inertial consequences of the initial violation."
- *Midwestern Machinery v. Northwest Airlines,* 392 F.3rd 265, 269 (8th Cir. 2004).
- Id. at 271.

	DELTA	nwa NORTHWEST AIRLINES	Combined
Passengers	109.1 million	66.4 million	175.5 million
Passenger miles flown	122 billion	78 billion	200 million
Planes	578	515	1,093
Revenue	$19.1 billion	$12.5 billion	$31.6 billion
Net Income	$1.6 billion	$2.1 billion	$3.7 billion
Employees	48,700	29,600	78,300
Major Markets	Eastern and Southwestern U.S. and	Midwest and Pacific	

2007 data. Operations statistics include regional carriers. Employee counts (Nov.2007) exclude regional carriers. Employee counts are in fill-time equivalents. Source: Carrier reports and Bureau of Transportation Statistics


DELTA
nwa


Airlines seek merger to increase profits
The merger between Delta Air Lines and Northwest Airlines would benefit from Delta's trans-Atlantic routes to Europe and its Latin American network along with Northwest's Pacific routes.
Detroit (DTW) 60% of 31m
Minneapolis/ St. Paul (MSP) 66% of 31m
New York (JFK) 16% of 25m
Salt Lake City (SLC) 40% of 21m
Cincinnati (CVG) 34% of 15m
Atlanta (ATL) 53% of 77m
Memphis (MEM) 48% of 11m
KEY
Circles represent 12-month passenger traffic, in millions (m), as of Jan. 2008
Hub
Airline's share of passengers
Headquarters
Northwest
Delta
Note: Northwest has a hub in Tokyo (NRT).
Source: Dept. of Transportation
BLOOMBERG NEWS

American Airlines to merge with US Airways

The merger, if approved, would create the world's largest airline, leaving four major carriers in control of 70 percent of U.S. passenger traffic.

KEY MARKET-SHAPING MERGERS SINCE 2000

Thickness of bands reflect annual domestic air traffic

American and US Airways both made key acquisitions since 2000. A merger of the two would create the world's largest airline.

Delta acquired Northwest in 2008, making it the world's largest airline.

United and Continental officially merged in 2012, making United the No. 2 carrier behind Delta.

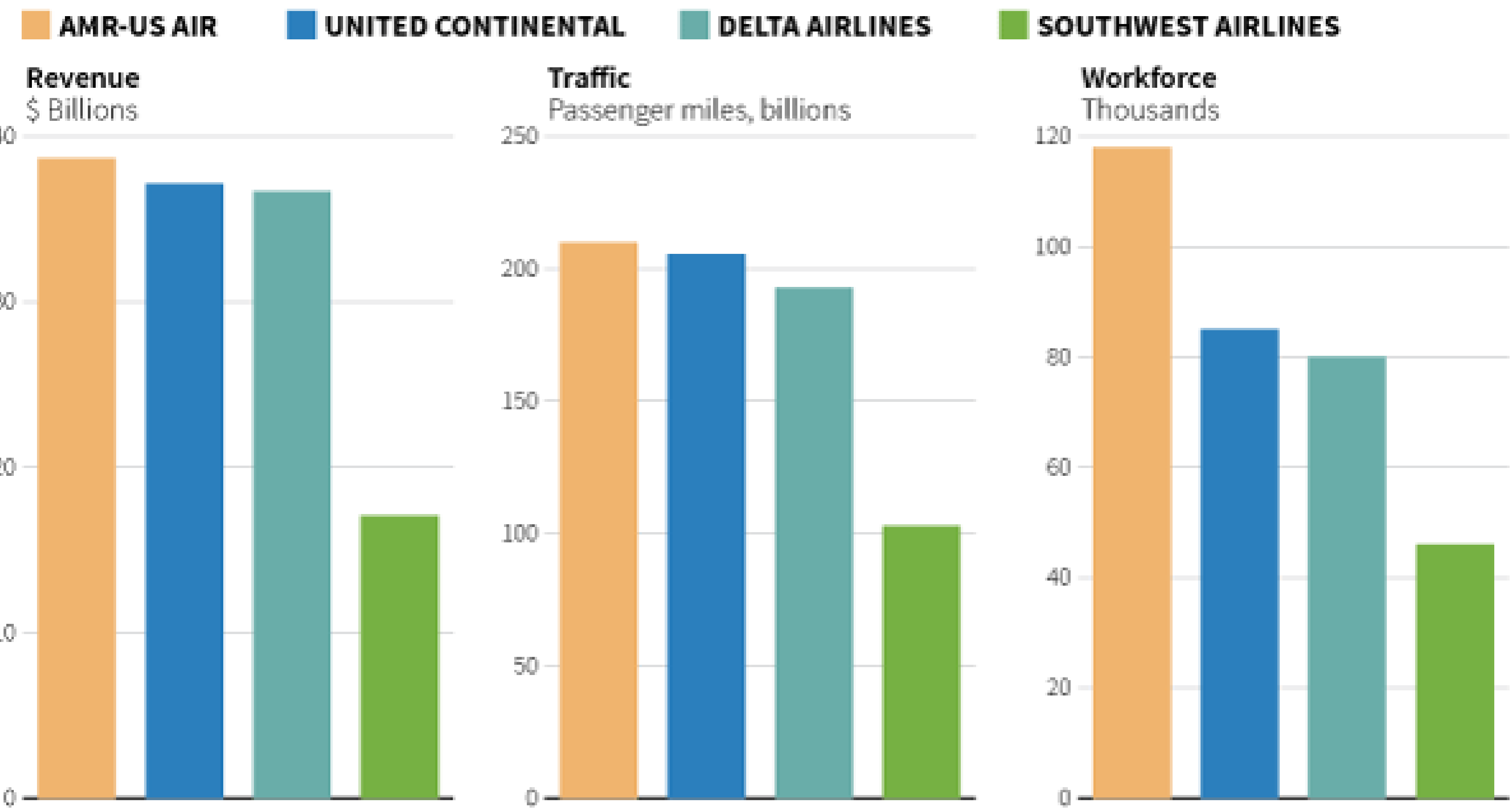
Southwest in 2011 bought AirTran, which continues to operate as a subsidiary.

SOURCE: Federal Aviation Administration

AP

A new airline order

merger of American Airlines and US Airways would create the world's largest airline. Here's how the major U.S. carriers ould stack up, based on 2012 figures.



urce: company reports

Culp, 14/02/2013

The European Union

In 1991, the United States and the European Union agreed to coordinate regulatory review on transAtlantic mergers, acquisitions, and alliances. For example, Boeing's acquisition of McDonnell-Douglas was reviewed by the EU Commission. Under the EU Merger Control Regime, "A concentration which would significantly impede effective competition, in the common market or in a substantial part of it, in particular as a result of the creation or strengthening of a dominant position, shall be declared incompatible with the common market."

- Council Reg. 139/2004. See Paul Stephen Dempsey, *European Aviation Law* 118-26 (2004).

Article 87 of the EC Treaty

- Prohibits State Aid “which distorts or threatens . . . Competition . . . .”

Section 2 of the Sherman Act

- Prohibits monopolization and attempts to monopolize.
- Focuses on market power – the ability to reduce service and/or raise price to maximize wealth, at the price of consumer welfare.
- Market power is the ability of a firm to raise prices to supracompetitive levels without losing so many sales so quickly that the price increase becomes unprofitable and must be revoked.
  - *Midwestern Machinery v. Northwest Airlines,* 392 F.3rd 265, 274 (8th Cir. 2004).

The Relevant Market

- The relevant *geographic market* is an area where the dominant firm can increase its price without large numbers of consumers turning to alternative supply sources outside the area, or producers outside the area can quickly flood the area with substitute products. The relevant geographic market in commercial aviation is certainly city-pairs; it might also include domination of a hub airport, where a large number of banks of flights from numerous cities enable it to dominate the city's local passenger market.
- The relevant *product market* requires an assessment of the products that are sufficiently close substitutes to compete effectively in each other's markets. Courts employ a "reasonable interchangeability" standard gauged by "(1) the product uses, i.e., whether the substitute products or services can perform the same function, and/or (2) consumer response (cross-elasticity); that is, consumer sensitivity to price levels at which they elect substitutes for defendant's product or services." One court found that a market definition as broad as "all non-stop scheduled flights into and out of each of Northwest's hubs fails as a matter of law." Scheduled passenger air transportation in defined city-pairs is probably the relevant product market in commercial aviation (the competitive alternatives of rail, bus and automobile transport, or freight transportation, likely can be ignored for long-haul flights).
- Robert Pitofsky, *New Definitions of Relevant Market and the Assault of Antitrust*, 90 Colum. L. Rev. 1805 (1990).
- *Worldwide Basketball & Sport Tours v. NCAA,* 388 F.3rd 955, 961 (6th Cir. 2005).
- *Rodney v. Northwest Airlines,* 2005 U.S. App. Lexis 18242 (6th ir. 2005)

Potential Geographic Markets

- City-Pairs
- Airport Pairs
- Networks
- Hubs
- Endpoint Concentration

Potential Product Markets

- Non-stop vs. Connecting Markets
- Premium Class vs. Economy Class
- Business vs. Leisure
- Time-Sensitive vs. Non-time Sensitive
- Low Frills vs. Full Service

Article 82 of EC Treaty

Prohibits "abuse . . . of a dominant position . . . ."

Examples include:

- Imposing unfair purchase or selling prices;
- Limiting production to the prejudice of consumers;
- Applying dissimilar conditions to equivalent transactions to other trading parties, placing them at a competitive disadvantage;
- Making the conclusion of contracts subject to approval by other parties without commercial justification.

Section 5 of the Federal Trade Commission Act

- Prohibits unfair methods of competition.

Section 41712 of the Federal Aviation Act

(formerly Section 411 of the Civil Aeronautics Act of 1938)

- Prohibits unfair methods of competition.

Unlawful Monopolization

- In 1986, the U.S. Supreme Court announced that the "consensus among commentators" was that "predatory pricing schemes are rarely tried, and even more rarely successful." It therefore created a test that make it virtually impossible for plaintiffs to prevail.
- Predatory pricing requires proof of:
  1. Pricing below cost;
  2. Recoupment of short-term losses.

- *Matsushita Electric Industrial Co. v. Zenith Radio Co.*, 475 U.S. 574, 589-90 (1986).

Professor Chris Sagers

- "The Court has made a mistake. The theoretical and empirical literature now suggests that predation is possible, can be rational from the predator's perspective, and might be quite harmful socially. . . .
- "During the [airline] industry restructuring that began almost immediately after deregulation, predation, by fairly common consensus, has been a tool to make new entry difficult and to protect pockets of market power, despite the generally high operating costs of incumbent firms. . . .
- "[Because of misguided jurisprudence] the fact that predation is effectively impossible to prove might, in the case of the airlines, produce a tellingly bad policy consequence. Predation is alleged almost exclusively against the major airlines, which have remained higher-cost than the entrants that are ordinarily their alleged victims. So, in this case, [jurisprudence skeptical of the existence of predation] might facilitate the most perverse of all outcomes within the neoclassical framework: the preservation of less efficient sellers and suppression (ordinarily leading to liquidation or cheap acquisition) of more efficient challengers."
- Chris Sagers, *"Rarely Tried, and . . . Rarely Successful": Theortetcally Impossible Price Predation Among Airlines,* 74 J. Air L. & Com. 919 (2009).
- Id. at 923-25.

Predatory Pricing

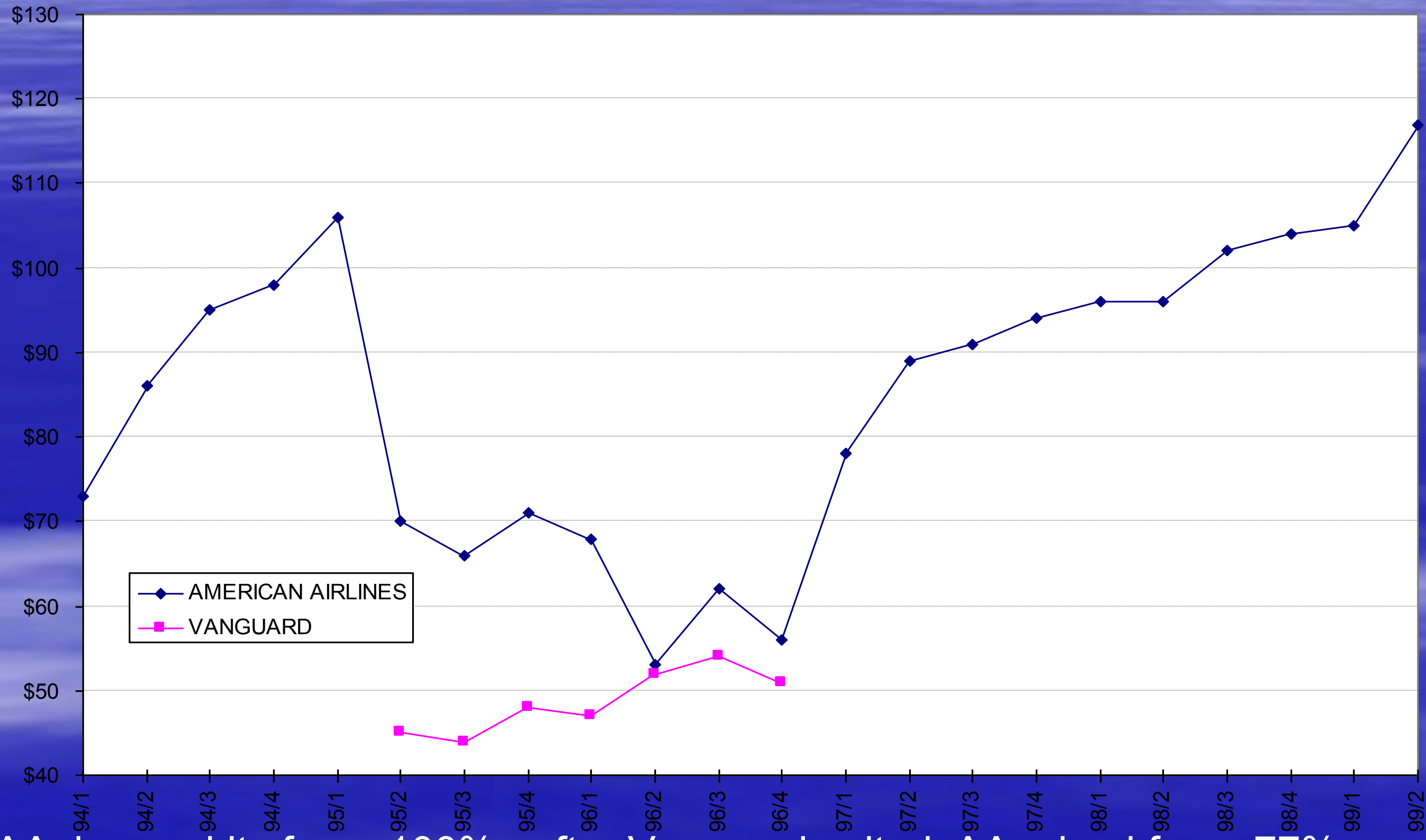
- BELOW COST PRICING. The prices complained of must be below an appropriate measure of its rival's costs.
- TARGET DISCIPLINED. The below-cost pricing must be capable of producing the intended effects on the firm's rivals, such as driving them from the market. This requires an evaluation of the extent and duration of the alleged predation, the relative financial strength of the predator and its intended victim, and their respective incentives and will. The issue is whether, given the aggregate losses caused by the below-cost pricing, the intended target would likely succumb.
- RECOUPMENT. The competitor must have a reasonable prospect (or a dangerous possibility) of recouping its short-term investment in below-cost prices by achieving longer-term monopoly profits. Once the rival is driven from the market, it must be likely that the predator will be able to raise prices above a competitive level adequate to recover the amounts expended on the predation, including the time value of the money invested in it. In other words, the predator must be able to obtain sufficient market power to set its prices above competitive levels for a sufficient period of time in order to earn excess profits beyond those lost during the period of below-cost pricing.

United States v. AMR Corporation

335 F.3d 1109 (10th Cir. 2003)

"The Government alleged that the airline engaged in multiple episodes of price predation in four city-pair airline markets, all connected to the airline's hub at Dallas/Fort Worth International Airport, with the ultimate purpose of using the reputation for predatory pricing it earned in those four markets to defend a monopoly at the hub. In the Government's view, the airline's combined response of lowering prices, increasing capacity, and altering yield management in response to low cost carrier competition constituted an unlawful, anticompetitive response."

Dallas-Wichita



AA dropped its fares 100% ; after Vanguard exited, AA raised fares 77%

United States v. American Airlines

- The U.S. Court of Appeals for the Tenth Circuit embraced the Chicago-school neo-classical economics view that predatory pricing is "implausible and irrational" and "irrational". With that as a starting point, it sliced to shreds the Justice Department's methodology.
- It first acknowledged that though predatory pricing requires proof of pricing below an appropriate measure of costs, no consensus had emerged as to what is the most appropriate measure. Marginal cost – the cost of producing an additional output of production – seemed potentially preferable, but notoriously difficult to measure. Therefore, courts have relied on some proxy for marginal costs, most using Average Variable Cost [AVC]. But the Court conceded that exclusive reliance on AVC may "obscure the nature of a particular predatory scheme . . . ."
- *United States v. American Airlines,* 335 F.3rd 1109, 1120 (10th Cir. 2003).
- *Brooke Group v. Brown & Williamson Tobacco Corp.,* 509 U.S. 209 (1993).
- *United States v. American Airlines,* 335 F.3rd 1109, 1119-20 (10th Cir. 2003).

The Justice Department's Tests

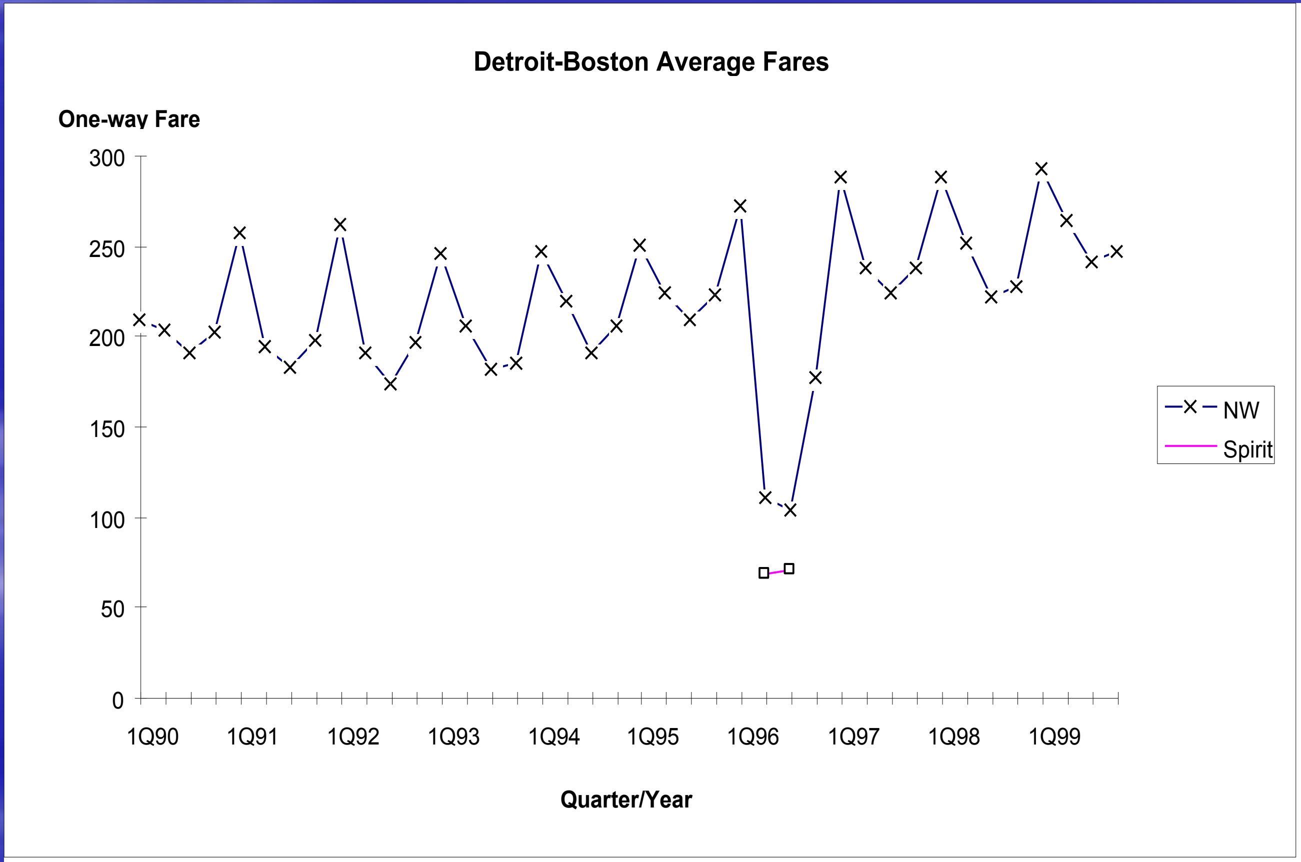
- The Justice Department proffered four substitutes for AVC. Several used American Airlines' internal decisional accounting system to determine whether they became negative following the allegedly predatory capacity additions. If American Airlines' internal computations showed a loss on added capacity in markets entered by low cost carriers, then the only rational motive for such losses would be to drive the new entrant out.
- But the Court expressed discomfort that American's internal accounting system allocated certain fixed costs to a route not related to the operation of the route or flight. According to the Tenth Circuit, this was the equivalent of applying an average total cost test, a methodology rejected by the U.S. Supreme Court. Other tests tendered by Justice were described as "short-run profit-maximizing tests", which assumed if incremental revenues from adding capacity were below incremental costs, this evidenced sacrifice in order to monopolize the market. The Court concluded that the test failed to identify the costs associated with the capacity additions, comparing incremental revenue to a combination of both average variable costs and average avoidable costs, and not the avoidable or incremental cost of the capacity additions.
- Despite the fact that airlines are disproportionately a fixed cost and joint cost dominated industry, the Court concluded that any allocation of fixed costs to the methodology would negate its consideration.

Spirit v. Northwest Airlines

- Before Spirit Airlines entered the Detroit-Philadelphia market, Northwest's lowest restricted fare was $355, and unrestricted fare was $125. Spirit entered in December of 1995 with a $49 fare. Its load factors rose to 88.5% in June of 1996, when it added a second frequency. Then Northwest dropped its fares in the market to $49. Spirit's load factors collapsed to 36% by August, when it withdrew its second nonstop, and to 31% in September, when it withdrew from the market altogether. Northwest then raised its lowest fare to $271, and later to $461.
- Spirit met a similar response in the Detroit-Boston market, where Northwest flew 8.5 frequencies daily and charged $411 unrestricted and $189 restricted fares. Spirit entered in April 1996 with lowest fares set at $69. Northwest responded by matching the $69 fare, and increasing frequencies to 10.5 per day, including the addition of a wide-body DC-10. Spirit's load factors never exceeded 31%, and it withdrew in September of that year.

It is probable that Northwest sacrificed out-of-pocket losses 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. . . . You will pardon us for believing that Northwest tried to put Spirit out of business in the third quarter of 1996."

Testimony of Mark Kahan before the Subcomm. on Aviation, of the U.S. House Comm. on Transportation and Infrastructure (Apr. 23, 1998).



Spirit v. Northwest Airlines

- The U.S. Court of Appeals for the Sixth Circuit in *Spirit Airlines v. Northwest Airlines* noted that the Tenth Circuit rejected “a price cost-test that included arbitrarily allocated common costs which do not vary proportionately with changes in American Airlines’ capacity. . . . By contrast, in this case, Spirit’s price-cost analysis is based on Northwest’s [Flight Profitability Segment] system which specifically distinguishes between fixed and variable costs, defining the latter term as costs which do vary with flight activity. Northwest’s expert conceded that the FPS system calculates a reasonable approximation of the average variable costs for a route and is the proper measure to use in evaluating allegations of predatory pricing.”

- 431 F.3rd 917 (6th Cir. 2005).
- Id. at 946.

Spirit v. Northwest Airlines

- *Judge Moore: "Unlike a traditional manufacturer . . . the bulk of [an airline's] variable costs are common costs shared among all passengers on a flight. Once an airline commits to flying a plane along a specific route, the airline must incur the costs of the pilots, flight attendants, fuel to fly the empty plane, ownership of the plane, and servicing, without regard to the actual number of passengers on the plane. Despite the common nature of these costs, they are still treated as variable costs of the route because the airline could avoid incurring all of them by exiting the route and redeploying the plane to an alternative route. In addition to these common-variable costs, the airline incurs incremental costs for each additional passenger added on the plane. These passenger-variable costs include the costs associated with processing the ticket, beverage and food service (if any), incremental fuel required to carry the passenger, and baggage service. Thus, the passenger-variable costs are quite minimal compared to the common-variable costs, or non-passenger variable costs of the route. This disproportional nature between the passenger-variable costs and the common-variable costs has significant implications with regard to evaluating a predatory-pricing claim."*
- Id. at 954.

Recoupment

- It is rational for an incumbent to drive a new entrant out even when it cannot recover the losses it incurs in short term below-cost predatory pricing. This is true because of the reputational benefits of predation. As economist Irwin Steltzer observed, one might ignore a "No Trespassing" sign and take a path across a field to save the need to walk circuitously around it, unless of course, there were corpses that lie on either side of the path. According to Steltzer, "[T]here is something called *predation* out there, no matter what the Chicago economists tell you." Hence, the courts are engaging in a temporal mistake, focusing on the *ex post* effects of predatory pricing, looking to see whether the predator is recouping its losses by charging supra-competitive prices, when it should instead be looking *ex ante*, examining the potential entry deterred by such aggression.
- **Gustavo Pinto, *Competition and Predation in the Airline Industry*, 74 J. Air L. & Com. 3, 10 (2009); Aaron Eldin, *Stopping Above-Cost Predatory Pricing*, 111 Yale L.J. 941 (2002).**


LAKER

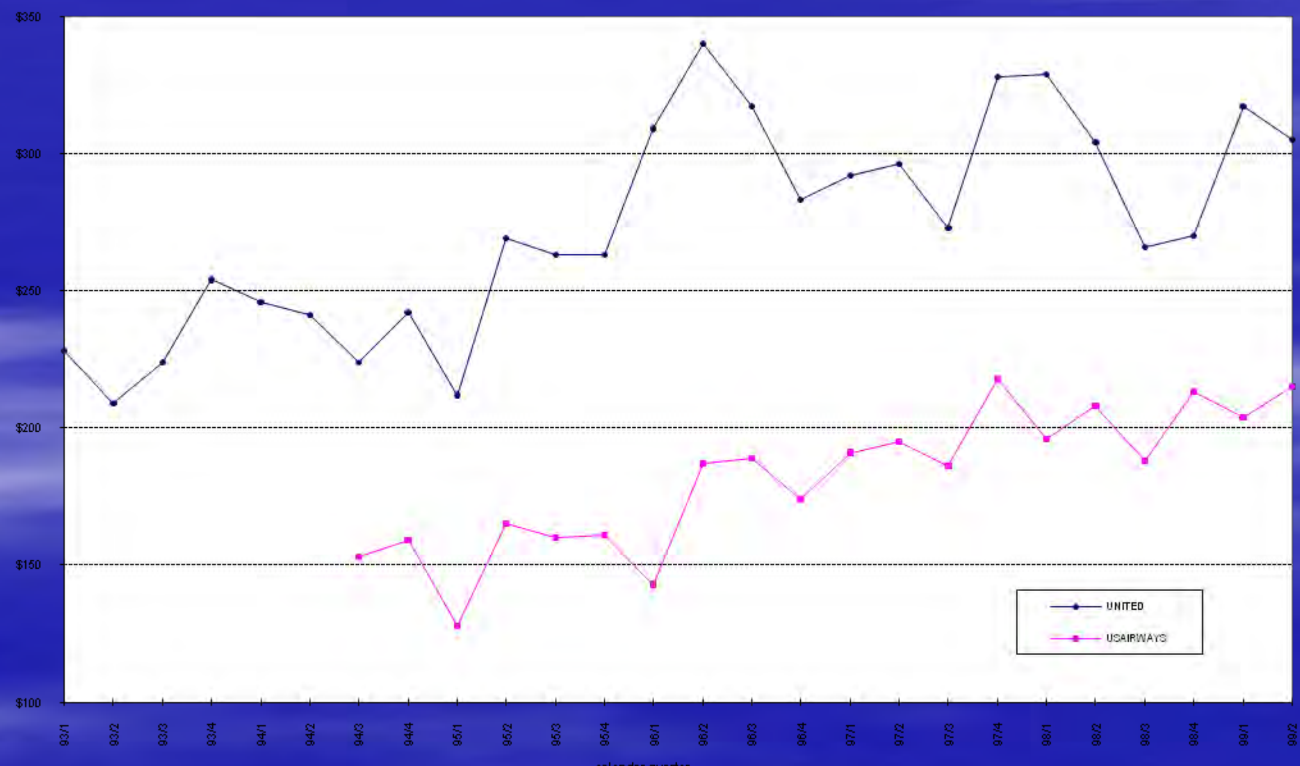
Types of Predatory Conduct

- Expansion of output or capacity;
- Predatory pricing;
- Pricing discrimination;
- Monopoly leveraging;
- Refusal to deal with a competitor;
- Refusal to share an essential facility.
- Raising rivals’ costs; and
- Exclusive dealing arrangements.

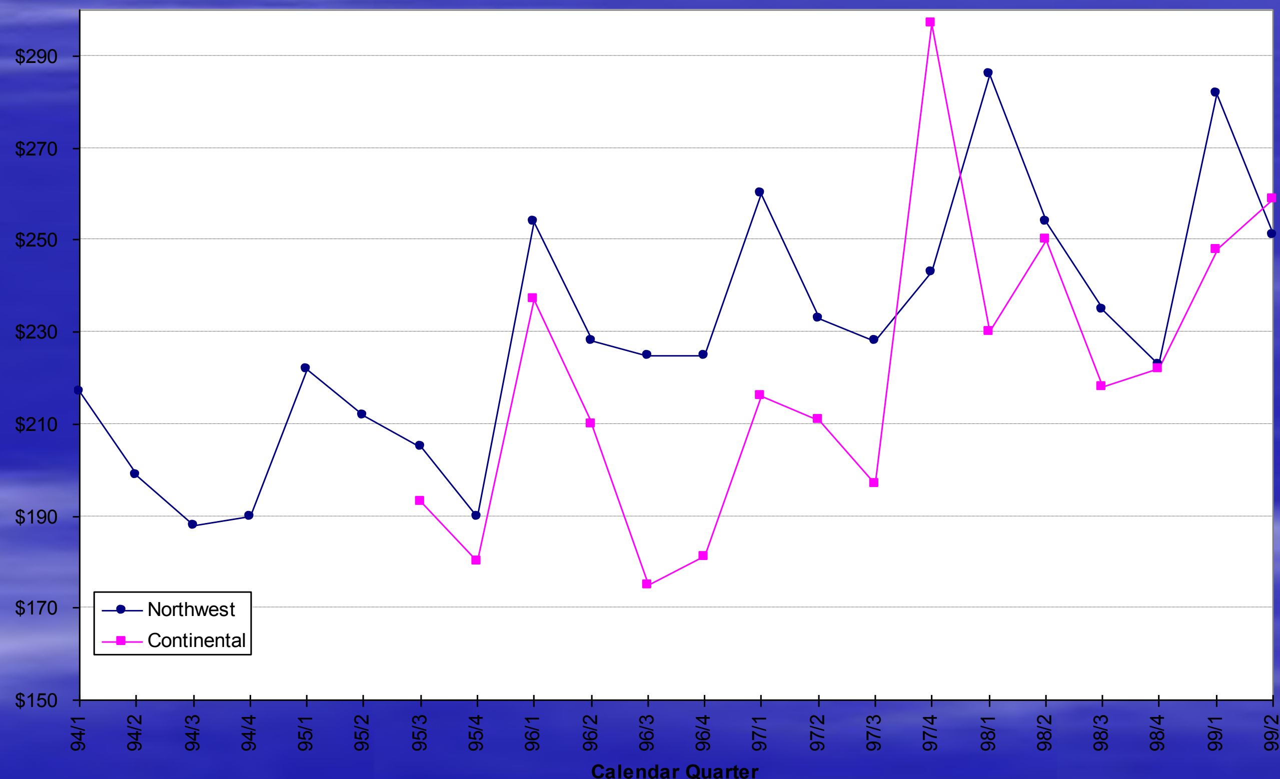
Prior to USAir's entry, United had a monopoly in the Denver-Philadelphia nonstop market. Within a year, USAir had a 26% market share. USAir flew two flights a day in the market, to United's five. *United's response to USAir's entry was not to slash fares below cost, but to raise fares.* During the first quarter of 1996, United's average fares were 116% higher than USAir's. United's fares averaged *62% higher* than USAir's after USAir (now US Airways) entered the Denver-Philadelphia market.

Legacy Carrier v. Legacy Carrier:

DENVER-PHILADELPHIA AVERAGE FARES

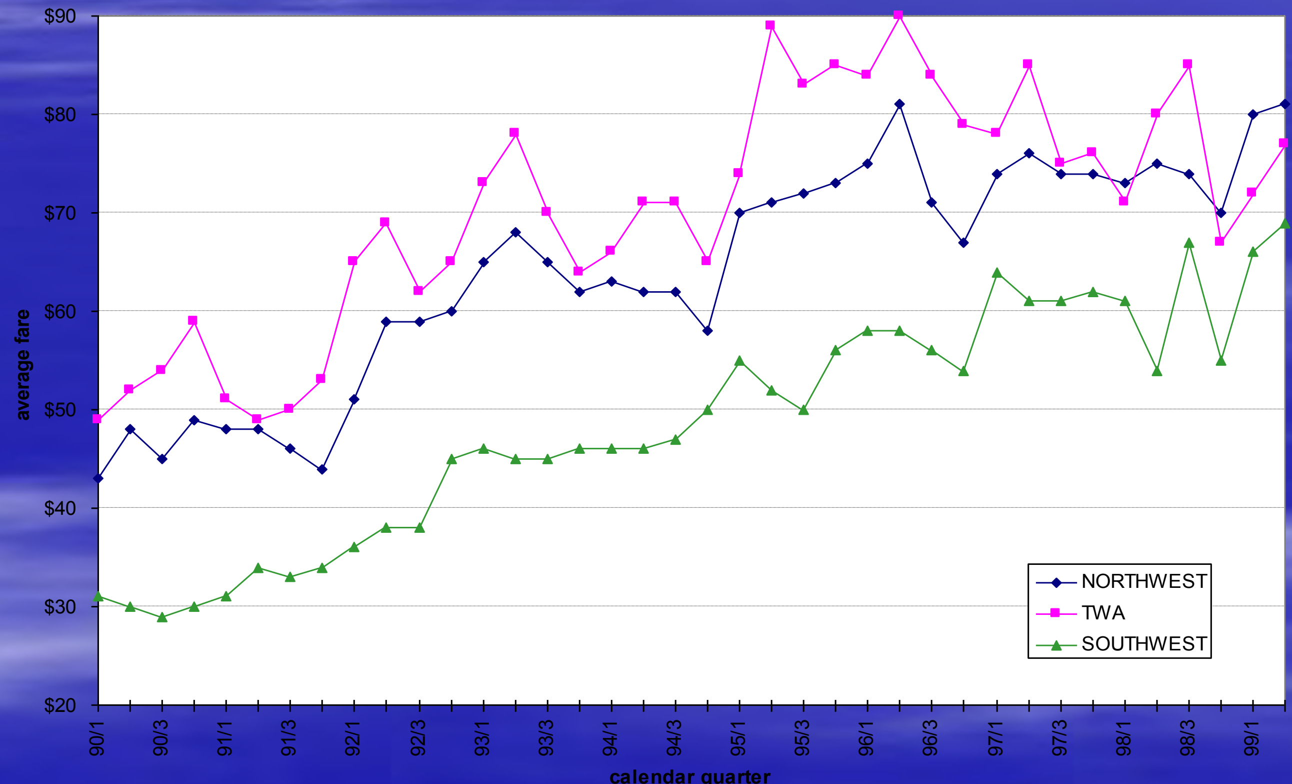


Legacy Carrier vs. Legacy Carrier: Minneapolis-Cleveland



3Q95, NW drops fares 4%; then another 4% the following quarter; 1Q96 NW raises fares 30%; thereafter NW's fares were 18% higher than CAL

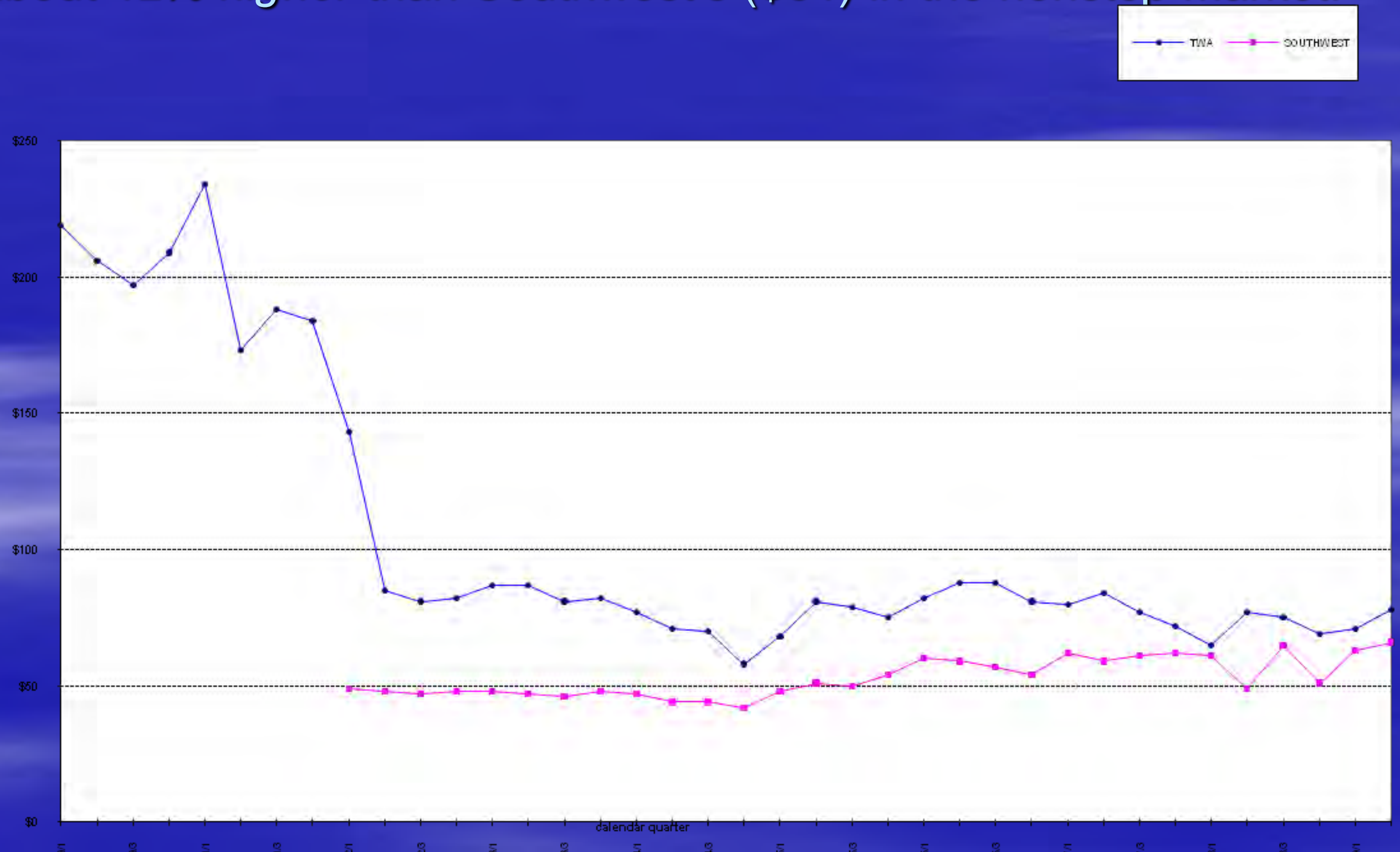
Legacy Carrier vs. Southwest: St. Louis - Detroit



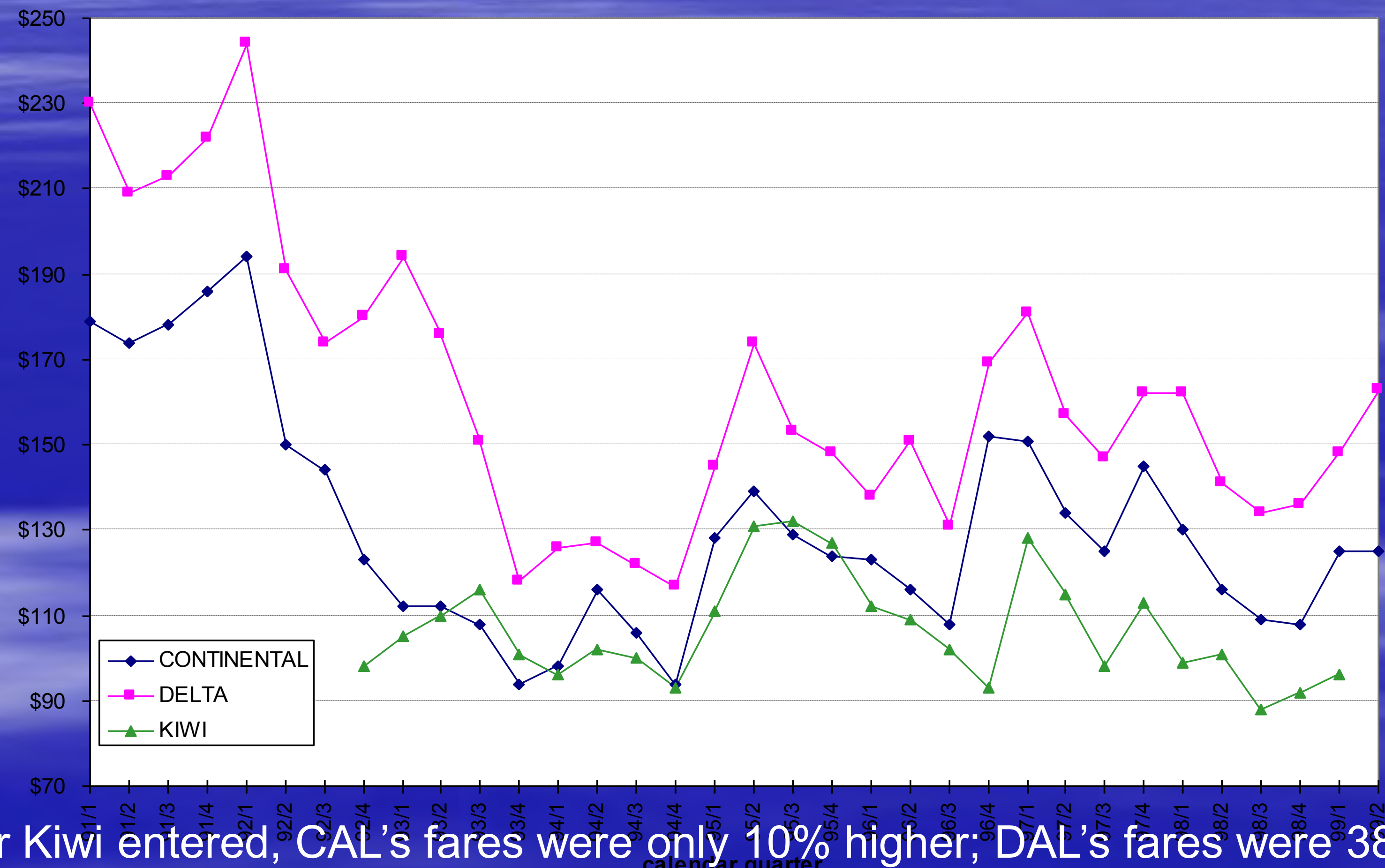
TWA's fares 42% higher than SW

ST. LOUIS-CLEVELAND: TWA vs. SOUTHWEST

Southwest Airlines entered the St. Louis-Cleveland market in early 1992. TWA then controlled 67% of St. Louis enplanements. As Figure 15.4, “St. Louis-Cleveland Average Fares,” reveals, TWA responded to Southwest’s entry by dropping its fares to remain competitive in the market, though not to levels lower than Southwest’s. In fact, after Southwest entered, TWA’s average fares ($72) were about *42% higher* than Southwest’s ($51) in the nonstop market.

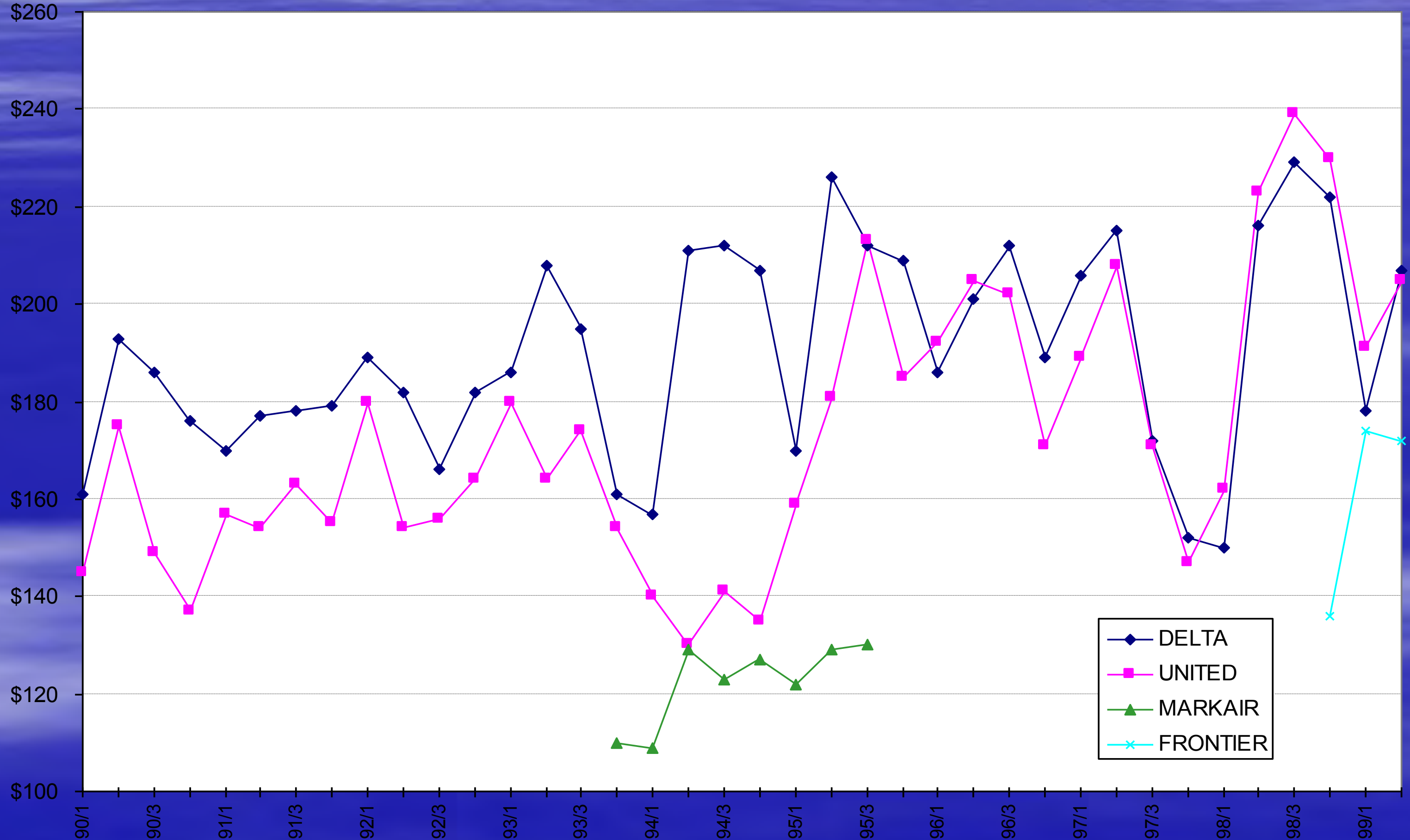


Legacy Carrier vs. New Entrant LCC: Atlanta-Newark



After Kiwi entered, CAL's fares were only 10% higher; DAL's fares were 38% higher

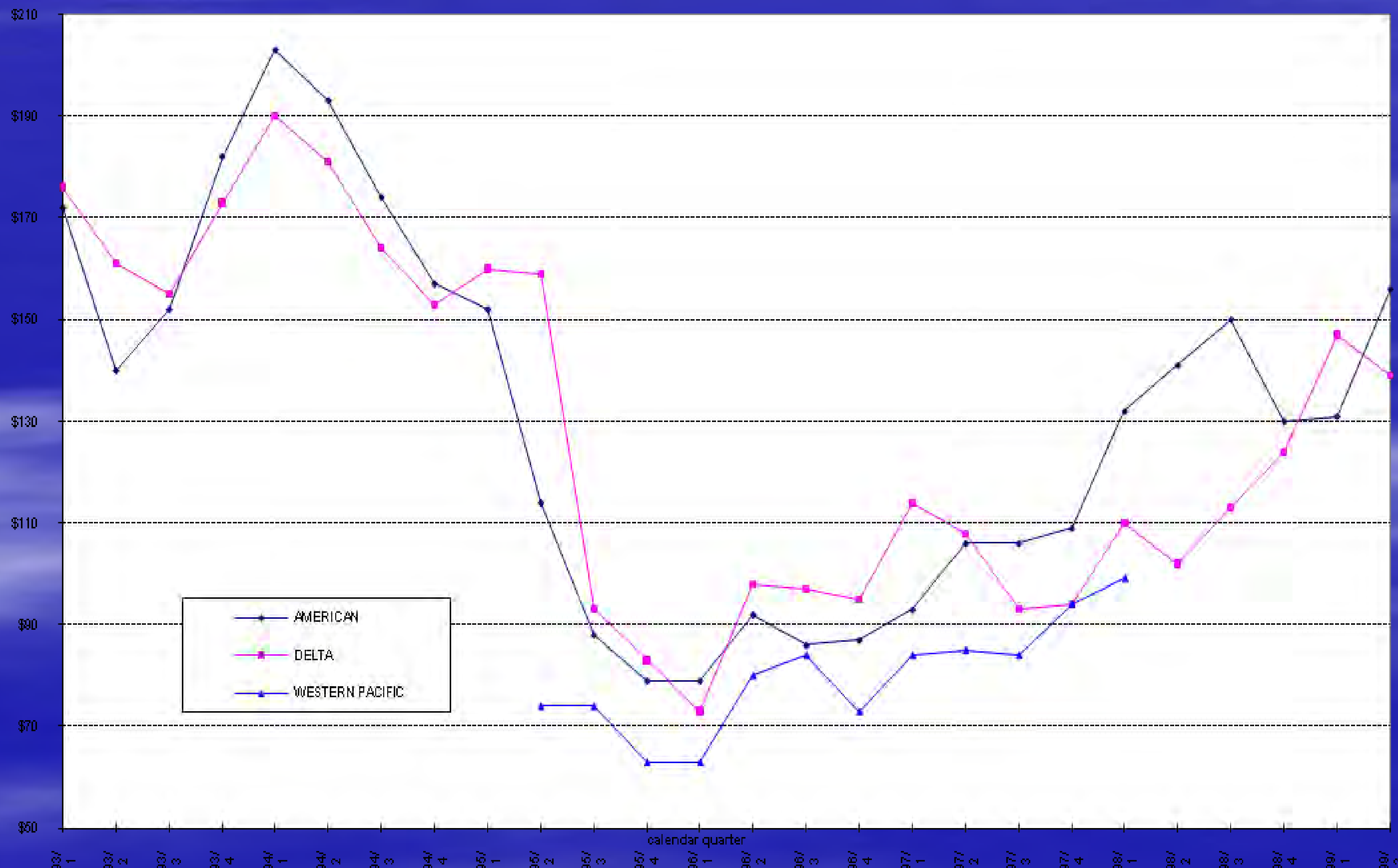
Legacy Carrier vs. New Entrant LCC: Denver-Atlanta



UAL dropped fares 38% after MarkAir entered; after it left, UAL raised fares 84%; note DAL

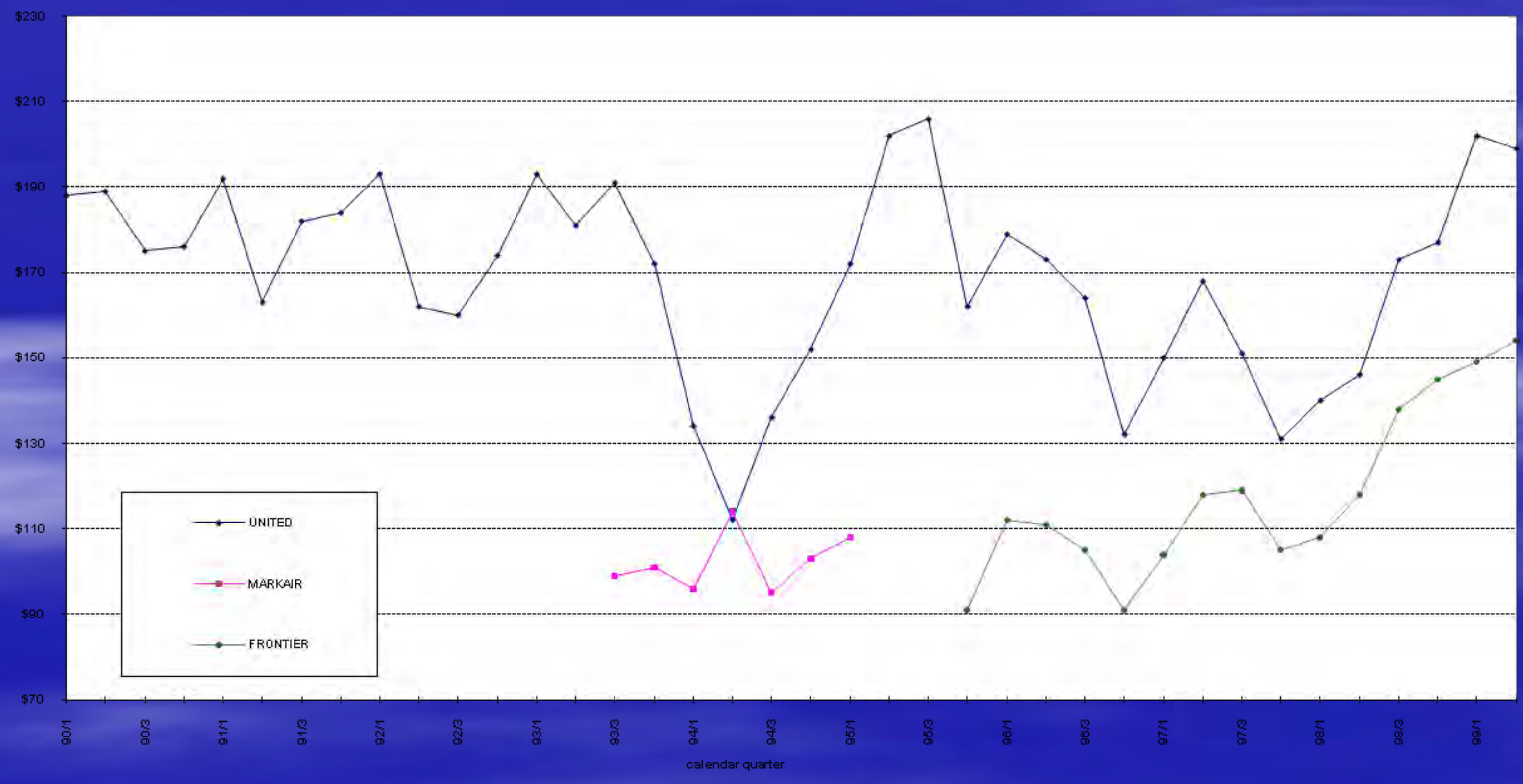
American Airlines and Delta Air Lines responded sharply and swiftly to Western Pacific's April, 1995, entry into the Dallas/Ft. Worth-Colorado Springs market by *dropping fares 92%* from their levels in the quarter preceding Western Pacific's entry to two quarters after such entry . American also added more seats at lower fares, larger aircraft and additional frequencies. On October 15, 1997, Western Pacific withdrew from its Colorado Springs hub altogether before collapsing in bankruptcy and liquidation.

DALLAS/FT. WORTH-COLORADO SPRINGS



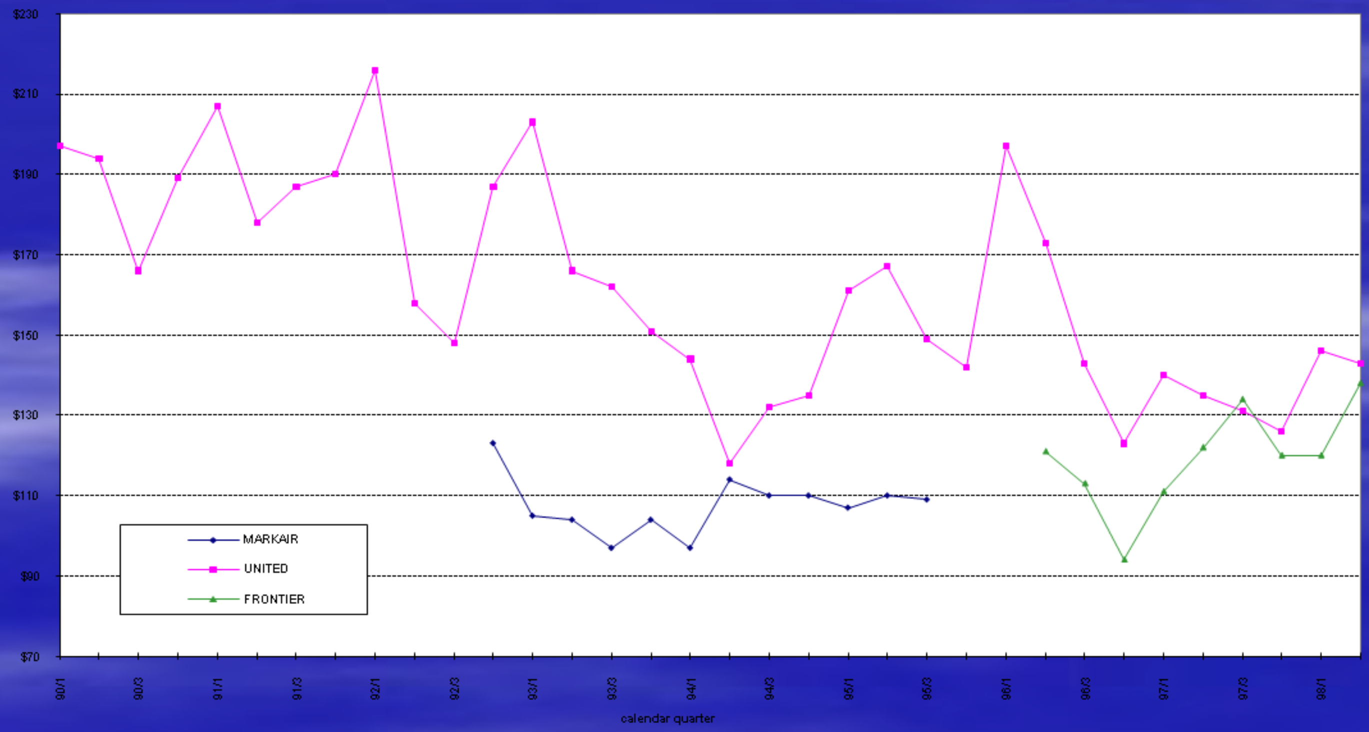
DENVER-SAN FRANCISCO: UNITED vs. MARKAIR

MarkAir entered the Denver-San Francisco market on September 7, 1993. United cropped its prices to levels *38% below* those prevailing before MarkAir entered. United priced below MarkAir's average fares in the second quarter of 1994. After MarkAir returned to bankruptcy, United raised its fares 84% above the predatory levels, to levels higher than those prevailing before MarkAir entered.



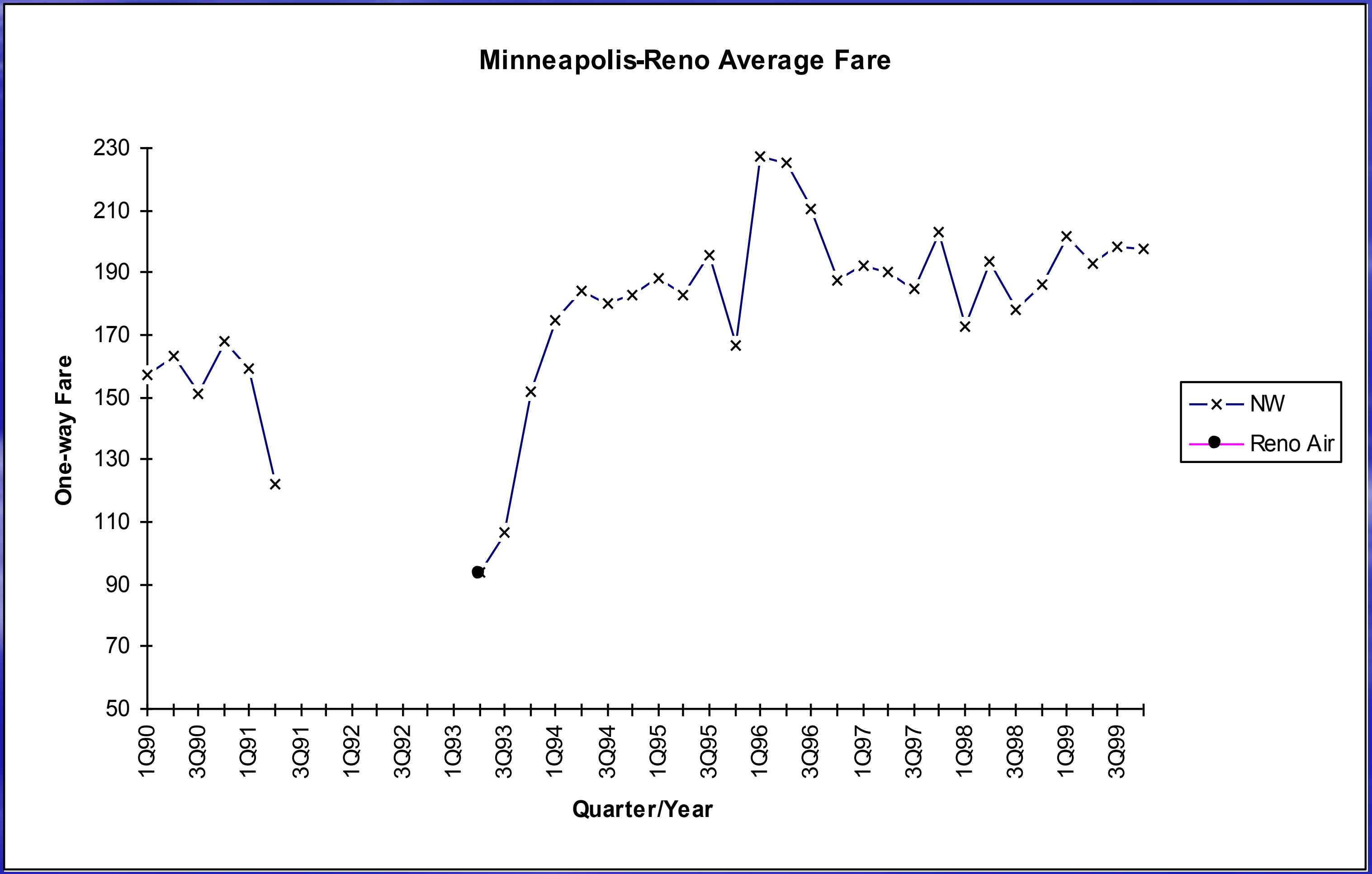
In the first quarter of 1993, United offered average fares of $203, some *93% higher* than MarkAir's $104. After MarkAir announced it intended to shift its hub to Denver, United dropped its fares to levels lower than those prevailing before or after in the 1990s. In the second quarter of 1994, as MarkAir was seeking to emerge from bankruptcy, United dropped fares *42%* (from $203 in the first quarter of 1993 to $118 in the second quarter of 1994). After MarkAir was driven out of business, United recouped its short-term losses by raising prices 67% (to $197 in the first quarter of 1996). Frontier Airlines entered the market on May 1, 1996, and United again began to lower fares sharply, pricing below Frontier in the third quarter of 1997.

Denver-Seattle Average Fares

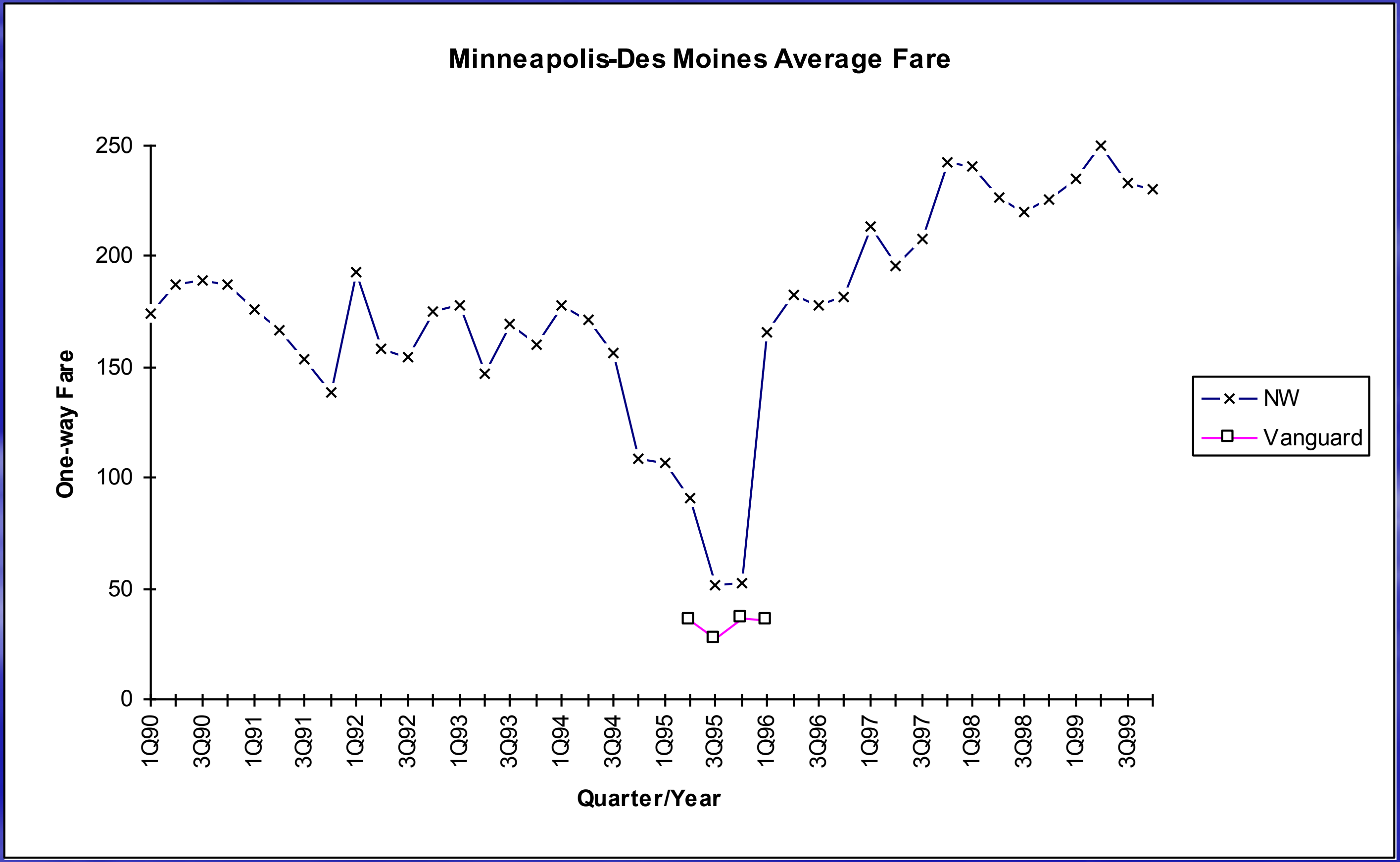


On February 10, 1993,, announced its intention to inaugurate thrice daily round-trip service between Reno and Minneapolis on April 1 at a fare of $95 one-way. Northwest had abandoned the route in 1991, because it was unprofitable.

The day after, Northwest retaliated by announcing it was beginning three round-trip daily flights between Minneapolis and Reno on April 1. The following day, Northwest announced it would begin new service to Reno, Nevada, from three of the West Coast cities served by Reno Air—Seattle, Los Angeles, and San Diego—on April 1, in effect, establishing a Northwest mini-hub at Reno, Nevada. These were routes not theretofore flown by Northwest.



After Vanguard's entry into the Minneapolis-Des Moines market, Northwest cut its air fares 68% in the third quarter of 1995 compared to average fares a year earlier. After Vanguard withdrew from the market, Northwest relentlessly raised fares to levels higher than ever have prevailed in the market. By the second quarter, Northwest charged an average of $244, over 400% more than the $48 fare it charged during Vanguard's brief appearance in the market.



NORTHWEST AIRLINES' 7-DAY ADVANCE PURCHASE FARES FROM MINNEAPOLIS/ST. PAUL

	Northwest July 1997	Northwest July 1998	Sun Country April 1999	Northwest April 1999	Northwest 1998 v. 1999
Detroit	$569	$602	$202	$202	**-67%**
Milwaukee	$294	$395	$202	$202	**-49%**
Seattle	$655	$582	$257	$257	**-56%**
San Francisco	$613	$501	$276	$276	**-45%**
Los Angeles	$630	$561	$276	$276	**-51%**
Phoenix	$489	$492	$239	$239	**-51%**
Las Vegas	$460	$870	$220	$220	**-75%**
Dulles	$590	$625	$257	$257	**-59%**
Orlando	$558	$501	$257	$257	**-49%**

The Pattern Repeats Itself

- Major airline establishes monopoly in a market, and raises prices to confiscatory levels.
- New low-cost airline enters the market, offering low fares.
- Major airline responds by matching fares (even if below cost), sometimes adding aircraft capacity and frequency. Major airline rebates a portion of the ticket price in the form of frequent flyer travel.
- After suffering severe economic losses, new entrant airline withdraws from the market.
- Major airline reduces service and raises prices to confiscatory levels, often higher than those prevailing before the new entrant emerged.

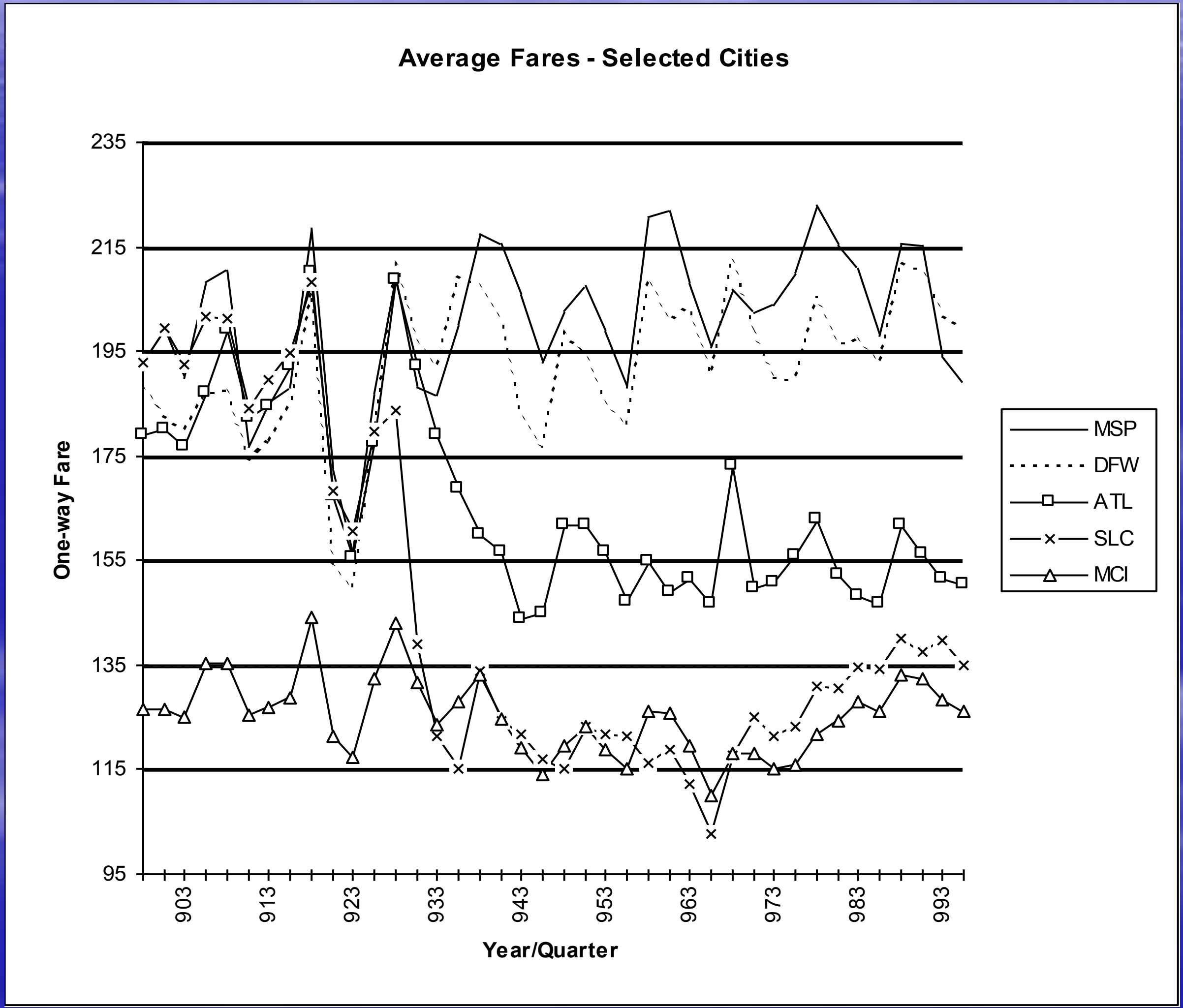
"Differences in cost structures between large, hub incumbents and small, low cost entrants cause these predatory incentives to arise. Low cost carriers, with low marginal costs, set low prices and cut into the profitability of the hub carriers. These hub carriers however have lower avoidable fixed costs, due to prior sunk cost investments in their network, and are thus more committed to the market. Hub carriers are then able to prey on their low cost rivals by making costly commitments of capacity to a route."

Connan Snider

UCLA

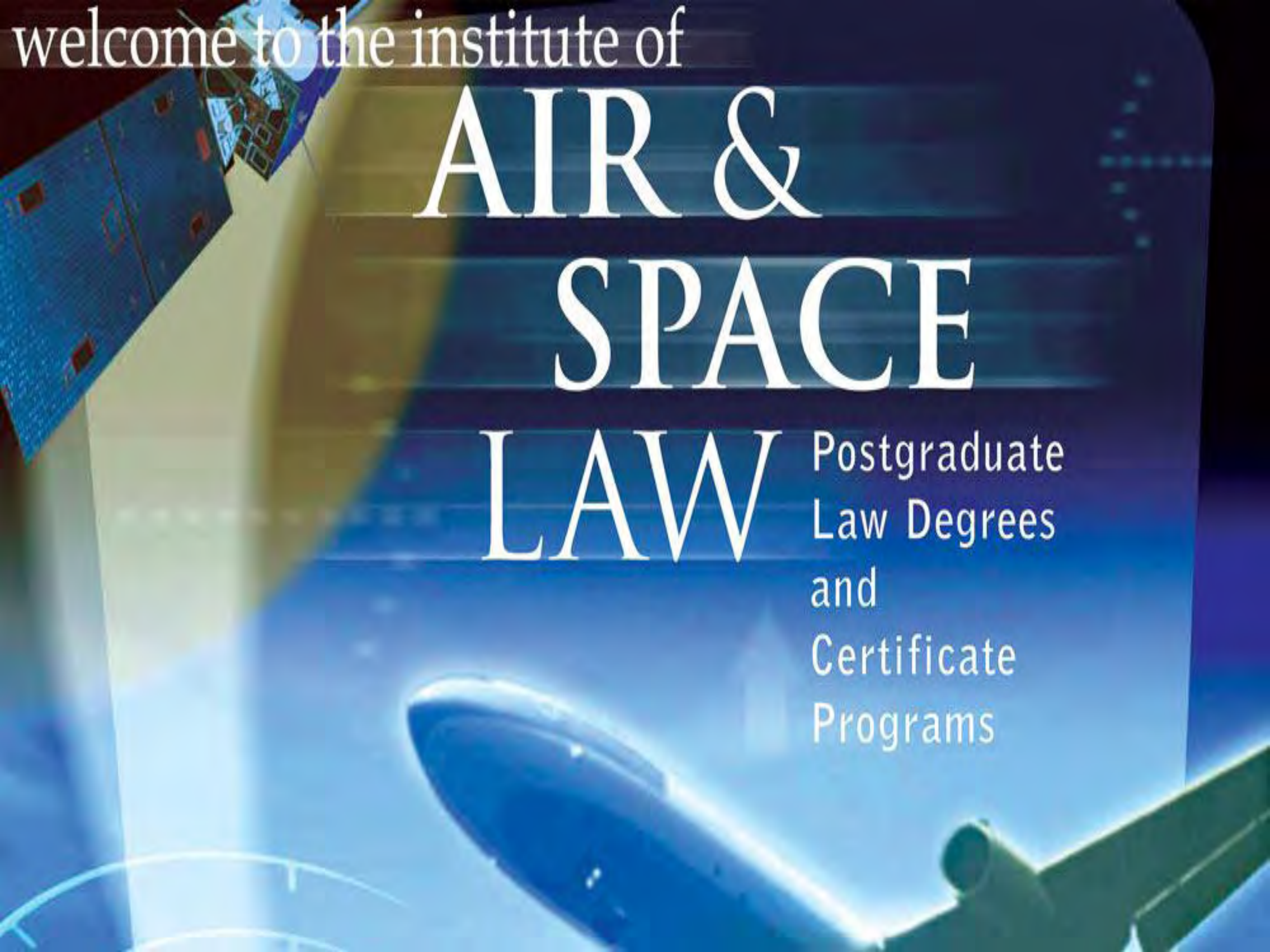
September 22, 2009

Average Fares: Selected Cities



MSP fares are 43% higher than ATL, 68% higher than SAL, 70% higher than KC

Questions?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