TESTIMONY OF

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BEFORE THE

UNITED STATES SENATE
JUDICIARY SUBCOMMITTEE ON ANTITRUST, COMPETITION POLICY AND CONSUMER RIGHTS

ON

"THE UNITED/CONTINENTAL AIRLINES MERGER:
HOW WILL CONSUMERS FARE?"

27 MAY 2010

Thank you Chairman Kohl and Members of the Committee:

Good afternoon. My name is William J. McGee. I appear before you today as a consultant on travel and aviation issues for Consumers Union[1], the nonprofit publisher of *Consumer Reports*®. I thank you for the opportunity to express our deep concerns about the proposed merger between United Airlines and Continental Airlines.

When Congress passed the Air Transportation Safety and System Stabilization Act just 11 days after the 9/11 attacks and the U.S. airline industry received a $5 billion bailout, it was argued that the nation's airlines were essential to America's economy, infrastructure, security, and defense. Consumers Union agrees with these assertions, and that is why we're so concerned that a mega-merger between United and Continental will be detrimental to airline passengers.

What we've been witnessing in recent years is an incredibly shrinking airline industry. With the approval of this merger, in less than 20 years we will have seen the demise of seven major airline brands in the United States: Pan Am, Midway, Eastern, TWA, America West, Northwest, and now Continental.

Such a merger undoubtedly will have an adverse effect on labor, since thousands of jobs will be at risk. It also will dampen the travel and tourism industries in certain destinations and threaten a host of airline suppliers, ranging from aircraft manufacturers to travel agencies. In fact, some airports, cities, and even entire regions would stand to lose service and jobs. This seems particularly true for Houston, Continental's headquarters, after the new airline consolidates at United's headquarters in Chicago. While others can speak to the consequences the proposed merger will have on communities and jobs, I will focus my comments on passengers, because passengers will suffer adverse effects as well.

In February 2001, the U.S. General Accounting Office (GAO) reported on airline consolidation and identified several potential threats to consumers, including:

- a decrease in vigorous competition in certain markets;
- a greater threat of travel disruptions due to labor or financial crises;
- a loss of service in certain communities;
- additional barriers for new-entrant airlines.

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We can't predict with absolute certainty how the United-Continental merger ultimately will affect consumers. But we can examine the recent historical record to see how passengers were affected by American's acquisition of TWA in 2001, US Airways' "reverse merger" with America West in 2005, and Delta's acquisition of Northwest in 2008. Unfortunately for consumers, that record is not good.

What follows is a breakdown of the key problems that have emerged for airline passengers in the wake of mergers between major carriers.

1. LESS CHOICE AND FEWER FLIGHTS. Historically we have not seen a merger among major carriers that has *not* led to reductions in service and usually a dramatic reduction of flights at one or more hubs. In fact, among the arguments *for* airline mergers are reducing redundancies and achieving "economy-of-scale" benefits. There is no reason to believe we will not see service reductions with United-Continental. This new airline states it will maintain ten hubs, eight of them in the continental United States: Newark; Washington, D.C.; Cleveland; Chicago; Houston; Denver; San Francisco; and Los Angeles. Only time will tell if the new airline decides to consolidate such an extensive network of domestic hubs. Due to the relative proximity of network hubs, potential redundancies include Newark and Washington, Cleveland and Chicago, and Houston and Denver.

What we do know is that other mergers between major airlines eventually led to hub closures and flight reductions, despite promises to the contrary. Consider the following:

- TWA's former hub in St. Louis saw a reduction in total passenger traffic from 23 million in 2002 to 12 million in 2009. After American's acquisition of TWA in 2001, it began reducing daily departures, from a total of nearly 500 down to just 36. Last year Francis Slay, the mayor of St. Louis, pointed out that passenger loads on American's flights out of St. Louis remained high, and stated: "I think this is a bad business decision for the airline. American is cutting service in a good market and walking away from loyal customers." Yet to many industry analysts, it was apparent that St. Louis' location between American's existing hubs in Chicago and Dallas meant St. Louis passengers and businesses would begin losing service shortly after American's acquisition of TWA became final. That's exactly what happened.

- America West's former hub in Las Vegas also has been reduced in size in the aftermath of that airline's merger with US Airways. At its peak it operated about 140 flights daily, but that number was slashed to 64 and then again last year to just 26 daily flights. Ten years ago Las Vegas was ranked as the 12th busiest airport in the world; it now ranks 23rd.

- Although the full effects of the Delta-Northwest merger have yet to be seen, it's apparent that Delta's hub in Cincinnati is already experiencing cutbacks. In March the airline announced 840 jobs were being cut there, and news reports stated 123 flights have been eliminated since the merger. Again, even before this merger analysts had noted Cincinnati's proximity to Northwest's former hub in Memphis.

In short, this means that consumers in these cities now have fewer choices, fewer flights, and fewer nonstop flights. Separately American and TWA could support hubs in Chicago, Dallas, and St. Louis, but after acquiring TWA American could only support hubs in two of those three cities. It's fair to ask if United-Continental will be able to support eight domestic hubs should their merger be approved. In addition, as the industry consolidates, consumers on many routes are losing the opportunity to "vote with their feet." The pressure to satisfy customers at the point of sale and during air travel is diminished when there is no effective competition for the consumer's business.

2. LOSS OF SERVICE. It seems apparent that a United-Continental merger would mean some cities—particularly smaller cities—would lose nonstop air service, if not all air service. A total of 12 cities recently lost nonstop service to St. Louis in the wake of the American-TWA merger, and a total of 10 cities have lost nonstop service to Las Vegas since the US Airways-America West merger. The more mega-mergers that are approved, the higher the probability that additional cities will lose service.

3. HIGHER FARES. A July 2008 report from the GAO concluded: "Mergers and acquisitions can also be used to generate greater revenues through increased market share and fares on some routes." Proponents of the United-Continental merger have noted that airfares have fallen nationwide in recent years, but this is an ironic observation since fares have fallen *despite* legacy airlines such as United and Continental, not *because* of them. Without this new generation of Low Cost Carriers, legacy airlines undoubtedly would be charging more on routes populated by these low-fare airlines, particularly in vacation markets such as Florida.

As the GAO noted, airfares rise after former rivals stop competing and merge into a single airline. In the case of United-Continental, overlaying their route maps indicates where such fare increases are likely to occur. *The Wall Street Journal* recently reported an airline analyst from J.P. Morgan identified 13 nonstop routes served by both United and Continental, and further noted that seven of these routes have no other competitors, which is even a higher concentration than occurred with Delta-Northwest. Further, this analyst indicated "only" four cities would experience price increases after a United-Continental merger. However, these are four very large cities: Washington, D.C.; New Orleans; Seattle; and San Diego. This means that millions of air travelers will experience fare hikes due to less competition.

What we saw in St. Louis was rather clear. A few years after American's acquisition of TWA, fares rose on three of the six routes dominated by those carriers pre-merger. The only reason fares also did not rise on the other three routes was because Low Cost Carriers such as Southwest had entered the market. This raises a key issue, since some analysts argue that a major airline abandoning a former hub will not harm consumers in the long run, because Low Cost Carriers will fill the void. The problem with this theory is that 1) there is no guarantee that Low Cost Carriers, with their more limited resources, will do so; and 2) even when a Low Cost Carrier enters a former hub, prices fall only on selected routes, not on *all* routes. In fact, spikes in ticket prices are particularly common on routes connecting the former rivals' hubs, such as American's hub in Dallas and TWA's hub in St. Louis. In late 2004, the St. Louis-Dallas route experienced a 34% year-over-year fare increase, the seventh-largest fare jump nationwide that quarter.

4. REDUCTIONS IN SERVICE QUALITY. Mergers tend to be contentious, and airline mergers have proven to be particularly contentious. This case involves two mature companies—United was founded in 1926 and Continental in 1934—so therefore a clash of corporate cultures is virtually guaranteed. There seems to be no question a merger of this size eventually will lead to lay-offs. These sterile corporate terms—downsizing, rightsizing, outsourcing, off-shoring, furloughing—really mean that two workforces already shell-shocked from two decades of lay-offs will experience more trauma. Those employees who remain will find themselves jockeying for position on blended seniority lists. Inevitably this will lead to employee morale issues and slowdowns due to melding of policies, procedures, and technologies; in the end, passengers will experience the brunt of these obstacles for years to come.

What we've seen with recent mega-mergers is the new airline does not perform as well as one or both of its partners performed pre-merger. American's on-time performance fell in the years after it acquired TWA, which had been an on-time leader. And US Airways currently ranks lower in on-time flights than it did when it operated as America West; similarly, it generates more consumer complaints today as well.

5. FEWER START-UP CARRIERS. Greater concentration of market share among just a few major airlines has a negative effect on competition and fares in an indirect way as well. The 2001 GAO report noted the following: "A January 2001 DOT report on exclusionary practices concluded that major airlines have the opportunity and the means to protect their market power by frustrating new entry. DOT found there had been instances in which incumbents drove new entrants out of markets by cutting fares and flooding the market with capacity. Once the new entrant was driven out of the market, the incumbent sought an increase in fares and reductions in service." The GAO report further noted: "Low fare carriers are recognized as providing the primary fare discipline in the marketplace." Simply put, the more market share that is dominated by mega-mergers, and the smaller the pool of major carriers becomes, the harder it will be for new airlines—particularly Low Cost Carriers—to compete. And there's no question this will hurt consumers.

6. FEWER AIRLINES, LESS RESISTANCE. In the post-Deregulation era since 1978, time and again we have seen how the marketplace affects airline pricing and even service. One major carrier will initiate an airfare increase and then the industry watches to see if others will match; if enough key players are strong enough to resist such an increase, then the initial fare hike will be withdrawn. This same principle has applied to the introduction of airline fees, particularly baggage fees, which recently topped a *Consumer Reports* poll of 2,000 travelers as the most annoying complaint about airlines. And there’s a greater need than ever for such resistance: The DOT recently reported that in 2009 airlines generated $7.8 billion in such "ancillary revenue" fees, an increase of 42% over 2008. Airlines also have employed this "matching" method to initiate changes to frequent flyer programs; new service initiatives; and even policies such as reducing travel agency commissions. If we help create a domestic industry with fewer major airlines, the likelihood of a rival carrier resisting a new fee or airfare increase will be much less likely. Conversely, there will be less chance of a single carrier successfully introducing consumer-friendly initiatives. In recent years, for example, we've seen major domestic airlines attempt to differentiate their products, such as American offering more legroom, Continental offering economy class meal service, and Southwest resisting baggage fees. Eventually both American and Continental gave in to competitive pressures, while the jury remains out on Southwest's ability to resist the fee movement. Obviously, greater concentration among the majors will mean even greater resistance to initiatives that help consumers.

7. THE THREAT OF WIDESPREAD DISRUPTIONS. With greater concentration of market share among just a handful of mega-carriers, the United States faces a much greater threat of travel disruptions. Imagine the nationwide effects of a labor slowdown or strike at a combined United-Continental, which analysts estimate would control nearly a fifth of all domestic airline seats. And while we certainly hope it never came to pass, imagine the effects if the Federal Aviation Administration were forced to ground this mega-airline's fleet due to maintenance or operations irregularities. Even a 24-hour disruption in service would have severe consequences for the nation.

8. THE "TOO BIG TO FAIL" ARGUMENT. Just as we have seen with banks, with financial services companies, and with automobile manufacturers, we are now seeing the domestic airline industry evolving into an oligopoly of 800-pound gorillas. Few industries are as financially cyclical as the airline business—the investor Warren Buffet famously declared the airline industry from the time of Wilbur and Orville Wright has made zero money, net. Five major U.S. carriers filed for Chapter 11 bankruptcy reorganization at least once during the last decade. In the past, Wall Street investors and executives at competing airlines have decried any form of assistance to financially struggling carriers, asserting the government should let the marketplace decide which airlines survive and which airlines fail. In the future, these same parties will reverse that argument, claiming that a mega-carrier such as United-Continental will be too big to fail. And they will be right: The overnight shutdown of such a large percentage of the nation's commercial airlift would have immediate and adverse effects on America's economy, infrastructure, and even security. Therefore the wise move is to prevent the further concentration of the nation's airline industry—before it's too late.

9. RAISING THE STAKES. Because of the Delta-Northwest merger, which was approved in the final days of the Bush Administration, some proponents of the United-Continental merger are arguing that fair is fair, and the Department of Justice and the Department of Transportation should allow United and Continental to join forces as well. If this were to happen, there is little doubt that within a short time executives from American Airlines will appear before this very committee, seeking your blessing to merge with US Airways, which of course just merged with America West in 2007. This underscores there are many ways to measure the size of an airline, but regardless of the method employed, it's clear that over the last decade the issue of which airline is the largest U.S. carrier has been in constant flux. Delta's recent merger with Northwest made it the number one carrier, only to be eclipsed by United-Continental, which in turn would be eclipsed by American-US Airways. And this sudden leapfrogging in the ranks has not been due to genuine growth—to expanding service into new cities, hiring more employees, ordering more aircraft—but to legal exercises, which have led to reductions in service, laying off more employees, and parking more aircraft.

What's become apparent is airline executives and investors are engaged in a high-stakes form of poker—and the pot keeps growing. It seems only fair to ask what the end game is here. At what point will this merger mania subside? Until there are only three major airlines in the U.S.? Two? One? And then what? Will this trend extend overseas, with the same domestic mega-players seeking to acquire and merge with carriers throughout Europe and Asia? Before future consolidation is approved, Consumers Union feels there should be more discussion about the airline industry's ultimate goals, and how those goals affect U.S. consumers.

The Air Transport Association of America, the industry's primary trade organization, states the following: "Commercial aviation is the backbone key engine of the modern American economy, driving $1.2 trillion in annual economic activity and 11 million well-paying American jobs. Aviation supports local economies and creates new markets at home and abroad. Communities from coast to coast depend heavily on access to the air transportation network for economic development." Why, then, would we want an industry that generates less economic activity, creates fewer jobs, abandons local communities, and provides less access?

Today we're being told the domestic airline industry can only support three large network airlines; how long before we're told that number has been reduced to one large network airline? And how will such consolidation benefit American consumers?

— William J. McGee
Consumers Union
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