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ANTITRUST ISSUES IN THE AIRLINE INDUSTRY

HEARING

BEFORE THE

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION UNITED STATES SENATE

ONE HUNDRED SIXTH CONGRESS

SECOND SESSION

JULY 27, 2000

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SENATE COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

ONE HUNDRED SIXTH CONGRESS

SECOND SESSION

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ANTITRUST ISSUES IN THE AIRLINE INDUSTRY

THURSDAY, JULY 27, 2000

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
Washington, DC.

The Committee met, pursuant to notice, at 9:34 a.m. in room SR–253, Russell Senate Office Building, Hon. John McCain, Chairman of the Committee, presiding.

OPENING STATEMENT OF HON. JOHN MCCAIN, U.S. SENATOR FROM ARIZONA

The CHAIRMAN. Good morning. Today's hearing will address the role that antitrust laws play in keeping the airline industry competitive. We are fortunate to have two distinguished witnesses with us to discuss these matters, one of whom has not arrived yet because, guess what, his plane is late. But anyway, there is some irony there.

Assistant Attorney General Joel Klein is considered an activist in terms of antitrust enforcement. His Antitrust Division has tackled many challenging and controversial cases in the last few years. Professor Alfred Kahn is frequently referred to as the "father" of airline deregulation. His efforts set in motion a dramatic change in the part that air transportation plays in our country. He is also one of the most thoughtful and well-regarded experts on the airline industry. I am grateful that both gentlemen are going to be here.

The airline industry has reached a critical stage in its development. More than 20 years have passed since deregulation, and the major airlines have matured into relatively productive networks. For all their flaws in areas such as customer service, the airlines have helped transform air travel from a privilege for the few into a necessity for the many.

It has not been easy, but most U.S. airlines have become strong and efficient. Recent developments in the industry raise questions about where the industry will go from here and how it will get there. Consolidation is one of the most pressing issues. If the proposed United Airlines and US Airways merger is approved, most everyone believes that there will be further mergers leading to three megacarriers. I cannot think of any marketplace that works better for consumers with fewer competitors. Apart from the ability of three bigger carriers to wield significant market power, especially at hub airports, new entry would probably become more difficult in a more concentrated industry.

That statement is validated by numerous Department of Transportation and GAO studies that show where there is significant hub concentration fares are higher and competition is less.

Senator Gorton and I have introduced a Senate resolution expressing our strong reservations about the proposed merger of United Airlines and US Airways. Through the deliberations of this Committee, we have carefully analyzed the proposed merger as well as its long-term consumer effects. We have concluded that whatever air travelers stand to gain from the merger is outweighed by what they stand to lose.

Although we felt compelled to make our views known, we are fully aware that this issue is now in the hands of the Department of Transportation and the Department of Justice. For obvious reasons, Assistant Attorney General Klein cannot comment on the particulars of the merger or other specific matters pending before the Antitrust Division. I want to make that clear to all Senators.

In addition to consolidation concerns, other important issues facing the industry include collaborations among major airlines and predatory behavior on the part of individual carriers. Just last week the Committee held a hearing on how the Internet is having an impact on the industry. Much of the attention focused on Orbitz, the Internet travel agency formed by five major airlines.

As a general matter, we want the airlines to compete at all levels. When they work together on the sale of tickets, it harkens back to the abuses of the computer reservation systems. But Orbitz may inject competition into the channels of ticket distribution, where it has been lacking.

Predatory behavior is a troubling phenomenon that can be difficult to get a hold of. At the risk of stealing some of his thunder, I note that Professor Kahn has spoken out on predatory behavior by the major carriers. He was quoted last year as saying: "If I had to choose between encouraging low-fare entry like the kind that has benefited the public with low prices and the unencumbered ability of major airlines to respond to low-cost competition, I will pick the first every time." I tend to agree with him.

Once again, I welcome our witnesses. I look forward to continuing our dialog on issues critical to the future of air transportation in the United States.

Senator Hollings.

STATEMENT OF HON. ERNEST F. HOLLINGS, U.S. SENATOR FROM SOUTH CAROLINA

Senator HOLLINGS. Thank you very much, Mr. Chairman. I appreciate your leadership in your calling for this hearing and I appreciate the distinguished Assistant Attorney General in charge of Antitrust Division being with us.

First with respect to airline deregulation, if you stay around here long enough you meet yourself coming around the corner. I voted for airline deregulation. I will never forget. At the particular time we were all busied up on our particular little disciplines, committee assignments. I was working on the oceans, working on communications. Howard Cannon was the Chairman of our Committee, and from time to time I could see various red flags and different other

things that I was worried about; "concerned" is the word used up here in Washington.

But I was assured at each turn by Mr. Alfred Kahn, the proponent, and the Chairman of the Committee, Senator Cannon, that the small, medium sized airports and facilities and service would be protected.

Welcome, Mr. Kahn.

The CHAIRMAN. Professor Kahn, welcome. I understand your plane was late.

Dr. KAHN. I am sorry.

Senator BRYAN. That is another hearing.

Senator HOLLINGS. I will comment on airline deregulation, Mr. Kahn, because you got me to vote for it. There is no question about your intellectual acumen, your brilliance. I just question your judgment, looking at the result.

Dr. KAHN. You cannot have everything.

Senator HOLLINGS. Incidentally, I had always hoped Mr. Kahn had gotten his original assignment. He got in the plane, was headed to Washington to be the Chairman of the Federal Communications Commission. I was working at that time and we were about to welcome him as Chairman of the FCC. But it was allowed that Speaker O'Neil was extremely disappointed in President Reagan. They had rebuffed each other and the only way to really make it up was to take Speaker O'Neil's right-hand man, Charlie Ferris, and appoint him the Chairman of the FCC.

So as you were landing to become the Chairman of the FCC, Charlie Ferris was appointed. So then to keep this busy mind at work, they appointed Dr. Kahn, who had headed up the Public Service Commission in New York, to the Civil Aeronautics Board. We listened at length about all the joys and pleasures and economies of deregulation.

It is terrible. I mean, everyone agrees. That is the one thing Republicans and Democrats can agree on, airline service; it is lousy and it is costly.

I just called and just within the last 20 minutes—you never can tell your schedule up here—because as I understood, we were going to vote tomorrow. But then I heard a rumor as I got to town this morning that: Wait a minute, the Republican colleagues all want to get off to the convention, which is understandable, so if we can possibly vote, if I do not hold up a vote tonight because I am opposed to PNTR, that if I do not hold it up we can vote tonight, which I am delighted to do. I am always willing to oblige my Chairman, because he has got to get that there express, whatever that thing is, the Talking Frankly Express or something like that, whatever. He is going to fill up that bus and head on down the highway.

The CHAIRMAN. Sir, I had not planned on doing that until Saturday.

Senator HOLLINGS. Excuse me. So I said: Wait a minute; I would like to go in the morning. And I get the government rate, but I said just get the coach rate round trip. Tomorrow morning there is a 9:10 flight, it is not a jet, that goes to Charleston, South Carolina, and then get it back up here at 11 o'clock next Monday, which is usually what I do. You know the price of that for my wife in coach? $896. Call it, check it yourself.

Now, I came to the Congress in the sixties and we had National Airlines, Piedmont Airlines, Eastern, Delta, all going into Charlotte and serving it. At this time, Dr. Kahn, we have got one airline and that is US Airways. They have 89% of that hub.

We will ask Mr. Klein and he will tell you, General Klein will tell you right now, that that is exactly the experience down there in Texas or the experience that they have had up there in Philadelphia with Northwest, where we had the testimony of Spirit, I think it was, that they tried to go in. Northwest immediately lowered the fares and put on even more services and then gave you the frequent flyer, which the newcomer is unable to do. And so they had to drop it. I mean, they have got a roadblock, a monopoly.

There is not any question in my mind when I can fly. I have got another ticket on my desk to fly to Frankfurt from Dulles, Frankfurt, Germany, and back for $279. But to go down to Charleston, South Carolina, is $896, and then you are lucky if you can get there because they will keep you out on the runway, it is a struggle to get in a little bus to go out there. You have got to carry your own luggage and then drop it yourself and then pick it up and come in. I can do that. Sometimes, my wife has had knee operations, and it is difficult for her to carry her own luggage and that kind of thing—so it is a tough goal.

All kind of delays, as you have just experienced, absolutely costly, and it is not working. It is a failure of deregulation. The comeuppance and the bottom line is the regulated European carriers are buying up the deregulated American carriers.

Other than that, Dr. Klein, General Klein, I would apologize to you. I opposed, Mr. Chairman, his nomination because a Senator had written him a letter and I thought he changed his mind on the letter. I found out that he was of more character and abilities than that. I apologized to him publicly.

You have been doing an outstanding job in my opinion. I have watched it closely because we have the appropriations on the little Subcommittee that I am Ranking Member, State, Justice, Commerce, and we have had the experience of those who did not like some of your work trying to cut the funds. Instead, we have been able to increase them. I hope I can increase them even more because of the outstanding job you have been doing.

Thank you, Mr. Chairman.

[The prepared statement of Senator Hollings follows:]

PREPARED STATEMENT OF HON. ERNEST F. HOLLINGS,
U.S. SENATOR FROM SOUTH CAROLINA

Good morning. I want to thank the Chairman for holding this hearing. I also want to thank Mr. Klein and Dr. Kahn for agreeing to appear before the Committee today. Dr. Kahn, I know, had legitimate concerns about the air fares that almost prevented him from attending.

Let's start with one fact—deregulation has not given us what we wanted, and the conditions it was supposed to rectify are worsening. When we passed the Airline Deregulation Act in 1978, we were promised a number of results—low fares, better service, and the absence of predatory conduct (given that planes can easily be moved from one market to another). The government applied those theories to every transaction proposed, and with one exception, approved them all. The result is what we have today—a balkanization of our aviation system—16 major hubs dominated by one carrier. New entry, real new entry is virtually unheard of, and people in small communities now have little choice in air fares (which are too high) or carriers. On top of all of this, we have carriers seeking to merge, creating further increases in

industry concentration, and control over more fortress hubs, with virtually no promised relief for consumers.

The proposed United-US Airways merger is supposed to give us better, "seamless" travel. What it is likely to translate into, however, is a shift in revenues from one carrier to another—not better service, not lower fares. Even if the United-US Airways deal increases revenues 1–2%, it would result in $300–$600 in incremental revenues to the merged carrier. One analyst, Goldman Sachs, indicated that "with fewer hub carriers, the airlines should become more disciplined in capacity, marketing, and pricing plans . . . [a] reduction in the number of network airlines creates a significant opportunity to raise connecting fares from medium to large spoke cities". We know what this means, and it is not good news for consumers.

Interestingly, Goldman Sachs acknowledges that investors are now conscious of the fact that airline mergers may "exacerbate service and labor woes". That is precisely part of our problem here. Not only do we see further increases in concentration, but not surprisingly, we see less service. There are many risks associated with consolidation, including fortress hubs and the use of market power to keep out new entry.

Currently, there are at least 16 hubs where one carrier accounts for more than 50% of the traffic. This is where the market power resides. For years, we have heard that actual and potential competition would keep fares low, and in fact that is what the fathers of airline deregulation envisioned. I suspect that Dr. Kahn will tell us why we have not gotten what we were promised, but a large part of it has to do with the fact that every merger ever considered was approved by the government, facilitating fortress hubs. As one system grew bigger, other carriers had to respond with their own mergers. That is a trend we want to end.

Pick any hub today. GAO tell us that the hub carrier can effectively extract a fare premium. For example, US Airways today has almost 90% of the traffic at Charlotte, and the combined carrier would have 91%. The deal may give Charlotte better service, and more international connections, which I know are important to the people of Charlotte. What it does not do, though, is provide new competition for those that fly to and from Charlotte.

We are doing what we can in Congress to encourage new entry. In the recently enacted FAA bill, FAIR–21, we have proposed to direct DOT to cease funding of mega-fortresses, unless there is some assurance that the airports will make every effort to provide facilities for other carriers, and thus help address the market power concerns. The European Union is considering forcing major airlines to divest up to 5% of their slots at Europe's busiest airports to facilitate new entry. The EU, however, would go to a buy-sell system for slots. The U.S. did the same thing back in 1985, and it was a failure.

With respect to airports, and barriers to entry, we have asked GAO to give us information on the ability to get gates at some of the hubs. Gates are available at some hubs (Pittsburgh and Charlotte), but no one wants to challenge the incumbent carrier. At other airports we have heard that it is harder to get gates since the major incumbent may have a say in the use of gates at their respective airports. We have given DOT the ability to stop that.

Mr. Klein and his office must continue to be active. They have challenged predatory actions by American, challenged the Northwest-Continental deal, and now must carefully consider not only the United-US Airways deal, but also the prospects that it will lead to additional deals. The DOT also must carry out its responsibilities, whether it is looking at competition policies, consumer policies or international deals. DOT has yet to issue a final set of predatory pricing guidelines. I know that the proposal was controversial, but it is time to address those concerns and issue the final rules.

In 1998, the Department of Justice challenged the Northwest-Continental deal based on an overlap of mere 7 markets affecting 4 million passengers. DOJ is well aware that we have untoward levels of market power—which were granted or obtained in the name of efficiency—which must be checked. The United-US Airways deal involves at least 4.9 million passengers in just the hub-to-hub routes of the two carriers, where there will be a reduction from 2 carriers to 1, or from 3 to 2, depending upon the market. In many of those routes, there is no likely carrier able or willing to enter the market. Few times do we see a carrier, be it a low cost carrier or a network carrier, challenge routes connecting two hubs. With the feed traffic at each hub, the combined carrier effectively controls price, service and scheduling. In addition, several cities like Boston and New York will see significant increases in concentration, as will Dulles.

We will be back here next year looking at how best to address competition policy matters. We took the authority away from DOT in 1988, leaving it to our antitrust regulators. Next year, we will need to rethink that position. As it stands, we are

going to be continuously beset by the types of problems we know exist, and will continue to exist, absent real competition and better service.

I look forward to the testimony of the witnesses.

The CHAIRMAN. Senator Rockefeller.

STATEMENT OF HON. JOHN D. ROCKEFELLER IV, U.S. SENATOR FROM WEST VIRGINIA

Senator ROCKEFELLER. Thank you, Mr. Chairman.

I listen to both the leaders of this Committee and wish, Mr. Klein, that they would bring the same enthusiasm to monopolistic, as they see it, behavior to what I call the problem of captive shipping with railroads. It does not seem to disturb either one of them as thousands and thousands of people are put out of work and lose income with monopolistic behavior by the railroads under the law, literally breaking the Staggers law, proceeds.

But that is not for this morning. I wish you could get into that. I would love it. I would invite you. I would even help fund it.

The Chairman of the Committee said that we had had careful deliberations on this matter. Of course we have had one hearing. We have not had careful deliberations. I just wanted to make two comments.

One is that I thought that the putting in of the resolution by the Chairman and the Ranking Member of the Aviation Subcommittee was highly premature and prejudicial in a kind of a subtle political way which does not help around here, because you have your work to do, sir, and as the Chairman said you will not be able to comment on the specifics, but you do not even have all the paper yet. So what you will be doing is you will be giving your general outlines of behavioral tendencies that you look for, this kind of thing, which I respect. But I regret the introduction of that sense of the Senate resolution just before we take off for a recess in a year in which we have basically done nothing.

Second, my view is different about this merger, and I want that to be very clearly understood. I have done my "careful deliberations," more carefully than this Committee has because I have spent more time at it, in talking with the different parties—D.C. Air, United, US Airways. US Airways is in extremely bad financial condition. It now—as in South Carolina, we pay the same prices to get to Charleston, West Virginia, as Senator Hollings does to get to Charleston, South Carolina, probably minus $10 or $15.

I do not like that, but one of the things that this does is it brings into some of our markets where US Air has dominated two carriers. In other words, we get competition for the first time. We get not just United, but we also get a second carrier, which would be D.C. Air, which would also be by its own definition all-regional jets, which are the salvation of my state.

In this case I am looking at my state. Sometimes in my job I have to look at my state and exclusively at my state because we have the lowest per capita income and economic development is something we have to take pretty seriously. Highways have had their day. Aviation is the future. Highways are important, but everybody has them. Not everybody has aviation.

Deregulation killed us, too, and my view is that this merger at this point holds substantially more promise for my state than our

present situation. So that my position is different perhaps from some of my colleagues and I want to make that very, very clear, at the same time as I make clear that I have a thorough and complete obligation to listen to what it is that you have to say today and what you will be looking at as you get the paperwork and do your work in the months to come. I would like to work on it on a systematic basis, rather than trying to push things along prematurely.

I thank the Chairman.

The CHAIRMAN. Before I recognize Senator Wyden, I would—I am not surprised that Senator Rockefeller would criticize me. I am a little disappointed that he would criticize Senator Hollings, who has been a member of this Committee for some 34 years. The fact is——

Senator ROCKEFELLER. I did?

The CHAIRMAN. The fact is there have been five hearings held by this Committee on captive shipping—or captive shippers. The problem is that there is not consensus on the issue and that is why legislation has not been passed, not for lack of attention on the part of this Member or certainly not for lack of attention on the part of the distinguished Senator from South Carolina.

Senator HOLLINGS. We have got a 15-month moratorium. The Surface Transportation Administration has instituted a 15-month moratorium, upheld by the courts. I would appreciate it if we could have a similar situation here at the airline level.

The CHAIRMAN. Senator Wyden is recognized.

STATEMENT OF RON WYDEN,
U.S. SENATOR FROM OREGON

Senator WYDEN. Thank you, Mr. Chairman. I am going to be very brief.

I think that our country is clearly at a turning point with respect to the airline industry. With United looking to merge with US Airways, if that goes forward it is widely assumed that other major carriers are going to follow suit. So in effect it is time for this country to have a real debate about the prospect of a consolidated industry with just three major airlines serving the United States.

I am of the view that if government is going to prevent consolidation it has to act soon. I think you, Mr. Chairman, and Senator Hollings are right on target with respect to your comments this morning. I am of the view that if you just have three airlines in this country it is hard to see how consumers are going to have the choices and the price competition that is in the public interest.

I hope to be able to be here for most of the morning, but I am particularly curious about whether Dr. Kahn at the time that deregulation was debated, whether he would have accepted some version of deregulation had we known that we would be on the eve of having just three airlines to serve this country. I do not happen to think that the people of this country view three airlines, consolidation with just three companies, as an acceptable result.

Having said that, I think we also ought to note the Inspector General continues to tell us that the airlines are not following through on their voluntary pledges, and I hope that very shortly we will be able to take up the legislation that was introduced re-

cently to block this merger and also go forward and pass a real passenger rights program.

I yield back, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Bryan. By the way, I would like to remind our colleagues we do have a vote at 11:30, so we probably would like to move on as quickly as we can. I thank you. Senator Bryan.

STATEMENT OF RICHARD H. BRYAN,
U.S. SENATOR FROM NEVADA

Senator BRYAN. Thank you. Thank you very much for holding this hearing.

I was listening to our Ranking Member discuss Senator Cannon and the role that he played in deregulation. I occupy the seat held by Senator Cannon, as the distinguished Senator from South Carolina knows.

I see both the pluses and the minuses. Las Vegas, which is my home town, has benefited enormously as a result of deregulation. Fairly, a couple of years ago my little daughter moved to Rochester, New York, and we were blessed with a grandchild and, as every doting grandparent, we wanted to get to Rochester as frequently as possible. The cost of that round trip fare from Washington, D.C., to Rochester, New York, which is about an hour and 15 minute flight, is more expensive than some of the rates that have been quoted from Washington, D.C., to Paris and back.

Now, I do not presume to know a whole lot about the airline business, but I do know a little bit about geography. That is much, much longer. So clearly the Northeast in my opinion, not the area of the country that I represent, has enormously high air fares, and that is part of the down side that I see.

The impact of this proposed merger that brings us here today is simply staggering in terms of magnitude. If this merger goes through, it will have revenues in excess of $26 billion and will account for 27.4% of all of the departures nationwide. That is more than one out of four. As my colleague from Oregon alluded, it has begun to ignite the so-called domino effect, where mergers have been discussed between American and Northwest, between Delta and Continental, TWA and AirTran, and the prospect of being left with just three megacarriers I think is a real possibility.

The impact on the hub system in the country is also staggering. There are six hubs in which a United-US Airways merger would dominate—69% of Denver's market would be this one carrier; in San Francisco, 59%; in Charlotte, 91%; Philadelphia, 71%; Pittsburgh, 88%; and at Washington Dulles, 71%.

You do not have to be an economist to know that this is going to have an enormous impact and what I apprehend, and I sense that from a number of my colleagues who have voiced opinions on this issue, there is the suspicion that ultimately the consumer is going to be the loser in this proposition.

So I am very interested to hear the comments from our distinguished witnesses. Unfortunately, those of us on Finance are going to have to go to another meeting shortly. So let me ask unanimous consent, Mr. Chairman, that my complete statement be made a part of the record.

The CHAIRMAN. Without objection.

Senator BRYAN. Again, thank you for your leadership in convening this hearing.

[The prepared statement of Senator Bryan follows:]

PREPARED STATEMENT OF HON. RICHARD H. BRYAN, U.S. SENATOR FROM NEVADA

Mr. Chairman, thank you for holding this hearing today on an issue that has a great impact on the airline traveling consumers. The proposed merger between United Airlines and U.S. Airways has spawned a wave of additional attempted mergers in the airline industry. [Although many of these additional proposals have failed, it is extremely important and beneficial to the consumers that we examine the impacts and potential outcomes here today.]

The proposed merger that has brought us here today is simply enormous. If successful, the combined airline would have revenues in excess of $26 billion and account for 27.4% of the departures nationwide. This monstrous undertaking has raised some serious antitrust issues that need to be addressed.

In addition to the concerns that this one particular merger raises, we must also be ready for the domino effect that will come as a result of the United/US Airways merger. Since the announcement, the remaining airlines have been scrambling, at a seemingly frantic pace, to establish some framework for a merger to compete with this new giant.

The avalanche of proposed mergers began with American and Northwest, then progressed to additional possible mergers between Delta and Continental, and TWA and AirTran and various other combinations, but none have produced a deal, yet.

Mr. Chairman, the point is that this merger presents a threat that could profoundly change the industry. We are heading towards a major consolidation of the airline industry with the consumer getting the short end of the stick. To create such dominant giants in such an aggressive industry would be like matching up the world champion L.A. Lakers against the San Jose boys club basketball team, they just can't compete in particular markets.

These markets that would be dominated to which I refer would be hub airports that have over 50% of the market by a single airline. The proposed United/US Airways merger would create a dominant market share in at least six major hub airports ranging from 59% of the traffic all the way up to an incredible 91% at the Charlotte hub. The airlines have claimed that the transaction would not result in a large increase in route overlap, but we must consider the size and strength of the airlines with whom we are dealing with.

We have heard testimony before this Committee detailing the tactics used by some of the major airlines to squash the competition at some of these hub dominated airports. In many of the cases, the smaller airline who dared to enter the market found themselves competing head to head with major airlines only to be pushed out of the market. And the result, a huge increase in fares developed once the competitor left the market. This activity severely limits consumer choice for consumers traveling from or to those hub airports.

Mr. Chairman, this is a dangerous precedent to set, especially with a wave of potential mergers following closely behind the one in question. Currently, the Department of Justice is involved in two suits involving similar anti-trust issues. The DOJ has challenged the Northwest/Continental combination as it has the possibility of controlling 87–100% of the market in seven locations. Similarly, the DOJ has filed suite against American for its actions out of Dallas-Fort Worth for its actions against a number of new entrants because the airline has used its 70% market dominance for alleged predatory conduct.

It seems to me, that the United/US Airways merger falls right in line with the current actions the DOJ is considering. I am pleased that the DOJ has taken such aggressive action and hope that the proposed merger warrants the same, if not closer, magnitude of scrutiny in order to protect the consumers.

Mr. Chairman, the proposed wave of airline mergers could result in a major consolidation creating just [3 mega-carriers that could wield an immense amount of power.] If we are not careful, the only loser in this deal can only be the American consumer.

The CHAIRMAN. Thank you, Senator Bryan.

Senator Dorgan.

STATEMENT OF HON. BYRON L. DORGAN,
U.S. SENATOR FROM NORTH DAKOTA

Senator DORGAN. Mr. Chairman, thank you. I will be brief. Let me thank Mr. Klein for being here and for his public service.

Dr. Kahn, I was chairman of the state airline commission in North Dakota and met with Alfred Kahn when he was taking the CAB apart in the late 1970's and had some interesting discussions about deregulation with him at that point.

Mr. Chairman, I do not support the proposed merger between United and US Air, nor would I support a merger between Northwest and American that has been rumored, nor would I support a merger between Delta and Continental. Monopolies are a form of cholesterol to the free market system. They plug the arteries of the system. They make the system not work very well.

What we have post-deregulation, I would say to Dr. Kahn, is major carriers having retreated into hubs which they can and will and do dominate, and major carriers then dominating regional hubs, effectively working on regional monopolies in an unregulated manner. You have unregulated monopolies in regional hubs, that is what we have.

If you were to leave here, I have indicated to this Committee previously, Mr. Chairman, leave here this morning to fly to see Mickey Mouse at Disneyland in California, you will pay half as much to do that as if you were to leave here to see Salem Sue, which is the world's largest cow, sitting on a hill outside of New Salem, North Dakota. So if you want to see the world's largest cow, you pay twice as much to fly half as far as opposed to going to see Mickey Mouse.

Now what does that say about our system? It says that deregulation has meant that where there is an income stream in big cities there is robust competition in some cases and where there is not an income stream in rural areas of the country you just pay through the nose because largely you have one choice of carrier and they say: Here is the way we will serve and here is the price you pay, and if you do not like it there is not much you can do about that.

So I think this is a hearing that is timely. I appreciate your having the hearing. We need to review what is happening. We know there is less competition. Startups are hard to come by. One other point: You do a startup someplace and guess what happens? The dominant carrier goes to the travel agents and says: I tell you what, we will pay you to make sure you do not have your folks travel on the startup. We will pay you what is called an override, which is fundamentally anticompetitive and ought not be allowed in this country. You are paying travel agents to make sure a startup does not get the business.

Refuse to code-share with the startup, that is the other thing that happens. When you were running the CAB they were required to code-share. Of course, that is regulation.

But we have got a lot of problems. The proposed mergers mean that we would be left with three carriers. That in my judgment is not progress. That is a retreat on the free market system.

So thanks for being here, Mr. Chairman. Thanks for holding these hearings. I am going to be interested to hear the testimony.

The CHAIRMAN. Thank you.

We will begin with you, Mr. Klein. Thank you, sir, for coming. Thank you, Professor Kahn.

STATEMENT OF HON. JOEL I. KLEIN, ASSISTANT ATTORNEY GENERAL, ANTITRUST DIVISION, U.S. DEPARTMENT OF JUSTICE

Mr. KLEIN. Thank you, Mr. Chairman. I would ask that my full remarks be submitted for the record.

The CHAIRMAN. Without objection.

Mr. KLEIN. And I will make brief introductory comments. Mr. Chairman, Senator Hollings, distinguished members of the Committee: It is a distinct pleasure to be here this morning and to sit next to one of my heroes from my youth, Fred Kahn, a man who has mixed economics and policy and politics as well as anybody, who truly always puts the public interest above self-interest or private interest. We need more like him in our country.

Mr. Chairman, I view this as a continuation of a colloquy that you, the Ranking Member, and I started a little over a year ago at the airport in Charleston, in fact on March 12th, where some of these very issues were raised. I think the fares were about the same to get down there as they were in the Ranking Member's comments this morning.

I pledged to you then that, in terms of the Department of Justice's priorities, the issue of competition in the airline industry would rank very, very high. I think it is fair to say that that has been borne out. Since that time we have sued American Airlines on an issue that I think is important with respect to new startups that enter into the market. One of the things we have heard a lot about, obviously, is consolidation, but I think a critical issue, a critical issue for this Nation, will be new entrants into the market, who will begin to develop opportunities that will bring more competition, and particularly to some of the less populated parts of the country.

We have seen some of that, for example, with respect to Southwest Airlines and the impact that it has had, and other startups as well. I want to talk briefly about that this morning.

Second, of course, we did challenge the acquisition of the stock in Continental Airlines by Northwest Airlines, and that case is scheduled to go to trial later this fall.

We obviously will pay very close attention—and I appreciate your remarks, Senator Rockefeller—to the detailed facts with respect to United-US Air. The parties are engaged. They will produce the documents in a timely fashion and I believe, as in all merger work, we need to scrutinize the documents carefully, we need to look at the competitive terrain and make sure that we do a thorough and complete analysis. This is obviously an important matter and it merits our significant and careful attention, which it will get.

As well, we are looking into the matter with respect to Orbitz that some of the Committee members referred to.

I want to make two preliminary comments and then turn to the policy issues. First of all, all these law enforcement matters are either under investigation or in court. One should not infer from an investigation that we will take action. We take action where we believe it is merited. And one should not infer from the fact that we

are in court that we will ultimately prevail. We of course think we will. That is why we went to court. But we have distinguished and worthy adversaries. American Airlines has conducted itself, I think, professionally, as has the Northwest-Continental team, and obviously they as well believe in their cause. That is the great virtue of the American system. The courts will sort that out. We are very confident of the merits, but I am not here to talk about the specifics of those litigations today or any pending investigation.

I just want to talk about what I think are a couple of policy issues that we need to pay careful attention to. The first one is one I am sure Dr. Kahn will speak to as well, the one I alluded to on new entry. I am of the strong belief that there are underserved populations in the United States that could be economically served to both increase the number of people traveling and reduce fares throughout the United States; and that, unfortunately, a fair number of these opportunities have been deterred by either predatory practices or in any case practices that make it impossible in the short run to sustain new entry and then over the long run can lead to the kind of regional monopolies we have heard some of the members of the Committee speak of this morning.

What I wanted to show you, because we talked about this in South Carolina, Senator McCain, is the impact of these new entrants on the market, to give you something of a short-term moving picture. This is meant to be illustrative and it is not meant to in any way argue the legal merits of the case, but to simply show you what I think the economics of the industry could open up for America's public.

Let me start with the Dallas hub, and I know this data simply because we brought this particular lawsuit. If I could, you see the three bar graphs over here. These are the fares in three cities. They happen to be cities we studied. They are illustrative, I think, of the national problem: Colorado Springs out of Dallas, Wichita out of Dallas, and Kansas City out of Dallas.

Senator Dorgan, you mentioned this regional hub monopoly. This particular hub is an American Airlines hub. Now, let us look. Before we had a new entrant into these three markets, the average fares, the first in all three, are in the blue graph. There in Colorado Springs the average fare that consumers paid, business consumers, was $156.

You had a new entrant come into the market, a new low-cost carrier. I believe this was Western Pacific. It drove the fare down for all travelers from $156 to $88. Then what happened was American flooded that market. They made it impossible—and they actually calculated how many people came off the other airline, the new carrier, and they made it impossible for that carrier economically to survive. Those are the facts we allege in the lawsuit. After that exit, the price went back up to $133.

Same exact pattern in Wichita and in Kansas City. In other words, you are talking about prices that were almost twice as high both before and after; as a result of the new entry, prices come down.

Now, what is more significant, if we can have the second chart, and this to me tells you something about the economics in the market and unserved demand. Look at the number of people that flew

this route in each of the three cities before, during, and after the entry. Start with Colorado Springs. We had on a monthly basis approximately 3,700 people flying before the low-cost carrier entered. After the new entry, that went up to 20,000 people a month for Dallas-Colorado Springs. You are talking about a vast change in the number of people flying. Of course, you saw before that the price goes down. Then it came down to somewhere in the neighborhood of about 9,000 after the low cost carrier exited the market.

We see the same kinds of changes in Wichita and Kansas City, perhaps not quite so dramatic. In Wichita it went from 4,000 to 11,000, back down to 8,500. So you are talking about, on a monthly basis in and out of that particular hub to that city, several thousand people. The same thing again in Kansas City, where you are almost talking about a one-third increase in output.

So this is to me a real consumer issue. I mean, the people who live in the cities, the businesses that try to flourish in these cities, depend upon this, and I think sound policy, as Fred Kahn has said, will facilitate entry into the market. I think those issues will be litigated in our case, but I do think in any event as a matter of sound policy this pattern is going to be repeated throughout the United States and we have to create the opportunities for appropriate entry.

Second of all, as I said, we now have a series of major airlines that are at least contemplating economic reorganization and consolidation. Obviously, in an industry that is so vital and sensitive to this Nation, the Department of Justice is going to have to give this very careful scrutiny.

In the 1980's there were two key mergers at a time when the Department did not have jurisdiction, but could only make a recommendation. There were two key mergers, one in the hub out of St. Louis and one in the hub out of Minneapolis, where the Department opposed the mergers. Unfortunately, the Department of Transportation approved them, and I think that is competition we lost in those particular hubs. That was unfortunate, and I can assure this Committee, without in any way prejudging the merits, that certainly I and my staff are fully prepared to engage with the parties. We will give this merger and any subsequent mergers in this industry very, very careful scrutiny.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Klein follows:]

PREPARED STATEMENT OF HON. JOEL I. KLEIN,
ASSISTANT ATTORNEY GENERAL, ANTITRUST DIVISION, U.S. DEPARTMENT OF JUSTICE

Mr. Chairman and Members of the Committee, I am pleased to appear before you today to discuss recent developments affecting competition in the airline industry and the role that our antitrust laws play in assuring that consumers receive the benefits of competition. Today's hearing takes place against a backdrop of recent reports regarding proposed or possible mergers involving some of our nation's largest airlines. While the Antitrust Division cannot comment on the specifics of any matter that it currently has under review, we fully understand the Committee's interest in knowing generally how the Division analyzes airline mergers and investigates other possible antitrust violations in the airline industry.

In my testimony today, I will review the circumstances that have brought us to the present state of competition in the airline industry, as it has evolved around the hub-and-spoke system, and identify competitive issues that are presented by that system. I will discuss the cases the Division has brought in recent years

against anticompetitive airline practices under the Sherman Act. Then, I will explain how the Division evaluates proposed mergers between air carriers.

Evolution of Competition in the Airline Industry

During the first part of the 20th Century, Congress enacted a number of statutes that subjected major industries to substantial governmental regulation. Building largely upon the statutory regime first enacted in 1887 to regulate railroads, various industries, including other transportation industries such as trucking and airlines, were subjected to restrictions with respect to markets they could enter or exit, prices they could charge, and acquisitions they could make. In most instances, those decisions were subject to prior review and approval by an administrative agency, such as the Interstate Commerce Commission or what became the Civil Aeronautics Board ("CAB").

While the premise of such regulation was that regulatory agencies could restrain anticompetitive behavior by regulated industries and thereby protect the public interest, regulated industries and the public became dissatisfied with regulation. Regulated companies balked at having to obtain regulatory approval every time they wanted to change service or alter price, and consumers complained that agencies often seemed to reflect the views of the industry they regulated, rather than the public interest.

This dissatisfaction culminated in a series of regulatory reform initiatives in the 1970s that reflected a congressional determination that consumer welfare could be enhanced by reducing regulation and allowing consumers—through their buying decisions in the marketplace—to identify products and services they desired and the price that they were willing to pay. Thus, Congress enacted a number of deregulatory statutes that curtailed regulation and allowed formerly regulated industries far greater latitude in determining markets to serve and prices to charge.

Following on the heels of a number of deregulatory experiments conducted by the CAB, Congress enacted the Airline Deregulation Act of 1978, which moved the domestic air transportation industry from government regulation to a new era of competition. Carriers were permitted to enter and leave domestic markets without governmental authorization and to set prices and conditions of service. Such behavior would thereafter be subject to the antitrust laws, while the CAB retained jurisdiction over mergers and acquisitions and its authority to prohibit unfair practices.

Industry responses to deregulation were swift. While the prior regulatory regime had resulted in carriers largely providing point-to-point service, with deregulation they began to consolidate their operations at airports, forming what came to be known as hubs. With a hub system, carriers could combine "local" passengers (those originating at or destined to the hub) with "connecting" passengers (those not originating at or destined to the hub but traveling via the hub) on the same flight. In this manner, carriers found they could serve more cities from their hubs (known as "spoke" routes) and offer greater frequency of service with their fleet of aircraft than had been possible with point-to-point service.

Competitive Issues Presented by the Hub System

The hub system has become the dominant business model for most of the major domestic airlines. Such a hub system provides some important benefits for local and connecting passengers. Local passengers benefit because the hub carrier will operate many spoke routes, which means that passengers will be able to obtain nonstop service to many cities. Also, because the hub carrier combines local passengers with a substantial number of connecting passengers on its flights, it is likely to offer more flights from the hub to any spoke city than other carriers (with the possible exception of a spoke city that is another carrier's hub). Connecting passengers benefit not only from the frequency of flights, but also from the ability to choose among routing alternatives offered by various airlines. A passenger seeking to travel from Washington to San Diego, for example, may find that service is offered by several carriers, each via its own respective hubs.

Notwithstanding these benefits, the dominance of spoke routes by hub carriers gives rise to concerns about the exercise of market power by those carriers on those routes. There will usually be at least two carriers providing nonstop service on spoke routes that connect two carriers' hubs, but on other routes there may well be no carrier providing nonstop service other than the hub carrier. Connecting service may be a reasonable alternative for some passengers, especially for those leisure passengers willing to endure the longer travel time that connecting service usually entails, but the absence of competing nonstop service can be especially problematic for business passengers, who often are in a hurry and generally place a higher value on minimizing travel time. Hub carriers can identify such "time-sensitive" passengers and discriminate in the fares they charge them. Studies have shown that

carriers generally can, and do, charge higher fares on hub routes, where they face less competition, than on routes that are more competitive.

Once an airline has established a hub at an airport, several structural and strategic factors combine to present high entry barriers to any other airline that might try to enter spoke routes emanating from that hub. By providing more departures to more destinations, the hub carrier can attract a disproportionate share of the hub airport's passengers. This happens for several reasons, including the preference of many travelers to use the carrier with the most flights in a city pair (so that the passenger can change departure times if travel plans change), marketing programs (such as frequent flyer programs) that create loyalty incentives for consumers to concentrate their travel on the dominant airline in their home city, and travel agent commission practices that create incentives for travel agents to encourage their customers to use the hub carrier. A hub carrier often also enters into contracts with local businesses that provide incentives for the businesses to concentrate their travel on the hub carrier. All of these factors serve to discourage entry into a hub carrier's spoke routes, especially by other carriers with similar cost structures.

There is little dispute that hub carriers dominate service at their respective hubs. Today, hub carriers often account for more than 70 percent and sometimes for more than 80 percent of passengers at their respective hubs. There is no reason to think this situation is likely to change in the short run.

Depending on the specific facts involved, there are times when the hub system can present competitive issues under either Section 1 or Section 2 of the Sherman Act.

Section 1 of the Sherman Act prohibits contracts, combinations, and conspiracies that restrain trade. Price-fixing agreements and market allocation agreements are examples of the kinds of collusive conduct that are particularly injurious to consumers. One of the most significant section 1 cases that the Division has recently brought involved the pricing practices of airlines.

In 1992, the Division sued eight airlines and their tariff publishing company for unreasonably restraining trade in violation of section 1. The complaint alleged that the carriers had used computerized fare dissemination services to negotiate fare changes, to trade fare changes in some markets for changes in others, and to exchange assurances concerning implementation of those changes.

Although each of the major domestic carriers offers service in thousands of city pair markets, the Division found that carriers had varying preferences as to the prices that should be charged in any particular city pair. Preferences may differ for any of a number of reasons, including the importance of a route to the carrier's hub operations. A carrier might be very interested in the fare level in city pair A–B if it operated many daily frequencies, and be less interested in the fare level in city pair C–D if it operated only one or two. Yet, city pair C–D might be very important to another carrier, and city pair A–B less so. The Division found that the airlines had used computerized fare dissemination systems to work out trades: "I'll go along with an increase in A–B if you go along with an increase in C–D." A consent decree now prohibits certain practices that the airlines had used to reach these kinds of agreements on fares.

Section 2 of the Sherman Act prohibits monopolization and attempts to monopolize. Unlike section 1, which requires some form of agreement between two or more persons, section 2 focuses on single firm conduct. Generally speaking, even a firm with a dominant share of a market does not violate section 2 unless it engages in some form of exclusionary conduct. The law does not penalize a person for obtaining a monopoly through superior skill, foresight, and industry. However, if a person seeks to maintain a monopoly through exclusionary conduct, or if there is a dangerous probability that a person will obtain a monopoly through exclusionary conduct, the Division may sue under section 2.

In the airline industry, concerns have been expressed that hub carriers engage in exclusionary practices to keep low-cost carriers (LCCs) out of their hubs. The Division takes these concerns very seriously, because LCCs may offer the only realistic prospect of competition to hub carriers in precisely the markets that suffer from a lack of competition. The Division has found that major carriers are not likely to challenge another carrier at its hub by offering point-to-point service (except on a spoke route from their own hubs). The advantages that a hub carrier enjoys at its hub make entry of that sort unlikely. But LCCs, with their lower cost structures, may be able to offer service on a hub carrier's spoke routes notwithstanding the hub carrier's advantages.

A hub carrier may therefore have a strong incentive to engage in predatory practices to drive LCCs out of its hub markets and to send a strong signal to others that might consider entry that the same response awaits them if they try. The airline industry has characteristics that may make such a strategy particularly attrac-

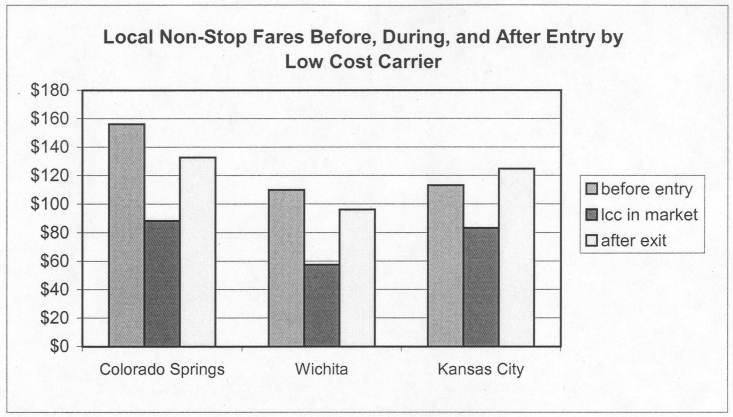
tive to a hub carrier. If an LCC begins service on a hub carrier's spoke route and the hub carrier engages in predatory conduct that drives the LCC out, the hub carrier has benefited in many ways. Not only has it driven the LCC out of that particular route, but it has also probably discouraged that LCC from expanding to serve other cities from that hub. And not only has this LCC been driven away, but all other LCCs contemplating entering that hub will see what fate awaits them if they dare to venture in. Thus, predatory practices directed at a single LCC in a single spoke route can protect the hub carrier's ability to charge high fares in other spoke routes it dominates.

The Division has filed suit against American Airlines alleging monopolization and attempted monopolization at its Dallas/Ft. Worth hub in connection with predatory practices directed at LCCs. The attached charts show what happened in some of the markets involved. When the LCC entered the market, fares declined, and the number of traveling passengers went up substantially. After the LCC exited the market, the opposite occurred: fares went up, and the number of traveling passengers fell.

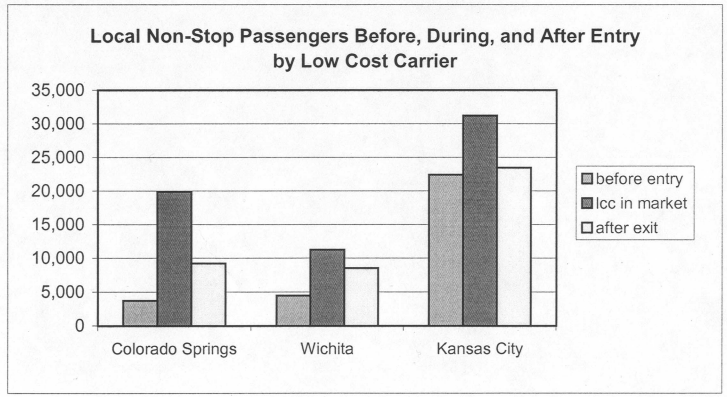
The case is still in discovery, and trial is scheduled for next spring. We view this as a very important case, one that can have a significant impact on airline competition and on the Nation's consumers.

non-stop, all carriers

fares	Colorado Springs	Wichita	Kansas City
before entry	$156	$110	$113
lcc in market	$88	$57	$83
after exit	$133	$96	$125



psgrs	Colorado Springs	Wichita	Kansas City
before entry	3,723	4,465	22,423
lcc in market	19,909	11,246	31,228
after exit	9,237	8,540	23,460



Evaluating Mergers and Acquisitions Among Air Carriers

Let me now turn to how the Antitrust Division evaluates proposed mergers and acquisitions among air carriers, starting with some historical background.

During the first years following deregulation, antitrust jurisdiction was divided between the Division and the CAB. The Division could—and did—prosecute airlines for price fixing and other violations of the Sherman Act, but the CAB retained sole jurisdiction to review mergers and acquisitions. The CAB was presented with a number of proposed mergers in the late 1970s and into the 1980s. When Congress sunset the CAB in 1985, it temporarily transferred merger review authority to the Department of Transportation ("DOT"). In ensuing years, the Division submitted comments to the DOT in some merger proceedings and supported many of the DOT's decisions. But the DOT approved two mergers that the Division opposed: the acquisition of Ozark by TWA in 1986 and the acquisition of Republic by Northwest in the same year. Both of those mergers involved carriers that operated hubs at common airports; the carriers involved in each merger provided the only nonstop service in many city pairs. The DOT predicted that entry or the threat of entry by other carriers into the affected markets—potential competition—would prevent noncompetitive performance by the merged entities. A subsequent study by Division economists found that potential competition had not prevented fare increases and service reductions.

The DOT's jurisdiction over mergers terminated effective December 31, 1988, after which time the Division assumed responsibility for airline merger review—although we continue to work closely with the DOT, given its substantial expertise with respect to the airline industry. Since then, there have been very few mergers proposed among the major airlines.

However, in 1998, Northwest, then the fourth-largest U.S. air carrier, sought to acquire a controlling interest in Continental, then the fifth-largest U.S. carrier. The Division has challenged the acquisition, and trial is scheduled for later this year.

In addition to challenges to mergers and acquisitions of stock, the Division has also challenged acquisitions of assets that it concluded would be competitively problematic. The Division has moved to block acquisition of gates or slots when it thought such acquisitions would lessen competition, as demonstrated by its challenges to Eastern's proposal in 1989 to sell gates to USAir at the gate-constrained Philadelphia International Airport and Eastern's proposal in 1991 to sell slots and gates at Reagan Washington National Airport to United.

For most of the 1990s, airline acquisition activity centered on acquisition of international route authority. Here, the Division shares review responsibility with the DOT, which has jurisdiction over transfers of international route authority. Such authority is literally an "admission ticket," since many international bilateral aviation agreements limit the number of U.S. carriers that can provide service to a foreign country, and service cannot be provided absent such authority. Financially ailing domestic carriers with substantial international route authority, such as Pan Am, Eastern, and (at the time) TWA, sold route authority to other U.S. carriers. The Division reviewed these transactions as well and challenged some of them, such as the proposed sale by TWA of its London route authority to American.

Recently, attention has turned back to the domestic scene, with the announcement of a proposed acquisition by United of US Airways and speculation about mergers involving other major U.S. carriers. The Division has announced that it will review the United-US Airways merger carefully, as it will any merger between major U.S. carriers. Meanwhile, there are reports of negotiations between other major airlines.

In reviewing airline mergers, the Antitrust Division applies Section 7 of the Clayton Act, which prohibits the acquisition of stock or assets "where in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly." Section 7 reflects the congressional judgment that merger enforcement should be able to arrest anticompetitive mergers in their incipiency, to forestall the harm that would otherwise ensue but be difficult to undo. Thus, merger enforcement standards are forward looking and, while we often consider historic performance in an industry, the primary focus is to determine the likely competitive effects of a proposed merger in the future.

A major U.S. carrier seeking to merge with or acquire another carrier must provide the Division and the Federal Trade Commission ("FTC") with notice of the proposed transaction pursuant to the Hart-Scott-Rodino Antitrust Improvements Act of 1976 ("HSR"). Although the Division and the FTC share merger enforcement responsibility as a general matter, the Division is the agency that reviews air carrier mergers. The initial HSR filing contains certain basic information, which the Division uses to determine whether more extensive review is appropriate.

The initial waiting period under HSR is usually thirty days. If the Division concludes during that period that the merger is not competitively problematic, the HSR waiting period is allowed to expire or may even be terminated early. The parties are then free to proceed, subject, of course, to any other required regulatory approvals. However, if the Division cannot resolve its competitive concerns within that period, it can issue a request for additional information, known more commonly as a "second request," which defers the ability of the merging parties to consummate their transaction until twenty days after they have provided the Division with the requested information. During this time, the Division will frequently seek or receive information from other persons interested in the merger; these may include suppliers, customers, and/or industry specialists. We work closely with the DOT, which obviously has substantial expertise with respect to the airline industry.

It is not uncommon during this process for the parties to have substantial contact with the Division. The process is confidential and, unlike the procedures in some administrative agencies, competitors do not have access to the merging parties' submissions. Sometimes parties are able to demonstrate that the merger is not competitively problematic, in which case the waiting period expires or is terminated early; again, the parties may then proceed, subject to other required approvals.

If the Division concludes, however, that the merger violates the law, the Division can attempt to stop the merger by filing a complaint in federal court and persuading a judge to enter an order prohibiting the parties from consummating it. It is not uncommon, however, for the parties to make a proposal to address the competitive concerns that the Division has identified, in which case some form of agreed-upon relief may resolve the problem while still allowing the parties to proceed with the overall transaction. In those circumstances, the Division ordinarily files a complaint along with a consent decree that embodies the relief in the form of an order entered by the court. There are times, however, when the competitive problem cannot be cured by any form of relief other than outright prohibition, in which case the Division is likely to seek a preliminary injunction to prevent consummation of the merger pending completion of judicial proceedings and then a permanent injunction prohibiting the merger altogether.

The Division looks for relief that will fully address the competitive problems presented by the merger, which almost always means seeking some form of divestiture. Parties sometimes propose conduct remedies—usually some form of behavioral restrictions—but these are generally unsatisfactory for a number of reasons. First, they are often difficult to draft with precision. Second, they require continuing monitoring by the Division. Third, they cannot be enforced without resort to the court on a continuing basis. Finally, they have often proven to be insufficient to remedy the anticompetitive problems presented by a merger.

The particular form of divestiture necessary to solve a competitive problem will vary from merger to merger and involves many inquiries. First, it is essential that the assets to be divested are sufficient to allow a purchaser to be an effective competitor over the long term, i.e. to replicate the competition that would otherwise be eliminated in the markets of concern. Sometimes the necessary assets are easy to identify—as, for example, when a party agrees to divest a stand-alone business entity such as a subsidiary or a pre-existing operating division. In those instances, the sufficiency of the assets can be evaluated in light of historical performance of the business unit in the marketplace. In other instances, parties propose divestiture of specific assets, sometimes even combining some assets from each of the parties to the merger. It can be difficult to assess whether such assets are sufficient to allow the purchaser to compete on a meaningful basis because there is no track-record to gauge the adequacy of the asset package. A recent study of antitrust divestitures by the FTC "suggests that divestiture of an on-going business is more likely to result in a viable operation than divestiture of a more narrowly defined package of assets," although "divestitures of selected assets can succeed."

Second, the Division will look carefully at the prospective purchaser. In most instances, the proposed purchaser is not selected until after the court has entered an order directing the nature and form of the divestiture, but occasionally parties to a merger will identify a proposed purchaser to the Division during the course of the investigation. In either case, the Division will review the experience, financial resources, and business plan of the purchaser, all in an effort to determine whether the purchaser is likely to solve the competitive problem presented by the original merger.

In performing this review, the Division considers the terms of the proposed contract and any other arrangements between the merged entity and the purchaser to determine whether the purchaser will be an independent competitor. The Division's form consent decree provides, for example, that the merged entity cannot finance the sale to the purchaser. Similarly, the Division is generally skeptical about supply

contracts between the merged entity and the purchaser, as well as any other arrangements that tie the purchaser to the merged entity, although there may be circumstances in which such arrangements are warranted. Our concern is that, if the purchaser is dependent upon the merged entity for critical products or services, there are two risks: (1) the merged entity may seek to influence the behavior of the purchaser by manipulating price or supply of such products or services and (2) the purchaser may pull its competitive punches for fear of antagonizing the merged entity.

The Division has, on occasion, refused to approve a purchaser unless and until changes have been made in the terms of the divestiture to assure that the purchaser will be viable and independent. While the Division does not (and should not) seek to ensure the success of a purchaser, it must be confident that the divestiture will remedy the competitive problem that it is intended to fix.

The Division and the FTC have jointly developed Merger Guidelines that describe the substantive considerations for analyzing mergers. "The unifying theme of the Guidelines is that mergers should not be permitted to create or enhance market power or to facilitate its exercise." Merger Guidelines 0.1. As suggested by the language of Section 7 itself, we usually start by seeking to define the relevant product or service markets ("line of commerce") and geographic markets ("section of the country") in which the parties to the merger compete, and then determine whether the merger would be likely to lessen competition in those markets.

The purpose of this inquiry is to ascertain whether, with respect to a product or service offered by the merging parties, there are alternative products and services to which customers could reasonably turn if it were assumed that the merging parties were the only suppliers of the product or service and sought to increase prices. Once relevant markets are defined, we look at various factors in order to determine whether the merger is likely to have an anticompetitive effect.

In performing this analysis, the Division considers both the post-merger market concentration and the increase in concentration resulting from the merger. As a yardstick for concentration, we utilize the Herfindahl-Hirschman Index ("HHI"), which is calculated by summing the squares of the individual market shares of all the participants. The Division will presume that mergers in highly concentrated industries that produce more than a small increase in concentration are likely to create or enhance market power or facilitate its exercise, unless other factors, such as the prospect of entry by other firms, make that unlikely.

We apply this basic approach to analysis of air carrier mergers. In this industry, the definition of product/service market and geographic market converge: relevant airline markets are likely to consist of scheduled airline service between a point of origin and a point of destination, generally referred to as city pairs. This market makes intuitive, as well as economic, sense. A passenger desiring to fly from Washington to San Francisco for a business meeting or a vacation is unlikely to regard a flight from Washington to Minneapolis as a reasonable alternative in the event the fare from Washington to San Francisco is increased. Thus, we should be concerned about a merger that significantly raises concentration levels in city pair markets.

The relevant market may, however, be narrower than all scheduled airline service in a city pair. Carriers can serve a city pair market on a connecting basis or a nonstop basis. If the only available service offered by carriers in a city pair is connecting service, there may be various routes that passengers regard as reasonable alternatives and from which they will choose based on fare, elapsed travel time, and other factors. However, there are many city pairs that are served by some carriers on a nonstop basis and others on a connecting basis, which poses the following question: is a passenger who is able to take a nonstop flight likely to regard connecting service as a reasonable alternative, such that he or she would switch from nonstop service offered by one carrier to connecting service offered by another carrier if the first carrier raised its fare?

Chances are that passengers traveling for leisure—on vacation perhaps—are more likely to consider switching; their demand is said to be more elastic. However, passengers making business trips are significantly less likely to regard connecting service as a reasonable alternative—they are often in a hurry and may place a higher value on getting to their destination in a hurry—so that a carrier offering the only nonstop service has power to raise fares without losing these passengers to another carrier's connecting service. Thus, there may be circumstances in which a merger will be competitively problematic because of its impact on nonstop service in city pair markets, even if other carriers provide service in those markets on a connecting basis.

Therefore, in considering the antitrust implications of a particular merger, the Division looks at the effect in all city pair markets served by both of the carriers in-

volved in terms of (1) nonstop service and (2) nonstop and connecting service. We have found—not surprisingly, given the operation by carriers of hubs in the post-deregulation world—that the mergers most likely to be problematic are those between carriers with hubs at the same airport or at airports in the same metropolitan area. These carriers are likely to serve many of the same city pairs and, especially in spoke markets, they may be the only two carriers, or two of a very small number of carriers, providing service.

That is not to suggest, however, that mergers between carriers that do not have overlapping hubs may not also present problems. Carriers with hubs in nearby cities are often the dominant carriers—usually on a connecting basis—for a significant number of city pairs in their region. And even when carriers' hubs are substantial distances apart, it is often the case that they are the only two carriers providing nonstop service between their respective hubs.

The Division has challenged, for example, the acquisition by Northwest of a controlling interest in Continental, even though the carriers do not operate hubs at the same airports. Our complaint alleges that the acquisition would lead to higher ticket prices and diminished service for millions of passengers, especially those traveling on routes dominated by the two airlines. Northwest and Continental are each other's most significant competitors—and sometimes the only competitors—for nonstop airline service between cities where they operate their hubs.

Once overlapping city pairs have been identified, the Division looks at the number of other carriers serving each of the markets and at the nature of that service, often by resorting to data that carriers report periodically to the DOT. This allows the Division to calculate market shares and focus further analysis on those city pairs in which pre-merger concentration levels suggest that the post-merger structure would be conducive to the creation or enhancement of market power.

As the Merger Guidelines indicate, however, the analysis does not end there. Pre-merger market shares are a useful tool for predicting future market shares of the incumbents in a market, but they do not take account of the possibility of entry by additional competitors. The prospect of potential competition can constrain the ability of incumbents to raise price or reduce output below a competitive level.

Indeed, the possibility of potential competition was the linchpin for many of the DOT's decisions approving mergers between carriers. Potential competition, it was said, could be relied upon to discipline carriers, even those with dominant market shares: if a dominant carrier sought to raise fares above competitive levels or reduce service below competitive levels, new carriers could easily enter, especially if they already had some operations at the affected airports. Airplanes were the quintessential mobile asset, it was said, and ground facilities could be easily leased or subleased. Knowing that noncompetitive behavior would attract entry, it was claimed that dominant incumbents would price competitively and offer competitive levels of service. Hence, the DOT reasoned that market shares—and the presumptions of market power that accompany them—were of relatively little use in airline merger analysis. The airline industry became the poster child for contestable market theory.

The Division does not subscribe to this entry analysis. It simply does not conform to the facts in a post-deregulation world consisting of hub airports. For all of the reasons I mentioned earlier, hub economics are powerful. In these circumstances, carriers with comparable cost structures to the hub carrier generally find it unattractive to take on the hub carrier head-on. Entry by a major carrier on a point-to-point basis into another carrier's hub has become very much the exception. Thus, the hub carrier dominates city pairs it serves directly from its hub, except routes to cities that are hubs for other carriers, in which case the two carriers providing hub service dominate. And without substantial actual competition, hub carriers charge higher fares to local passengers than they do in more competitive markets.

This does not indicate that entry into a carrier's hub is impossible. Carriers with low costs (known as low-cost carriers or "LCCs") may be able to enter profitably, even with point-to-point service. But such entry has tended to be gradual and limited. Under our Merger Guidelines, the Division considers whether entry into the affected markets is so easy—in the sense that it would be timely, likely, and sufficient in its magnitude, character, and scope—that it will likely deter or counteract the anticompetitive effects. For a merger between major air carriers with substantial overlaps in markets in which they are the dominant providers of service, it is unrealistic to expect that the prospect of potential competition can fully address the competitive concerns.

Finally, the Division will consider and take into account airline-specific business practices and characteristics that can affect merger analysis, especially those that differ from most other industries. Airline fare data is available instantaneously not only to consumers, but also to the airlines themselves, which can act as a disincentive to fare reductions. Airlines frequently propose general or system-wide price in-

creases, which may be more likely to "stick" as the number of major carriers diminishes. Carriers have developed loyalty programs that tie passengers and travel agents to them at their hubs, making entry into those hubs more difficult. And airlines apply sophisticated computer modeling techniques and ticketing restrictions to identify passengers to whom they can charge higher fares, a form of price discrimination. The Division will consider these and other factors in seeking to determine whether any proposed merger threatens to substantially lessen competition.

Conclusion

Mr. Chairman, competition in the airline industry is critical for the millions of people who depend on air travel in their business life and in their family life. If the Division concludes that hub carriers are engaging in collusive or monopolistic conduct, or that any proposed air carrier merger threatens to deprive consumers of the benefits of competitive air service, I assure you that the Antitrust Division will take appropriate enforcement action.

Mr. Chairman, this concludes my prepared remarks. I will be happy to answer any questions that you or other members of the Committee may have.

The CHAIRMAN. Thank you, Mr. Klein.

By the way, I think the competitor Western Pacific later went out of business; did they not?

Mr. KLEIN. Several of these have gone out of business, because what happens is that the dominant carrier essentially floods the market and they then sell you a Cadillac for the price of a Chevrolet. As soon as they take the Chevrolet out of the market, they raise the price back to the prior levels. That is what I think the problem is.

The CHAIRMAN. Literally driving them out of business.

Mr. KLEIN. In that case specifically, yes, sir. But that is not unique. That has happened quite frequently.

The CHAIRMAN. Professor Kahn, we always greet you with affection and appreciation and respect. I know that all too often this Committee has called on you for advice and counsel, and we appreciate the fact that you have made yourself available over the years. I thank you for being here today.

STATEMENT OF ALFRED E. KAHN, PH.D., ROBERT JULIUS THORNE PROFESSOR OF POLITICAL ECONOMY EMERITUS, CORNELL UNIVERSITY

Dr. KAHN. Thank you, Mr. Chairman.

The CHAIRMAN. Would you pull the mike up.

Dr. KAHN. Am I audible?

I am sure of course it is customary for people appearing before committees such as these to say that they are honored to do so. I am sure half the time they are lying.

[Laughter.]

The CHAIRMAN. At least.

Dr. KAHN. I am not lying. I regarded your invitation to appear and to appear with Mr. Klein as a command, and of course I am delighted to be here.

I will not spend any time now assessing the results of airline deregulation. There may be an opportunity to do that later. I do think we should recognize that if a comparison of some relatively short distance fares with long distance fares produces such results as the $279 to Munich and the $700 to South Carolina, remember, we produced the $279 to Munich, too.

But I will set that aside. There was never any question in my mind that as we deregulated the airlines the antitrust laws and

other policies bearing on competition would become progressively more important. I think there have been lamentable failures to apply the antitrust laws to mergers in the past. I am delighted to see that this Department of Justice is going to examine many of those.

There are at least three headings of major antitrust issues, about all of which—well, about two of which I have testified at some length. I have sent you a letter. I have testified before the antitrust committees and the House Judiciary Committee. One is the issue of predatory pricing or predatory responses, and I want to use the word also unfairly exclusionary responses in order to emphasize that the Department of Transportation also has jurisdiction in this area, just as the Federal Trade Commission has concurrent jurisdiction with the U.S. Department of Justice in the rest of the economy.

So I applaud the efforts of the Department of Transportation. I think this is a real problem. Getting rules that are both correct and enforceable is extremely difficult. I have in fact made some proposals in past testimony to other committees and would be happy to put them in the record.*

So number one, predation or exclusionary conduct. Second, of course, mergers. I do not have any wisdom to add to the letter I sent you about the United Airlines merger. I do think in our approaches to these mergers it is important to take into account the effect on potential competition, upon which we relied very heavily in deregulating and depending upon competition. That is particularly with respect to the most troublesome aspect of the performance of the airlines, which is the 6% of all travel—please bear that in mind; it is 6% of all travel—that is at full fares.

While the average fares have since deregulation, inflation adjusted, gone down 40%, full fares, paid by only 6% of the travelers, full fares have gone up, inflation adjusted, by 70%. So that is why we are particularly concerned, as Mr. Klein has said, on entry to challenge those high fares and making sure that it is not subject to predatory responses.

In the case of the United merger, I have not made up my mind. I do not know enough of the facts about the merits of the merger. But I do, as I emphasized in your letter, point out that potential competition, the presence of somebody at one hub or another end of a journey but not yet on the particular route, is a disciplining factor. To the extent that United's union with US Air eliminates that potentiality of competition, that has to be taken into account. In particular, if, as I understand to be the case, United feels strongly that it needs a strong hub in the Northeast, just as American does, well, that means to me that it is a potential competitor of US Air and that the consumer might be better served by saying: If you do not buy the only other hub in the Northeast, build your own. So it is that potential competition that is also embraced, or should be, by the antitrust laws.

The third subject has not been mentioned and I have only become aware of it, and again I assure you I have not made up my mind about it, but I am sure that the Department of Justice will

*The information referred to was not available at the time this hearing went to press.

be paying attention to it. That is the joint venture of all the major airlines to set up their own collaborative web site for information and booking of tickets, the Orbitz case.

Now, it is certainly arguable that only with an industrywide agreement to file all the fares, including all discount, all available fares, can you get the kind of universal useful means to people who are price conscious and want to use the Internet, and that as reasonably connected with that joint venture it might be argued that the members all have to agree then that they will give all their cheap fares to that Orbitz venture.

In terms of the antitrust laws, it might be argued that this is a reasonable joint venture and that reasonably ancillary to that is an agreement where everybody will supply all their fares to it.

But the other side of that coin that I think has to be looked at very carefully is what happens to the willingness of major carriers to compete with one another if they must by agreement disclose all their secret discounts, because a large part of competition consists in big buyers or big distributors, like Travelocity and, what is the other, Expedia, making special deals with airlines and then pushing their discount sales.

So number one, that is a real question in my mind whether, even if their intentions are the best in the world, simply to compete with other methods of distribution—and travel agents do not deserve protection from competition, so you can say this is competitive and provides a more perfect market. But what will it do to their willingness to compete with one another when they must disclose every discount they give?

Second, you want to ask the question, what about the competition of low-fare carriers? What do they feel about this? The organizers of Orbitz say that they will all be able to list their flights on equal terms, but that also means that they then are required to disclose all discount sales. So I would have the Committee, if you look into this, talk to those low-fare carriers.

I observe that Southwest is opposed to the venture. Now, you may say Southwest is Southwest, it is unique and it uses its own web site. But I think there is at least a strong possibility that the other small airlines will feel that they have to join the venture in order to get their flights listed, but it will deny them one of the major methods by which they compete, by making special deals with other comprehensive web site agencies like Travelocity.

So we do have these three areas, and of course there are others, bearing on the issue of hub dominance, about which we are all concerned. I should point out that it has clearly been demonstrated that there is a premium on fares in and out of hubs on medium flights that originate or terminate at the hub. Competition in the longer run, over the longer hauls, is between carriers over different hubs.

Several years ago I looked to see how many carriers a traveler in Boston had, how many choices of going to Phoenix. It had nothing to do with you. It was just simply that it was Phoenix that I looked at. There were nine separate choices. That is, you could go via Delta over Cincinnati, Delta over Atlanta, American over Dallas, American over Chicago, US Air over Pittsburgh, TWA over St. Louis and so on.

If these consolidations in the industry occur, that nine will go down to I think four. So we must be concerned even over the long hauls, which are giving us the low fares, which are giving us the $279 to Munich, for which I want to take some credit while getting beaten over the head that I had to pay almost $700 between Ithaca, New York, and Washington, and that includes my 10% discount for the advanced state of my decrepitude.

So I think there is a genuine basis for concern. Specifically on the override commissions, I went to the assistant attorney general in a previous administration and said: This seems to me to violate the Clayton Act. It amounts marginally to a commission of 35–40% on incremental sales that you take away from small carriers, and I said, should you not think about applying section 3 of the Clayton Act, which prohibits giving people special deals to induce exclusive dealing.

Well, these I think are the major areas. I should mention one other one, however, that has a great deal to do with my delay today, although my delay was not really so much in the air; it was in Washington, D.C.—a taxi driver who did not know where Capitol Hill was, and that is genuinely the case, let alone the Russell Building.

But another very important factor bearing on competition and the adequacy of it—and I gave speeches back in 1977 and 1978 about this to DOT—is the insane way in which the government provides infrastructure to this industry. It clearly has fallen behind technologically. What we clearly have to have is some sort of autonomous corporation which can raise its own capital.

It is the shortage of airport capacity and air traffic capacity that is one of the problems. You know you can give a parrot a Ph.D. in economics by teaching it to say "supply and demand." Excessive congestion means that our institutions for providing additional supply are defective and it also means that we are not controlling demand by pricing correctly. What would happen—airplane landings are charged by the pound. Well, what would happen if you charged for Old Master paintings by the pound? You would sure as hell have a lot of congestion at various places where Van Gogh paintings are available.

We ought to be pricing intelligently so that the people to whom it is important to fly to congested airports at peak time pay the congestion costs that they are imposing on everybody else or the cost of expanding capacity that they necessitate, and correspondingly that bargains be made available, negative landing fees, if you wish, competition between airports.

In Europe you are now seeing a great deal of competition by underused airports, like Luten and Stansted, attracting low-fare carriers in order to take business away from the major carriers that patronize Heathrow and Gatwick. Well, I think that is a fit subject for this Committee to look into, the way in which we both supply, increase the supply, and price access to the infrastructure.

With that, I thank you again for the opportunity to appear.

PREPARED STATEMENT OF ALFRED E. KAHN, PH.D., ROBERT JULIUS THORNE PROFESSOR OF POLITICAL ECONOMY EMERITUS, CORNELL UNIVERSITY

Before proceeding to a listing of the major antitrust issues in the industry, I emphasized the importance of another factor that poses severe obstacles to competition in airline markets—the way in which we are organized to provide and price access to infrastructure—specifically air traffic control and airport services.

I then identified, as the three major current antitrust issues,

1. the identification and prevention of predation or unfairly exclusionary conduct;
2. mergers; and
3. the Orbitz venture.

All of these, I pointed out, are extremely difficult to resolve, even in the context of specific cases; about none of them am I in a position to offer firm conclusions; but all clearly deserve intensive investigation by the antitrust enforcement agencies and, in the case of predation, the Department of Transportation, which has explicit statutory authority in that area comparable to that of the FTC in the rest of the economy.

Since I had already presented testimony on the first two issues before three committees of Congress during the last few months, I proposed to concentrate on the antitrust questions that the Orbitz venture seemed to me to raise, with the qualification, once again, that I am not in full command of the facts and therefore am not in a position to offer a final judgment.

Orbitz is, as I understand it, a joint venture of all the major carriers—assertedly open also to all other airlines on equal terms—to provide universally comprehensive, competitively neutral, instantaneously available information about all available fares and flights (except, I understand, so-called E-fares) in a convenient form for immediate access over the Internet to travelers, in direct competition with other such Internet booking media as travel agents generally and such companies as Travelocity and Expedia, in particular.

At first blush, this appears to be—and could well be—entirely beneficial to consumers, offering travelers comprehensive market information in competition with other information—and ticket-distributing mechanisms, which have no entitlement to protection against competition—provided it is efficient and fair.

Moreover, for such a venture to provide this valuable service, it would or might appear necessary for the participants to commit themselves to (a) make all their lowest fares and inventories available to Orbitz (except, as I understand it, the E-fares offered by the carriers on their individual web sites and acceptances of Priceline bids, which are not regarded as posted prices), and, as a corollary (b) to make no special deals of ticket and seat offerings with other booking agencies that are not equally available to Orbitz (i.e., to give Orbitz "most favored nation" treatment). Such undertakings would appear on their face to be essential for the venture to succeed—that is to say, in antitrust terminology, reasonably ancillary to the success of a legitimate joint venture.

Orbitz also, however, raises inescapable antitrust questions—specifically, whether such a collective undertaking by all the major carriers, however reasonable on its face, may also be anticompetitive, in either *intent* or likely *effect* (to use the criteria pertinent to a rule of reason evaluation under the antitrust laws—that is, intent or effect) it poses threats to competition (a) among the participant carriers, (b) by outside, more typically low-cost low-fare non-major carriers, who have played a disproportionately important role in bestowing on travelers the benefits of price competition, and/or (c) in the distribution side of the business—i.e., to competition between Orbitz and other Internet booking agencies.

(a) As for the first, there is the familiar fact that in an oligopolistic industry, the negotiation of special, preferably secret deals with large buyers or distributors in a position to threaten to supply their own needs or take their business elsewhere is a particularly effective form of competition, reflecting an exercise of countervailing power on the buying side of the market, in an oligopoly whose members will typically be reluctant to cut prices openly and across the board; and that the prohibition of any such special deals or a requirement of their full disclosure and equal availability, in advance, to all comers, will discourage it. So the very jointness of the venture and the ancillary commitments of its members (as I understand) not to enter into any special exclusive promotions with independent distribution agencies and/or openly to disclose their lowest available fares (except, as I understand it, E-fares) to their rivals—which may in a sense be essential to the venture—

may justify the inference of anticompetitive intent or, whatever the intent, an anticompetitive effect among the partners.

(b) What about the independent airlines, which typically compete more heavily on the basis of price? Orbitz will evidently be open to them on equal terms, free—as Mr. Katz has testified—of the onerous booking fees charged by CRSs. I urge the Committee to hear their views. I was struck by the fact that Southwest Airlines not only does not want to join but openly opposes the venture. This might be simply because Southwest, being virtually unique in its ability to compete on its own, will not feel it has to join: it points out that its own web site is enormously popular and saves it 80–90 percent of the cost of selling tickets in other ways—and does not want to see its competitors be strengthened in their ability to reach travelers who seek the lowest possible fares. On the other hand, the history of the last 20 years demonstrates that when Southwest speaks, consumers do well to listen.

I urged the Committee and the antitrust agencies also to probe the view of these other, far less well-known low-fare carriers. Orbitz claims it will improve their access to the market. On the other hand, it seems to me possible that they feel, on the one hand, compelled to join Orbitz in order to have equal access to the market but also fearful that in so doing they would have to give up the right to make special promotional deals with non-carrier-owned Internet distribution agencies, and so be impaired in their ability to compete effectively.

(c) As for competition among Internet booking agencies, such as Travelocity and Expedia—they emphatically claim (1) that they will *not* have full access to Orbitz' low fares and low-fare inventories, and (2) that they compete in part precisely by making special, *exclusive* promotional deals with individual carriers, which the commitments of its members to Orbitz would preclude.

If these last claims are correct, the Orbitz venture takes on the aspect of a group boycott of competitive distribution agencies, which should I think be illegal per se under the antitrust laws and flatly impermissible. While an *individual* seller may well have the right to resist the "commoditization" of its product—as I understand at least one of the Orbitz organizers has characterized its purpose—by setting up its own distribution system, it is and should be contrary to the antitrust laws for carriers to do so collectively. The other Internet booking agencies claim that one important way in which they compete—and, by so doing, put pressure on the carriers to compete as well—is, precisely by making special, exclusive promotional deals with individual airlines; if indeed the commitments of its several members to Orbitz would preclude such deals, the venture would clearly weaken competition—not only at the distribution level, but even more important, among airlines themselves.

I concluded by expressing my regret that I have in my testimony on these antitrust issues been unable to offer definitive judgments of particular cases; I expressed the hope, however, that I had helped the Committee understand the essentiality of the antitrust agencies investigating them, and of Congress giving them the means to do so.

The CHAIRMAN. I thank you again, Professor Kahn, and we appreciate you taking the time and effort to join us this morning.

Mr. Klein, obviously any question that is inappropriate given what is taking place in the Justice Department, I fully understand any reluctance you might have to respond. When evaluating a merger acquisition, do you consider the risk of further industry consolidation or is each case considered solely on its own merit?

Mr. KLEIN. Ultimately, Senator, we consider each case on its own merits, and we have found that that is the most effective way, that even though you can see industry consolidation move across an industry, there are some consolidations that raise a different competitive mix of issues than others. Actually, we went through this when we saw a six-to-five merger in the big accounting firms with the prediction that it would go to six-to-three, and actually there was a second merger that was ultimately abandoned because it raised, I believe, different competitive problems.

Of course, as we look at the industry and we look at the strategic arguments that are made, we cannot help but think of what the implications will be across the industry. But in the end, if we go to court under section 7 of the Clayton Act, it will be on the specifics of any particular merger.

The CHAIRMAN. The reason why I ask this is obvious, because the concern now is, look, you have got one merger and there is concern on consolidation or domination of hubs in the Northeast, et cetera. But every analyst that I know of has said if this merger goes through there will be the other two and we will end up with three instead of six major airlines. The implications of that are dramatically more impactful than just the United-US Air merger. That is why I ask the question.

DOJ has taken a very high profile role over the last few years in promoting air fare competition. Given the track record of the airline industry in opposing most of your Department's efforts, are you concerned that ventures such as Orbitz, which will be jointly owned and controlled by five of the major airlines, would have the effect of limiting competition and therefore increasing air fares?

Mr. KLEIN. As you know, Senator, we are currently looking at that particular venture and I think it would be premature for me to comment on the merits. I think you are right, we have been very vigilant in this area. When we looked at the airline computerized tariff publishing systems several years ago, an initiative actually started by Assistant Attorney General Rill during President Bush's tenure and then concluded under our watch, we did find information-sharing and fare stabilization, the kinds of concerns that led us to prosecute an action there.

As for this one, we will certainly take a hard look and evaluate the very kinds of arguments that Professor Kahn made in his opening statement. I know the Committee is as well concerned about this and I want to assure you that it is high on our radar screen. That does not mean we will take action, but it means that it will get the serious attention it deserves.

The CHAIRMAN. I thank you.

Professor Kahn, I understand your point about potential competition and I think that that is really the crux of the matter here. If we ended up with three major airlines, but there are new entrants that will be coming in—Western Pacific, AirTran and others—then it is one thing. But if they are precluded, such as, as I say, unable to compete because of the practices of the major airlines, then I think the scenario is rather different.

In your view, is the airline industry too concentrated right now?

Dr. KAHN. Certainly it is uncomfortably concentrated, particularly if you realize that markets are individual routes. I live in Ithaca. I am concerned about the availability of alternatives to me in Ithaca, and my alternatives are limited to one. Now, Syracuse is 50 or 60 miles away. When I was quoted the fare of over $700 before this discount, I asked my travel agent: Well, what if I drove to Syracuse, which is a way of escaping sometimes. And the fares there were identical.

So we do have a problem that most markets cannot support more than one or two carriers. The overwhelming majority of routes in the United States are served by only one or two carriers. That is

a degree of competition. What it does mean therefore is that we have to place reliance on potential competition, and that is the enormous importance of making sure that low-fare, low-cost airlines have equal access. They might not fly to Ithaca, but they might come to Syracuse and be useful to us there. That means access to airport facilities and we are back at that problem of the government's management of those facilities.

I would have to admit that we were overly optimistic about the efficacy of potential competition. I think we were just misled to some extent by the fact that airplanes can move. It is not like a steel plant. I remember saying that, that their main capital can move from one place to another. But certainly several studies of which I am aware show that potential competition, while it does exert a disciplining effect, still one competitor, actual competitor in the market, is worth three potentials in the bush.

So it means we must do everything we can to strengthen the potential of that competition, not only against predation but in terms of access to infrastructure, in terms of avoiding exclusionary practices such as you mentioned, Senator, and also encouraging the use of auxiliary airports for people who are price-conscious. That has proved to be really quite important in a number of European markets. I have just seen a study that is very influential. That is associated with the privatization of the airports where they compete with one another.

The CHAIRMAN. Well, we intend to have a hearing concerning the ATC. As you know, many in the industry put the responsibility on the failure of the ATC to modernize, and I think the privatization of the airports should be an issue that probably should be explored as well.

I do not have any further questions except just to make an editorial comment. We are hearing more and more from thousands of Americans about the delays and the inability to get from one place to another and the fact that the fares continue to go up. I understand the airlines are experiencing increasing fuel costs. I am not without sympathy that there is still a slot-controlled airport here that could handle much greater capacity if it was not for the NIMBY predominance here in Washington, D.C., including the continued home-towning on the part of *The Washington Post.* I am always pleased to be mentioned every Saturday in their editorial.

But the fact is that I believe that what we are discussing today is of the utmost importance. I think it was well you pointed it out, Professor Kahn, that we need more runways and we need more concrete, we need more terminals, we need an updated and modernized air traffic control system as well.

But if only three major airlines are flying to those places, then I think that all of those efforts may not provide as much benefit to the consumer as this issue raises.

Senator Hollings.

Senator HOLLINGS. Well, right to the point, I am worried about just one airline flying, not three. I have already got the problem of one airline. Dr. Kahn, let us get right to the expression you just used, whether or not a community would support airline service. Now, we started off in the Constitution to promote the general welfare, and in accordance thereof in telecommunications we have

what you call the Universal Service Fund. You know communications better than anybody else in this room, and it would not support putting a communications line to Roundo, South Carolina, or up to another little community here, there, or yonder. But we do, because we have got that universal service, we put in the REA because it ordinarily would not support running a line all the way to get electrical services, let us say to Hilton Head, in the original days. That is why it is served this minute, the richest place in my state, is served by the REA. Of course, the private crowd now wants to buy it out. But the REA were willing to serve it.

The mistake we made, General Klein and Dr. Kahn, is that we did away with you, we did away with the CAB [Civil Aeronautics Board], Dr. Kahn. We should have maintained it. Now, we have maintained the Federal Communications Commission so that they can administratively oversee. Right to the point, they go and they look at Bell Atlantic taking over Nynex and these other mergers and they oversee whether or not they have complied with the 14-point checklist, and just about, let us say, 12 and a half items, they have got one and a half more to go, they said it is in the public interest that we go ahead and approve it and not be picky and legalistic. So they are now enforcing that particular merger—and that is good, because they can get into long distance and everything else.

But you see, we do not have a CAB overseeing, and you go to the Civil Division, more or less, the Justice Department. You have got an Assistant Attorney General where he believes it is a crime almost. And he does not have that flexibility about the public interest. To him it is either categorically, monopolistic or predatory, and he does not have that maybe grey area about public interest.

What befalls you, General Klein, is you have got to supplant for CAB because you have got right this minute 16 antitrust cases that you are not enforcing, namely 16 carriers' control over 50% at different hubs, the comings and goings at those hubs. If I were king for a day and had your position and the money, I would immediately tell the staff, let us get all 16 of them, because there is no question that they have predatory practices.

We have seen it down there in Dallas-Fort Worth. We have had it testified before here in Detroit-Philadelphia with Northwest. They immediately put Spirit out. They increased their flights 15%, met the price, and then quadrupled or raised the price ten times after they put them out of business.

So our frustration is that we just do not have the CAB as we have the FCC to carry through on these merger decisions, where we do not just have to stand like the police cop, saying red or green. There ought to be a caution light for this particular industry.

Otherwise, in addition to the hubs, which we ought to do, you are right, Dr. Kahn, there are cheaper prices, but is it in the public interest that 85% of the small and medium-sized airports in America should subsidize the 15% long hauls? That is why it is lower. Nobody is going into the long haul unless they have got the subsidization down here in small and medium already in force. So there is less and less long haul because they do not have the subsidization.

As to slots, I used to practice before the CAB. The community built the airport, put up the tower, paved the runway, and then they got Captain Eddie Rickenbacker and said: Now, can you bring us service in here? And then we would come before the CAB and we would say we would get so many flights for so much, generally speaking, and that would be approved, and I would have those slots and have that service.

Now what we have is one of the greatest leaders against pork who is now oink-oinking for pork. Namely, he wants slots, and we are going to politically assign them around, not on the public convenience and necessity, but on the political power. You have got this whole thing about deregulation askewed. It is a mess. I am a born-again regulator. I wish we could go ahead and get back to where we were, because it was working good. It was theoretical that we were going to get more and everything else like that. Everybody was making money, the flights were there, and everybody was happy.

But we came in with this theory. I go, General Klein, to the question that the distinguished Chairman asked. That is the problem. If you go ahead and approve the United-US Air, then you got to approve all the rest. So it is not just that one. It is a precedent-setting job. As Senator Rockefeller says, most of us that have looked kindly on that particular merger are saying it cannot get worse, until I read in my paper now that United is even worse than US Air, and so we will worry about it.

Could either one of you comment? I know that is not a question, but I wanted to get those hubs. You have got to immediately break up the hubs. That is predatory. We know it is predatory. It is antitrust, and we do not have an administrative body like the CAB to do it. The Antitrust Division has got to do it.

Second, on these slots and everything else, let us go back to the communities rather than having the airlines assume they own them and sell them back and forth and everything else like that. The ones that we got, the ones that I appeared before the CAB to get, ultimately got in the hands of Air Florida. They crashed out here on the bridge and they immediately sold them. It had nothing to do with the community, nothing to do with their success, but their failure.

I thank you, Mr. Chairman. If anybody wants to comment.

The CHAIRMAN. Thank you very much.

Any comments?

Dr. KAHN. Well, it is a little hard to know where to begin, sir. One could make in every case a plausible argument for retaining regulatory supervision and scrutiny, but as you yourself point out, the assignment of slots by an administrative agency immediately introduces political influences and pressures.

I have been very critical of the FCC because, apart from its correctly enforcing the Telecommunications Act, it does not want to take its hands off. It uses the occasion of approving mergers to say you have got to do all sorts of good things for poor people—the way to take care of poor people is the way Congress did—or rural areas.

I was specifically asked in 1978, what did I think if we had an essential air services program that would be taxpayer-financed and it would provide service so that no community that had certificated

service before deregulation would lose it. That program as I understand it when I checked perhaps ten, 12 years ago was a complete success in explicitly saying, we have an interest in serving rural areas and it will not be done in a competitive market, so we, Congress, will set up a system that will put it out for bids and we will see that that service continues to flow.

But the idea of a government agency assigning slots—there was an interesting case. They assigned slots to Reno Air, which was a low-fare, low-cost low-fare carrier. Within two years, Reno was bought by American Airlines and now American Airlines has those slots. The notion that those slots should belong to anybody is ridiculous. The value of those slots is the value of the scarcity of the facilities, and we have got to have some institution that takes care of the scarcity by increasing capacity so the slots get—use the high revenue in order to increase capacity. Well, that has got to be under a private sort of motivated venture. It is never going to be done under a government-controlled aegis.

So I do not really think more regulation is the solution. I think making competition more effective and the government doing its job of supplying infrastructure.

Senator HOLLINGS. But bottom line, the Universal Service Fund in airline affairs is in my price of $896. But rather than going to serve North Dakota, because I can tell you now, as you said, some fields will not support that service, and I do not think Senator Dorgan can prove that it will support it. But if you had, instead of subsidizing the long hauls so they could serve the champagne and movies and filet mignon and all that kind of stuff, on the contrary public convenience so we could serve Bismarck, North Dakota—the money is being put up by the public, but it is being skewed to big moneymaker places, and it has gotten so out of kilter now so that Steve Wolf, who comes and testifies for this particular merger of United and US Air, says: I have either got to go monopolistic or I have got to go bankrupt. Now, that is a pretty sorry result of deregulation.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, sir.

Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman.

Both of you have been excellent. I would like to start, Dr. Kahn, with essentially what your goal is at this point in terms of competition and antitrust, because my sense is that what consumers want in real markets in the real world is a choice of carriers and they do not have it. It seems almost as if it is not even being articulated as the current goal.

United CEO James Goodwin came to this Committee recently and he said that a particular benefit of the United-US Airways merger is that Charlotte would offer a competitive alternative to Delta's hub in Atlanta. Now, I am not going to dispute that there is some benefit with respect to this hub competition, but it seems to me that what consumers want in both Atlanta and Charlotte is a real choice of carriers.

What is your sense about where antitrust really ought to be going here?

Dr. KAHN. Specifically first, I am reluctant to give conclusions that I am not in a position to reach about that assertion about Charlotte. But Charlotte does compete with Atlanta and on longer flights that can go over either Charlotte or Atlanta customers do have the benefit of competition.

I do not at the moment see how United joining with US Air in Charlotte increases those alternatives. Now, there may be arguments that the combined carrier can provide better service in ways that I cannot at the moment see. But second, we inveigh against the monopoly power that is conferred by hub dominance, but I think we make a great mistake if we think that hubs should be broken up, as it was said.

Hubs are an extremely efficient way of delivering air service. If it were not for the Pittsburgh hub, my service at Ithaca would be much worse than it is now, because I can go from Ithaca to Pittsburgh and go anywhere in the country by noon. One of the reasons that hubs are something like natural monopolies is that the carrier that offers the greatest number of convenient flights to the greatest number of destinations on short- and medium-haul flights is the carrier that business travelers mostly will want to patronize.

It is very hard to have two-carrier hubs. Look what happened to Continental and previously Frontier at Denver. So the hub and spoke system is extraordinarily efficient and there are ways of demonstrating that, that you can get—out of the same number of planes, you can get a multiple number of origins and destinations.

But clearly, the practices that augment that hub power is the function of antitrust laws to get at. Practices that discourage competition among carriers, as the Orbitz venture may do, are the kind of thing that antitrust could get at. Predation, where people come in and can offer a different kind of service, they do not pretend to offer the entire range of convenient origins and destinations, but they will offer real price competition on hubs—there are difficult questions in weighing the fact that competition does consist in part in responding to competition and you do not want to totally prohibit that, against the danger of discouraging real price competition.

But I do not know how to operate at the structural level.

Senator WYDEN. We have got a fair amount of evidence that fares can be significantly higher at the fortress hubs, where you have got one carrier, for the reasons that we have been talking about. Sometimes a ticket to a hub city costs less than a ticket that goes through the hub but then continues on to a second city. Do you have any problem with this pricing practice? Should we, should the Congress, be restricting airlines' ability to do this?

Dr. KAHN. I am sorry, I did not completely follow. Restrict their ability to respond to that competition?

Senator WYDEN. Yes. I mean, as we do in our passenger bill of rights legislation, we would address this pricing practice by allowing the passengers to use tickets as they see fit, including using partial tickets. Of course, the airline industry is up in arms about that as well.

Dr. KAHN. Well, I know Harry Truman used to go to bed every night praying for a one-handed economist. The practice of price discrimination is not in itself bad. For one thing, a lot of it is not real-

ly discrimination. It is charging more at peak times when there is a shortage of seats. If you want to get discount seats, you find you can get them when a lot of planes are empty. You will not get them when they are full. That is OK because that is saying that at the time of peak travel is more expensive and you should pay more, and we should offer people to whom money is more important than time the opposite alternative.

So price discrimination is not in itself bad. In fact, it makes it possible to use bigger planes. If you can sell some of the tickets at full fare and then fill the empty seats, that is not bad. So to the extent that the airlines have these "you cannot use a half of a ticket" and so on, to some extent that is a way of protecting a structure that benefits both the people who get the convenient service, larger planes and more frequent flights, and the people who take advantage of the discounts.

I think we have got to do something that is more pinpointed at what is really predatory, really destructive of competition. My own suggestion has been that—I do not know at what length you want to go into this, but the Department of Transportation has been trying to develop rules that say if you deliberately take losses by foregoing responses where you could make more money, then we will assume that that taking of losses is a sign that your intention is predatory.

Now, the idea of a government agency deciding whether the carrier had other alternatives and weighing them and saying you could have taken this more profitable alternative than that, would raise my hair on end if I had any. But I think the thing to do is to put it in the hands of the carrier, say to the carrier: If you come down and meet competition and the competitor is driven out, then you must hold those frequencies and those fares for two years. That leaves it to the carrier to decide whether the offer of these striking reductions is only temporary and is worth it only on the theory that they will drive people out or they can live with it.

Senator WYDEN. The only trouble I have with that is what we have done in passenger rights. I mean, we have left it to the carriers, and what we have seen after their voluntary pledges is that complaints are way up and they have really not acted meaningfully. That is why a number of us are reluctant to leave it to the carriers.

Dr. KAHN. Well, there is nothing voluntary about my suggestion.

Senator WYDEN. Oh, I did not understand that. I heard you say leave it up to the carriers, and I appreciate your saying it ought to be required.

The last point I wanted to ask you is, I am very dubious of this Orbitz venture. It just strikes me as a sort of glide path toward collusion and anti-consumer activity. But I wonder if you think there are any safeguards that could be required that might make Orbitz a venture that would not be abusive?

Dr. KAHN. I am really very reluctant to talk in an area in which I read the testimony of the proponents of Orbitz, I have read some of the objections to it. I think it is inherent in the venture itself that all its members must post all their fares, all their special discounts and low fares, with Orbitz. Otherwise it has no reason for existence. So a provision, an obligation undertaken by the members

in order for Orbitz to do what it wants to do inherently I think involves the danger that it cuts off secret discounting, which is the way in which you get competition, and inhibits the ability of other big independent agencies like Travelocity to drive hard bargains and exert countervailing power.

So at the moment I am not saying I am for it or against it. I truly do not know.

Senator WYDEN. A last question, if I might. If someone told you back when this whole debate began with Senator Hollings and others that we would end up with the significant prospect of just three airlines calling the shots in America and dominating this critical sector, would that have been acceptable to you?

Dr. KAHN. No. No, it would not.

Senator WYDEN. Why not?

Dr. KAHN. Because, first of all, you are talking about three airlines nationally. That means that in many local markets you would have a reduction in the numbers from two to one. I noticed that the complaint of the Department of Justice against the Northwest-Continental joining points out that on many routes between their respective hubs, Minneapolis-St. Paul and Houston for example, they are the only two major carriers. So you are talking there on individual routes of going down from virtually two to virtually one.

So it would not be acceptable because it would mean, I think, excessive concentration and an even greater barrier to competitive entry.

Senator WYDEN. Mr. Chairman, I would wrap up only by saying I think that Dr. Kahn's answer is particularly important. It certainly in my view strengthens the arguments for passing the resolution that has just been introduced. I do not think that the American people are aware of the very real possibility that we will be left shortly with three airlines in this country. Your resolution at least gives us an opportunity to ring a very loud kind of warning bell over that prospect.

Dr. Kahn has now made it clear that he did not envisage or desire what we are faced with, and I think it is time to recognize that we are on the cusp of having that kind of air service in this country and the American people ought to know that is what we are facing.

I thank you.

The CHAIRMAN. Thank you, Senator Wyden. I believe that we plan on marking up that resolution through the Committee.

Senator Dorgan.

Senator DORGAN. Mr. Chairman, thank you very much.

Again, Mr. Klein, thank you for your service to our country. I think there is a lot of action that is needed to respond to what is happening in our country today. Someone mentioned the Federal Communications Commission. I would only say I have been looking at radio issues recently. There is a pending merger request that will mean one company will have over a thousand radio stations in this country because the Congress decided that there will be no limits on the number of radio stations you can own. What a foolish thing to do, but nonetheless that is where we are.

Mr. Kahn, I was a little disappointed to hear you suggest the hub and the spoke system is such a wonderful system. I am not certain that that will be the model in the long term. I mean, I am

not certain that point to point flying does not work in a number of cases.

Let me just describe to you where we were before you came to the Civil Aeronautics Board. Incidentally, I supported much of what you did. But let me tell you where it was in North Dakota. If you were living in North Dakota prior to you coming to Washington, D.C., to serve, we had five companies flying jets into North Dakota. We had Northwest, Western, Delta, Republic, and Frontier. All of them provided jet service to North Dakota communities, connecting us to three hubs, Minneapolis, Denver, and Salt Lake City.

Then we had deregulation and then we had Northwest as the dominant carrier. I happen to think Northwest is a good carrier. I like Northwest Airlines. They have good equipment. But they are a better carrier if they have competition. Every carrier is better with competition.

So we were connected to the Denver hub. You remember Western Airlines? Western Airlines used to fly champagne flights. All flights leave North Dakota at some awful hour on the morning, 5, 6, 7 o'clock in the morning. Well, Western would fly to Denver, among other things, and competed with Frontier, and they had a champagne flight. They would pour champagne in the morning flying to Denver.

Then after we deregulated, we had a 19-passenger little silver cigar with two propellers and no bathroom and no flight attendant and Dr. Pepper in a paper cup, and that was four stops on the way to Denver. So you can probably understand why a North Dakotan, for example, would say, gosh, I am wondering whether deregulation has helped us a whole lot. We had five different companies flying jets into our state and now we have deregulated and we have one jet carrier in North Dakota. Now we have just added a second, regional jet.

But my point is that we have a series of things that have happened that have created hubs and spokes with one carrier dominating the hub, which means that you will always have one carrier dominating the hub. In the old days you had a Denver hub, you flew on Frontier or Western to Denver and then got on United because there was code-sharing and interlining and then flew to Los Angeles, or you flew on Northwest to Minneapolis and got on another carrier to fly to New York, United perhaps.

So you do not inevitably have to have a hub and spoke system in which there are dominant carriers in every single hub. Yet that is exactly what has happened and what will continue, in my judgment, until we decide as a country we want something different.

Now, Mr. Klein has a role in all of this. The question is, are scope clauses fundamentally anticompetitive? I am referring to the scope clauses by which airlines reach agreement with their pilots that they will limit the number of regional jets so that a regional startup with a regional jet cannot happen because you have a scope clause in a labor contract? Is that anticompetitive?

How about override payments to travel agents? Is that anticompetitive? Or how about the screen on which a reservation is shown? When Frontier came back to North Dakota, with my help, to serve us with a 737 to Denver, they could not make it. You know

why? Because if you are in Los Angeles trying to plot a flight to go back out of Bismarck after a meeting, the fact that there was a jet going from Bismarck to Denver showed up on the third computer screen on the reservation system, not the first screen, not the second screen, the third screen. So guess what? The Los Angeles travel agent put them on a 19-passenger propeller with four stops going to Denver.

My point is this. This system is not working for rural areas. You know it, I know it, we all know it. It needs some fixing and it needs antitrust enforcement.

I would ask Mr. Klein, do we need to change the Clayton Act? Are there other tools you need? I would ask Dr. Kahn, are there ways for us to have a system that provides efficiency for the air traveling public without having dominance, market dominance, in each and every hub in this country? Because market dominance by one carrier will never give both the quality of service and effective price competition which consumers need and deserve in this country.

So those are the two questions I would ask. Mr. Klein, you first.

Mr. KLEIN. Sure. Let me say this. I think there are obviously serious problems here, and there is no sort of silver bullet that is going to solve all of them. I think, in general, markets work incredibly well when there is competition, and I think there are efficiencies in a hub and spoke system, but one of the costs has been that increasingly on point-to-point routes, like Ithaca to Washington, there is no competition and so then price discrimination can be very effective and can extract real rents from the market.

I believe, Senator—I believe this based on everything I have observed in my job in the last five years—that there are low-cost new entrants that could be getting into this market that would change it and would have a significant impact. I have seen this in places where they were not taken out early and the markets are now functioning.

I have a deputy who has practiced antitrust in the transportation area for 25 years. He went to the University of Michigan Law School. We did not hold that against him; we gave him a job. He has got to go back for some meeting this weekend. He is going to go to Baltimore and fly there for 200 bucks round trip rather than fly from Washington because there is a low-cost entrant on that route that enables him to do that.

That means that there is a service that can be provided at that rate that would benefit consumers, and there are a lot of consumers who will fly at that rate who will not fly at 700 bucks.

Senator DORGAN. Mr. Klein, I would say good for him and good for them, but that will never happen in rural states ever. You may have some low-cost entrants that come into the urban populations, but I guarantee you that is not going to be part of our model in rural states.

Mr. KLEIN. What I think you will see develop, and I think you are seeing this some with the low-cost carriers that have become more efficient—you know, it is a funny business. If you fly one or two routes it is very hard because you do not have the interconnection of passengers. You have got to get bulked up.

The whole strategy I think that the majors are engaged in, which I think we will wait and see the outcome of our suit, I think the whole strategy is take out the new entrants early, because if they bulk up I think they become quite formidable and begin to get the benefits.

Now, there may be at some point, Senator, in northern North Dakota the demand-supply curve may be such that it is going to be an issue of subsidization. That is the problem that Senator Hollings mentioned with respect to universal service. We as a country may decide that we need to facilitate increased travel in rural areas and we have to address that.

What I am primarily concerned about is I believe there is massive opportunity right now, that there would be capital flow, and that if some of these new entrants—a lot of people are talking about whether we are going to go in the direction of greater concentration. I think if there are some of these new entrants, I think that will facilitate some real competition and strategic competition.

Senator DORGAN. My time is about up. Dr. Kahn, what if we said that if a new carrier meets certain standards and you are going to fly somebody to the Denver hub or some other hub, that the other carriers, the major carriers, have to do code-sharing and interline agreements with them, period? They had to when you ran the CAB, but now they refuse to. That is why when Frontier came back to Bismarck they could not make it. The only passenger flight they could haul was Bismarck to Denver. Passengers would get to Denver and then want to go on United, but guess what? They couldn't do a joint fare because United would not allow them to do that.

My point is I think they should be required to allow them.

Dr. KAHN. We have a division of labor here. Attorney General Klein has to be responsible and cautious. I can be irresponsible. I find very attractive the notion of mandatory interconnection, interlining. I have not yet been able to get over the concern that the CAB was able to do it because it dictated the terms, and I do not exactly know how, consistently with an unregulated system, you can avoid having some ruling about the terms of interconnection, just as the FCC is involved in having to set the terms at which unbundled network elements are made available to competitors.

Scope clauses, of course they are anticompetitive. And your observation that there might be much more possibility of point to point non-hub carriage would be enormously increased if there were not restrictions on the use of regional jets. It may well be that as the market develops we will be going back to some more point to point carriage.

Senator DORGAN. Let me just make the point as I conclude that Mr. Klein's notion that you have to bulk up and fly more than two city pairs in order to make it would not necessarily be the case if you had mandatory interlining or code-sharing. I think we have to think about that. I do not think we are going to break the dominance at any point soon, but there are ways, I think, to give startups the opportunity to pick portions where they can come in and provide service, especially in areas that are now underserved. That is my concern.

I did not mean to interrupt you, but I want to also thank the Chairman for holding this hearing. I think it is enormously timely,

given what is in the news these days about where the major carriers are thinking of going. There is no question that if US Air and United merge the other carriers must for their own protection take action. That is why I hope, Mr. Klein, that when you are looking at this you look at the downstream effects as well, and so does the DOT.

The CHAIRMAN. Thank you, Senator Dorgan.

Mr. Klein mentioned that we had a meeting in South Carolina and twice before this Committee new entrants have mentioned that they will not go head to head any more with a major carrier. I asked one executive of a new entrant, I said: "How do you account for your success?" "I stay away from going head to head with the major airlines."

Mr. Klein's chart showing what happened before and after a new entrant is obviously something that perhaps we did not anticipate enough in this deregulation business, and obviously that is why we are appreciative of all the work that the Department of Justice has done.

I do not mind a major airline competing head to head, but when, as Mr. Klein has testified, they calculate the number of seats, they calculate the fare, and then as soon as they are driven out, as there has been several documented cases, they raise the fares back up again, that is not what we had in mind with deregulation. I think Mr. Kahn agrees. So Mr. Klein, I think it is hard for you to differentiate where predatory activity is and competition. But I think in some of these cases any observer would be able to tell.

Just one additional point, and I hate to keep beating this dead horse. But the reason why you can go to Baltimore and get a lower fare is because Baltimore is not slot-controlled. The highest air fares in America are right here at Reagan National Airport. The sooner we get rid of those slot controls, I think the more entrants you are going to see. There are fewer takeoffs and landings at Reagan National Airport than there was in 1986. It is quite a remarkable story, but I will not continue to belabor that. I will probably earn another editorial in *The Washington Post.*

But I want to thank both of you. Could I just put again a little perspective on it. We had a very important blue ribbon panel report out a couple years ago and they said if we do not modernize the air traffic control system, if we do not pour more concrete, if we do not do a better job, every day in an airport in America—I will never forget; this is their report: Every day in America is going to be like the day before Thanksgiving, the busiest day of the year.

That is becoming true. Any one of us who now takes the shuttle say to New York or Boston, you had better get there an hour earlier than you had planned because it is going to be at least an hour delay, and that is on a clear day. Clearly, our air traffic control system contributes to this problem. Clearly, the fact that there are not enough places to land and the NIMBY kind of behavior.

But at the same time, I do not think we can ignore the subject of this hearing. Please correct me if I am wrong, Mr. Klein, but I think that some people and I think you testified that perhaps a couple of the mergers that took place during the 1980's in retrospect would not have taken place if the Justice Department had had the final decision. Is that true?

Mr. KLEIN. That is correct.

The CHAIRMAN. And those were very small mergers as compared with what is being contemplated now.

I do thank you both for taking the time you are two of the busiest men I know, and I thank you for being here. We are very appreciative of your enormous contributions you make to this Committee and to this great debate. I thank you, and this hearing is adjourned.

[Whereupon, at 11:06 a.m., the Committee was adjourned.]

APPENDIX

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY
HON. JOHN MCCAIN TO PROF. ALFRED KAHN

Question 1. In your opinion, does United's commitment not to increase fares over a two year period carry any weight and do you think they have been clear as to what this commitment means?

Answer. In my opinion it does not deserve any weight: the only pertinent question is whether the merger does or does not threaten to impair the effectiveness of competition.

Question 2. In order to qualify for the discounted CRS booking fee, participating air carriers in Orbitz must enter into a so-called "most favored nation" clause. If an airline sells a low fare elsewhere, the MFN clause requires it to offer that fare to Orbitz, as well.

- Please elaborate on your concerns with most favored nation clauses in general.

Answer. I have, since appearing before the Committee, spelled out these concerns in a written summary of my testimony, a copy of which I attach. Please see the paragraphs marked (a), (b) and (c), on pp. 3–5.*

- What can or should the government do about the uncompetitive aspects of MFN clauses when parties enter into them?

Answer. If the antitrust authorities find that "most favored nation" commitments are an essential and inseparable component of the Orbitz venture, they should simply prohibit the entire venture; if they find that it can be purged of such potentially anti-competitive undertakings, they should impose conditions to their approval that ensure such a purging.

Question 3. I have heard complaints from the low fare air carrier community that the low fare carriers were precluded from the opportunity to purchase an equity stake in Orbitz.

- Would it be a cause for concern if all potential participants in an enterprise do not have an opportunity to make an ownership investment in that enterprise on the same terms as other participants?

Answer. I think it might be a cause for concern; I suspect, however, that the greater concern might be the one I mentioned in my testimony—namely, that the smaller, low-fare carriers would feel compelled to join in order to ensure equal access to the market even though they might fear that doing so would undermine their ability to make special deals with other agencies and so hamper them in their competition with the major carriers. It seems to me urgently important to solicit the views of these carriers about the entire venture.

Question 4. I'm interested in your views on Orbitz, the new travel website owned by Delta, United, Northwest, Continental and American. Last week, this Committee heard some concerns about the potential impact of the five largest carriers getting together to control a distribution channel. Do you have any concerns about Orbitz?* Would your views change if the site were not owned by the air carriers?

Answer. I refer you, once again, to the attached description of the concerns I have about Orbitz. Those would be mitigated if Orbitz were not owned by the major air carriers; but it is conceivable that if it involved the same commitments, raising the same anti-competitive possibilities as I described in my testimony, their not owning it would make no difference.

Question 5. Last year you served as a member of the Transportation Research Board Committee that investigated "Entry and Competition in the US Airline Industry." The Committee's report contained this warning: "Changes in the distribution system

*The information referred to was not available at the time this hearing went to press.

should be viewed as opportunities to enhance the system's overall benefit to consumers, and should not be dissuaded unless the neutrality and completeness of the distribution system is fundamentally threatened."

- What type of activity, in your opinion, would fundamentally threaten the "neutrality and completeness of this distribution system"? Does Orbitz possibly constitute such a threat?

Answer. What we had in mind were activities on the part of the major carriers—especially if undertaken collectively—that would deny alternative methods of ticket distribution an equal opportunity to compete with carrier-owned systems. As I explained in the paragraphs labeled (c) of my attached statement,* the Orbitz venture might have such an effect.

Question 6. Last week, the Committee held a hearing on the Internet and the airline industry. During that hearing, the DOT Inspector General suggested that, as an interim measure, airlines be required to make available any fares they provide to Orbitz to any other entity willing to offer the same financial terms on booking fees, and that such a provision should be predicated on an agreement by these entities to abide by the non-bias regulations that apply to CRSs. What do you think of that suggestion?

Answer. The suggestion seems a plausible one, as a possible means of eliminating the threat to which I referred in my answer to the previous question, but (a) I do not have a sufficiently good feel for the Orbitz arrangement to know whether it would be sufficient and (b) there would remain the other causes for concern that I described in my statement.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY
HON. SLADE GORTON TO PROF. ALFRED KAHN

Question 1. Are there any possible benefits to further consolidation in the industry?

Answer. Travelers typically prefer to make their trips on single carriers: the more consolidated the industry, the more they are likely to be able to make "on-line" rather than "inter-line" any changes of flights necessary to reach their destinations. This would also have the advantage of providing the greatest "seamlessness" to inter-line travel, with one carrier responsible for all aspects of the service, handling of baggage and so on. It is not clear to me to what extent the same assurances of service can be provided, without further consolidation, by inter-lining arrangements among separate carriers; and while I find attractive the possible remedy of requiring the major carriers to inter-line with others, on an equal basis, from the point of view of providing that same "seamlessness" while preserving competitive opportunities for more specialized carriers, I am uncertain how such a requirement can be enforced without some government agency having to regulate the terms of such arrangements—in particular, the division of fares between the cooperating airlines—and to what extent this would in effect entail reregulation.

Question 2. As you know well, the major airlines have some history when it comes to manipulating distribution of their products to affect competition. The Computer Reservation System rules were put in place in 1984 because of the detrimental impact of these activities on consumers. Now the airlines are getting together to control a website that does not fall within the scope of the CRS rules. Are we looking at a sequel to the activities that led to the CRS rules in the first place? What lessons can we take from the history of CRSs?

Answer. I do not see any direct lessons, although there may well be some. The abuse of the monopoly power conveyed by carrier ownership of CRS was that it deprived non-CRS-owning carriers of an equal opportunity to compete and may have imposed monopoly booking charges on them. As I explained in my written submission, Orbitz might have the same effect on low-fare carriers, although for the different reasons I mentioned there; and might in addition threaten efficient competition between Orbitz and other, competitive ticket distribution systems.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY
HON. JOHN MCCAIN TO HON. JOEL I. KLEIN

Question 1. The General Accounting Office and other highly regarded analysts have found the perimeter rule at Reagan National Airport to be an impediment to com-

*The information referred to was not available at the time this hearing went to press.

petition that tends to harm consumers and keep airfares relatively high. Are federal laws and regulations that prohibit private airlines from flying routes sought by their customers warranted in a deregulated industry?

Answer. As a general matter, restraints that impair the provision of goods and services may harm consumers by denying them the full benefits of competition. Perimeter rules such as the one at Reagan National Airport thus may not be not warranted from a competition standpoint. Whether there might be justifications for such rules based on other policy concerns would fall outside the purview of the Antitrust Division.

Question 2. Can we have a truly competitive industry where some competitors, especially new entrants, do not have access to essential facilities, such as airport gates?

Answer. Lack of access to essential facilities, such as airport gates, would certainly be a barrier to entry by a new airline. And, as I testified, entry by low-cost carriers is an important source of new competition in the airline industry.

Question 3. Is the Antitrust Division lacking adequate resources to conduct its enforcement activities?

Answer. We are in a period of very active antitrust enforcement in each of our three major programmatic areas. Antitrust enforcers face a continuing record wave of mergers and acquisitions throughout our economy. We are also addressing important non-merger issues in industries adjusting to new technologies, and we remain committed to detecting and prosecuting companies engaged in illegal cartel behavior that affects U.S. citizens. We are committed to vigorous enforcement of the antitrust laws in the airline industry as in other sectors of our economy. The President has requested a budget increase from $110 million in FY 2000 to $134 million in FY 2001 to enable us to continue to fulfill that mission.

Question 4. In order to qualify for the discounted CRS booking fee, participating air carriers in Orbitz must enter into a so-called "most favored nation" clause. If an airline sells a low fare elsewhere, the MFN clause requires it to offer that fare on Orbitz, as well.

- Please elaborate on the Justice Department's concerns with "most favored nation" clauses in general.

Answer. Although MFN clauses may appear to guarantee the availability of discounts to the contracting party, they can in some cases have the perverse effect of suppressing discounting. A firm that wants to enter a new market, or to attract additional customers to its product or service, may consider offering a lower price as an incentive. But if it can do so only by offering the same lower price to all of its customers, or to a large additional portion of them, it may conclude that the "cost" of the price reduction outweighs the benefits of trying to enter the new market or to attract the additional business. In this way, an MFN clause could effectively prevent the firm from offering the lower price to anyone, if the amount of the firm's business that is subject to the clause is significant enough to make the discount unprofitable.

- What can or should the government do about the uncompetitive aspects of MFN clauses when parties enter into them?

Answer. If the Antitrust Division concludes that an MFN clause is likely to have the anticompetitive effect described above, the Division can challenge it under the antitrust laws and ask a court to enjoin the parties from enforcing it.

Question 5. I have heard complaints from the low-fare air carrier community that the low-fare carriers were precluded from the opportunity to purchase an equity stake in Orbitz.

- Would it be a cause for concern if all potential participants in an enterprise do not have an opportunity to make an ownership investment in that enterprise on the same terms as other participants?

Answer. As you know, the Antitrust Division is currently looking at Orbitz, and I therefore would prefer not to comment specifically with respect to that enterprise. In general, whether there might be cause for concern would depend on various factors, such as the anticipated market share of the enterprise, the competitive significance of the benefits to be gained from equity ownership as opposed to other forms of participation, and whether the equity owners brought resources or expertise to the enterprise of a special nature that were not generally shared by all potential participants.

- Will you look at factors such as this in your investigation of Orbitz?

Answer. The Division will consider all factors that are relevant to determining the likely effects on competition of the enterprise as structured.

Question 6. What are the antitrust or competitive implications of a situation where a dominant group of producers form a vertically integrated enterprise in which other producers are precluded from equal participation?

Answer. As a general matter, the situation you describe could potentially raise both horizontal and vertical issues. With respect to horizontal issues, because the enterprise involves a collaboration in the marketplace among competitors, we would look at whether it would likely reduce competition among them to an extent that outweighs any procompetitive benefits that can be derived only through the enterprise. With respect to vertical issues, we would look at whether the enterprise would likely give the producers who formed the enterprise control over an essential input into the product or service in question, or over an essential avenue for distribution or marketing, so as to foreclose other producers from the market. Any particular enterprise would be analyzed in light of these concerns according to the specific facts involved.

Question 7. Do you anticipate that the Antitrust Division's investigation into Orbitz will be completed before this site comes on-line sometime this fall?

Answer. It is always difficult to predict in advance how long any particular antitrust investigation will take. Attorneys and economists in the Division are working actively on this matter and will continue to do so until they reach a conclusion as to the joint venture's competitive effects. Incidentally, there have been press reports that the site will not come on-line until sometime well into next year.

Question 8. The Department of Justice, in its filing with DOT on the AA/BA proposed alliance, highlighted the anticompetitive nature of slot controls. In those comments, the Department stated:

> [W]here service in a market is constrained by slot availability, a hub carrier with access to a large pool of slots has even greater ability to respond to entry . . . because the entrant will be unable to add capacity on its own. American's president has referred to such strategic responses as "predatory scheduling." The net result of "predatory scheduling" is to discourage new entry in the first place, or to render it unprofitable where it occurs.

- Aren't these same issues applicable domestically? Are new entrants able to compete for traffic in hub airport and high density airport markets?

Answer. Yes, the same issues are applicable domestically, and we take them into account in our enforcement actions and investigations in the domestic airline marketplace.

- As part of your review of the United/US Airways merger, will you take into consideration the need for gates and slots to be available at each of the airports where United and US Airways have a significant presence?

Answer. While I cannot comment on our pending investigation, in general the availability of gates and slots can be an important factor in assessing the likely competitive effects of a proposed airline merger.

Question 9. United's service in the Northeast and on the East Coast is minimal and they would like to increase their service in this part of the country. Are we at a stage in the airline industry where it is easier for an airline to merge with a competitor rather than investing the resources needed to establish a presence in a new region of the country?

Answer. As a general matter, in our free enterprise system a firm may choose between entering a new market de novo or acquiring a firm that is already in the market. However, there can be circumstances in which such an acquisition will tend to substantially lessen competition by eliminating a significant potential entrant into the market. Thus, the fact that it might be feasible for a firm to enter a new market through "greenfield" investment would not necessarily preclude it from entering the market through acquisition instead, as long as the acquisition was not likely to substantially lessen competition. By the same token, however, the fact that greenfield investment was considered a less feasible means of entry would not excuse an otherwise anticompetitive merger from challenge under the antitrust laws.

Question 10. Two years ago, the Congress passed an omnibus budget bill that included provisions regarding DOT's competition guidelines. In a memo commenting on those provisions, Air Transport Association (ATA) President Carol Hallett said, "[W]e have won a significant victory on the competition guidelines. Included in the new law was a provision to conduct two studies of DOT's proposed regulations. . . .

Following the DOT study, a hold of 12 *legislative* weeks is in place for Congress to review and act on the issue." She continues, "DOT is barred from implementing any guidelines during the 12 week period. . . . The provisions . . . take away DOT's ability to act independently. The likelihood of the guidelines being adopted is diminished by this law." Ms. Hallett also states, "[W]e are entering the next phase of this fight in a vastly strengthened position with the tools and the political atmosphere necessary to hopefully relegate DOT's proposal where it belongs—in the regulatory scrap heap." What do you think of DOT's proposed competition guidelines and would you care to respond to Ms. Hallett's comments?

Answer. The Antitrust Division shares the concerns of DOT that responses by dominant hub carriers to low-cost carrier entry have had the effect of eliminating or limiting competition in airline markets. Indeed, our pending lawsuit against American Airlines for conduct at its DFW hub reflects this concern. Division lawyers and economists have consulted with DOT staff on these issues at various times during DOT's consideration of its policy, and we understand that DOT is reviewing the numerous public comments that it has received during the course of its proceeding in this matter. The ultimate decision on the Guidelines will be made by DOT, and I expect that its decision will be a well-considered one.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY
HON. SLADE GORTON TO HON. JOEL I. KLEIN

Question 1. Are there any possible benefits to further consolidation in the industry?

Answer. That touches on some of the questions we are focusing on in our pending investigation of the United/US Airways merger, on which I cannot comment. But as a general matter, there can be potential benefits to a merger, that can take various forms. Whether such benefits are likely to result from a particular merger, and whether—even if they are—they will outweigh any likely adverse effects of the merger on competition, are questions that must be considered on a case-by-case basis.

Question 2. In your prepared remarks, you state that airline fare data is available instantaneously, which can act as a disincentive to fare reductions. Can you please describe circumstances when that would happen? Doesn't perfect information lead to a perfect market?

Answer. It is true that the more information a consumer has about the prices and other attributes of the product or service he or she is shopping for, the easier it is for the consumer to comparison shop for the best possible product or service at the lowest possible price. In markets that are highly competitive, such information works to the consumer's benefit. However, in a marketplace with relatively few competitors, immediate and perfect access by the competitors to each other's pricing information can create a disincentive to compete as vigorously. Firms often look for ways to increase their profitability, and one important way to do this is to entice new customers away from competitors. Often, a firm will attempt this by offering price discounts targeted at potential new customers. A firm is more likely to try this strategy if it believes that it will be able to sell at the discount without its competitors discovering the discount immediately and responding with matching price discounts of their own—because if that occurs, the first firm not only will fail to win additional sales to new customers, but also risks having to lower its prices to customers who would have bought the product or service at the higher price anyway. Knowing this, a firm in such a market will have less incentive to offer discounts in the first place.

Question 3. When evaluating airline industry activities, do you take into consideration in any way the significant public investment in the infrastructure that supports the activities of the industry? Does that public investment set the airline industry apart from non-transportation industries?

Answer. In one sense, every assessment we make of the competitive effects of any airline industry merger or other airline industry activity occurs against the backdrop of the significant public investment in infrastructure. Those infrastructure investments are likely to have an important role in the competitive analysis, because they affect many important business decisions, such as the ability of carriers to offer service in particular markets or even to expand overall service. But it should be noted that many industries rely directly or indirectly on some infrastructure supplied by the public or by others, and this is one factor among many that antitrust enforcers consider in making competitive assessments.

Question 4. In a hearing this past May before the Subcommittee on Antitrust, Business Rights and Competition, Roger Ferguson of Midway Airlines testified that his

airline has "consciously avoided picking fights with the major airlines by flying directly into their hubs." Is that something that concerns the Antitrust Division? If concentration at major hubs continues to grow, isn't this going to impede competition? Aren't we likely to see more new entrants avoiding hubs in a more consolidated industry?

Answer. New entrants, no less than hub carriers, should be free to compete on the merits for business. New entrants may sometimes decide to operate out of underserved airports and may sometimes decide to operate out of airports that serve as another carrier's hub. In either event, they will have to compete with whatever other carriers are also serving the route. The Antitrust Division would be concerned, however, if a new entrant is deterred from serving a market because of its fear that a dominant incumbent will respond by flooding the route with additional capacity and reducing fares in a manner that does not make economic sense except for the prospect of driving the new entrant out. Indeed, our focus in our pending case against American Airlines is the use of predatory conduct to eliminate competition from new entrants. Further consolidation in the airline industry could exacerbate such concerns.

Question 5. Do you believe code-share relationships between major carriers could be more beneficial to consumers, as compared with full mergers, or do you think any type of alliance between major air carriers may lead to a lessening of competition in the industry?

Answer. Code-share relationships may enable airlines to achieve some, but probably not all, of the benefits that might be available from a full merger. A code-share relationship may preserve some ability for the carriers to compete, thus preserving some competition that would be lost in a merger. But all alliances between horizontal competitors, by their very nature, have some potential for anticompetitive harm, and the greater the horizontal overlap between the alliance partners, the greater is the risk to competition.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY
HON. MAX CLELAND TO HON. JOEL I. KLEIN

Question 1. Mr. Klein, you have indicated that the Department of Justice examines mergers on a case-by-case basis. Could you please state for the record whether or not, in the context of the Justice Department's review of the proposed United/US Airways merger, the Department will examine the likely consequences of the merger, including the possible follow-on mergers by other carriers?

Answer. We will carefully examine each market that may be potentially affected by the merger and assess the likely effects of the merger on competition in that market. In general, as we look at the industry in which a proposed merger is taking place and consider the strategic arguments that are made, we cannot help but think of what the implications will be across the industry. But in the end, if we go to court and challenge a merger under section 7 of the Clayton Act, our legal challenge will be on the specifics of the particular merger.

Question 2. There currently is relative equilibrium among the major network U.S. carriers in terms of hubs, capacity, schedules, aircraft, personnel, and other resources. The size and strength of the rival networks are more or less in balance. However, if the United/US Airways merger is approved, the combined entity would be about 50 percent larger than the next largest U.S. carrier, with more than twice as many hubs, aircraft, routes, and personnel. It would seem that the size and scope of United's post-merger system would necessarily induce other carriers to respond with their own mergers, because if they fail to do so, United would have huge competitive advantages over the rest of the industry, especially in terms of its ability to capture traffic flows over its expanded network hubs. Indeed it has been publicly reported that other large carriers are exploring merger options in the aftermath of the United/US Airways announcement.

- Do you believe an examination of the follow-on merger consequences of an approval of the United/US Airways merger is essential to fulfill the Department's responsibilities?

Answer. See answer to Cleland question 1.

- Is there any question in your mind as to whether the Department has the existing authority to examine all of the possible consequences of a United/US Airways merger, including follow-on mergers?

Answer. The existing antitrust laws provide us with the appropriate authority to protect consumers and the economy against anticompetitive mergers in the airline industry.

- Do you think it necessary for Congress to clarify your authority in this respect?

Answer. No.

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