



STATEMENT OF

WILLIAM J. McGEE
CONSUMERS UNION

BEFORE THE

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

ON

THE AMERICAN AIRLINES/ US AIRWAYS MERGER:
CONSOLIDATION, COMPETITION, AND CONSUMERS

MARCH 19, 2013

Introduction

Chairwoman Klobuchar, Ranking Member Lee, and Members of the Subcommittee: Consumers Union, the policy and advocacy arm of Consumer Reports, commends the Subcommittee for holding this important hearing, and we appreciate the opportunity to present our views.

We are well aware that the airline industry has been under considerable financial stress in recent years, leading to a number of reorganizations under the bankruptcy laws. And we know that the urge to merge can be powerfully seductive even under the best of circumstances.

But we have seen growing consolidation in the airline industry in recent years bring substantial harm to consumers, communities, and the economy. We are concerned that the proposed merger between American Airlines and US Airways has the potential to further deprive air travelers of healthy, robust competition, and to further deprive communities of being part of a vibrant air transportation network. We believe the proposed merger warrants a careful and thorough investigation by the Justice Department's Antitrust Division.

This merger was formally announced just a month ago, on Valentine's Day, and a full review of its implications is still underway. But the potential harms to the public that could result from allowing this corporate courtship to be consummated are clear enough already.

These two airlines are singing a song we've heard sung many times before. For the fifth time in the past decade, executives from one legacy network airline are attempting to acquire the assets of a second. Each time, the airlines promise that air travelers will benefit from a stronger airline with a wider reach, more determined and able than ever to compete vigorously.

That's what American and US Airways are saying now. And that's what we heard from United and Continental when they merged, from Delta and Northwest when they merged, from US Airways and America West when they merged, and from American and TWA when they merged – or technically, when American acquired TWA's assets in bankruptcy.

That's what we always hear. But what we have found, once the merger goes through and the dust settles, is not greater choice and better value for consumers. Instead we find fewer flights and routes, and hubs downgraded or abandoned, as the new combined airline sees less need to provide those greater choices in flights and routes once they have less competition to worry about. Similarly, we find that airfares rise on routes where the merged airlines previously competed head-to-head.

The bottom line changes for the merged airline, and not necessarily in ways that translate into good news for the rest of us. Consumers lose choices, workers lose jobs, and communities lose business activity and the associated tax base and job opportunities. The interests of consumers and communities get overlooked in favor of the interests of the senior executives and major investors of the two airlines.

Two decades ago, there were 11 legacy network airlines in the United States. If this pending merger is approved, the country will be served by only three full-service airlines – four if you add in Southwest – along with Alaska Airlines, and a handful of smaller low-cost and regional airlines who have themselves been merging.

One industry analyst estimates that American, United, and Delta, plus Southwest, would comprise 87% of the domestic market,¹ a concentration never before seen in the modern era of U.S. commercial aviation. The dramatic consolidation that has occurred over the last 25 years is best illustrated by another analyst who notes that in 1985 ten separate airlines controlled the same amount of market share that soon could be controlled by just American, Delta, and United.²

Moreover, as the legacy network airlines continue to consolidate, they are abandoning domestic routes, or outsourcing them to regional code-sharing partners. We are concerned that they are looking at the domestic market as a “mature market” that is not worth the effort trying to expand, and are focusing their energies on the more lucrative long-haul coast-to-coast routes and the international routes.

And so we must ask what the end game truly is for U.S. commercial aviation. With each mega-merger we’ve been told that profitability will return, competition will be enhanced, and consumers will be served, and each time this has not happened. Will domestic airline consolidation now

¹ USAToday.com, Feb. 14, 2013: (www.usatoday.com/story/travel/flights/2013/02/13/american-usairways-merge/1916961).

end with the merger of American and US Airways? Or will we be told in short order that the Big Three must become the Big Two, or the Big One? Will the industry double down on its efforts to get Congress to amend foreign ownership rules, so that the next round of domestic acquisitions comes from Lufthansa, British Airways, and Air France-KLM?

Competition is the Key

Merging corporations always say their merger will make them more “competitive.” But they mean something quite different than what the antitrust laws mean by preserving competition in the marketplace.

The corporations mean something akin to “strong.” They mean the merger will enable them to profitably expand operations they can charge for, and maybe to also charge more, and to profitably cut costs by trimming overhead and redundancies in service. It is certainly understandable that corporations would pursue those goals, and that merging with another firm in the same line of business might seem an attractive route for pursuing them.

An airline naturally wants to maximize its profits, and the way to do that, simply stated, is to sell as many tickets as possible at as high a fare as possible. There is, of course, a trade-off – at some point, higher fares charged eventually means fewer tickets sold.

² The Travel Insider, March 1, 2013: (blog.thetravelinsider.info/2013/03/the-collapse-of-airline-competition-a-visual-analysis.html).

One way that trade-off can take hold is that as airfares rise, more consumers will decide they cannot afford to fly, and will simply have to give up flying to see family, or to take a vacation, or to expand their business. They will drive instead, if that is practical. They will give up the special vacation and stay closer to home. They will make do with phone calls instead of personal visits.

But in any event, it won't be the same – it won't be as convenient, or as satisfying. Consumers will suffer as fares increase and service decreases. Those who are not forced to give up flying will pay more for it.

Up to a point, an airline focused on its bottom line may not care so much about the reduced ticket sales, as long as its higher fares on the tickets it does sell net higher overall profits. This is not to suggest that the airlines have ill will against consumers; it is because their first goal is to increase profits. It's in their corporate DNA.

When there is competition, we never get to that unfortunate point. When there is competition, consumers have a choice, and if one airline raises its fares too high, consumers will look to other airlines for lower fares. And as long as another airline can sell that ticket at a lower fare and still make a profit, that's what it will want to do. So when there is competition, the airlines will have a healthy incentive to reduce their fares to increase ticket sales until the point is reached where no additional profit can be made by reducing fares further.

Of course, airline ticketing strategy is more complex than this. But the underlying motivation is the same, to increase profits. Pricing and service decisions are all made with this goal in mind.

This basic insight of economics is at the heart of what the Justice Department's investigation of this merger is and should be all about.

Competition makes sure that our free market system brings good deals to consumers, by aligning the profit-making incentive with providing maximum value to consumers. And the purpose of the investigation is to make sure that competition is preserved and consumers are protected.

Specific Risks of Harm

The following are some of the specific kinds of harmful effects that we are concerned could flow from this merger.

1. Fewer Flights, Fewer Choices

Historically, we have not seen a merger among major carriers that has not led to reductions in service. In fact, the primary business motivation driving an airline merger, aside from the prospect of increased profits from reduced competitive pressure, would seem to be the elimination of what become unprofitable redundancies after the merger, but are competitive niches before the merger, when the two carriers are still competing against each other.

After American acquired TWA's assets in 2001, for example, the merged airline's daily departures out of TWA's former hub in St. Louis plunged from nearly 500 down to just 36 – undoubtedly helping add to the merged airline's profits, but at the expense of a drastic reduction in flying choices for consumers, and a diminished convenience as a business home or destination of the city once celebrated as the Gateway to the West. This pattern has been repeated at other former hubs downsized by mergers: America West's former hub in Las Vegas, Delta's former hub in Cincinnati, and Continental's former hub in Cleveland.

Similarly, with this merger we could see fewer flights and fewer non-stop routes, as well as more mainline jet service replaced by outsourced regional jets. Comparing the route maps of American and US Airways raises obvious questions: Would the merged carrier sustain present levels of service at the US Airways hub in Phoenix, so close to American's hubs in Dallas and Los Angeles? How can the US Airways hub in Philadelphia co-exist at current service levels adjacent to American's hub at New York's JFK? Will it ultimately make business sense to downsize the US Airways hub in Charlotte, when there is an American hub in Miami? Consolidating hubs and routes and flights may make perfect sense from the merged airline's perspective, but it comes at a high cost to consumers and communities.

2. Higher Fares

We could also expect the merger, where it reduces competition, to result in higher fares, with fewer promotional fare sales, and fewer rebellions

against fare increases and new fees. As the Government Accountability Office put it in a July 2008 report on airline mergers, “Mergers and acquisitions can also be used to generate greater revenues through increased market share and fares on some routes.”³ Again, good for airline profits, but not so good for airline consumers.

3. Lower Quality of Service

The more concentrated the airline industry becomes, the less incentive the airlines have to compete in areas such as comfort, on-time flight performance, baggage handling, and conflict resolution. Compounding this reduced incentive, the synergies that the merging airlines so confidently predict often fail to fully materialize. Merging firms are prone to underestimate the difficulty of merging two workforces that have been operating under two distinct corporate cultures. Here, blending these two workforces, who are still adjusting to previous mergers their respective employers undertook not so long ago, could be especially challenging.

Indeed, American Airlines’s parent company, AMR Corporation, in a filing with the U.S. Securities and Exchange Commission last month, cautioned that it “may be unable to integrate AMR’s and US Airways’ businesses successfully and realize the anticipated benefits of the Merger.”⁴

³ “Potential Mergers and Acquisitions Driven by Financial and Competitive Pressures,” GAO-08-845, July 31, 2008.

⁴ American Airlines Inc. Form 10-K, File Number 1-2691, Feb. 20, 2013: (phx.corporate-ir.net/phoenix.zhtml?c=117098&p=irol-secText&TEXT=aHR0cDovL2FwaS50ZW5rd2l6YXJkLmNvbS9maWxpbcueG1sP2lwYWdlPTg3NDA1ODYmRFNFUT0xJINFUT0mU1FERVNDPVNFQ1RJT05fQk9EWSZleHA9).

4. Devalued Frequent Flyer Benefits

Among the places where we could expect quality of service to suffer is in the frequent flyer programs. The airlines originally referred to these as “loyalty programs.” But as competition among airlines decreases, so does the need for them to worry about customer loyalty. In the midst of the growing consolidation in recent years, airlines have rewritten their frequent flyer program rules to lower the currency value of miles traveled, to put expiration dates on accumulated miles, and to add redemption fees.

For members of American’s AAdvantage and US Airways’s Dividend Miles programs, the merger will not only mean less competition; it will also mean an increased pool of frequent flyers with fewer open seats and upgrades to go around.

5. More Formidable Barriers to Entry

As the DOT has noted, in what it has termed the “Southwest Effect,” Southwest and other low-cost carriers have provided a vital service to consumers by entering the market in dozens of American cities, increasing competition and reducing fares. But an industry comprising only a “Big Three” oligopoly operating out of fortress hubs will make it much more difficult for new low-cost airlines to get a foothold to compete effectively.

6. A “Too Big to Fail” Industry

As the airline industry becomes ever more concentrated, the failure of any of the major carriers becomes ever more unthinkable, a threat to the economy and security of the country, heightening the prospect of full-scale government intervention in the event of a bankruptcy filing, labor action, or Federal Aviation Administration grounding that might disrupt the carrier.

Needed: A Careful and Thorough Antitrust Investigation

In light of the potential for this merger to do significant harm to consumers, workers, communities, and the economy, Consumers Union urges the Justice Department’s Antitrust Division to conduct a most careful and thorough investigation, and we urge this Subcommittee to encourage and support such an investigation.

The two airlines are undoubtedly looking at this merger in terms of opportunities to increase profits. That is only natural, and to be expected.

But this merger needs to be investigated in terms of how it would change the competitive structure of the market, and how that might change the incentives for how airlines look to increase profits. Will those profit-making incentives naturally coincide with more flights, more convenient routes, lower fares, and better service, all hallmarks of a healthy marketplace where competition reigns? Or will those incentives begin to coincide with fewer flights, consolidated routes, higher fares, and reductions in service

quality, symptoms of an unhealthy marketplace where there is a shortage of competition?

Solemn promises by merging airlines that they will maintain routes or flights or service, or will keep fares low, need to be greeted with some skepticism. For one thing, you can look at what has happened in the wake of previous airline mergers. But even aside from the lessons of history, it is simply not realistic to expect an airline, or any business, to maintain service that does not add to its profits.

And that is why a proper merger evaluation under the antitrust laws needs to examine what would happen to the structure of the market – to examine where the healthy incentives for competition would be supported by the new market structure, and where those healthy incentives could be undermined by the new market structure. That examination involves not only looking at which airlines compete on which routes now, and who will be competing where on the day after the merger, but also looking at what the merger does to the options for these two airlines, and all the others, to increase profits by adjusting where and how much they compete.

We are depending on the Justice Department to undertake this kind of thorough evaluation of how this proposed merger will affect the market structure and the incentives to compete. Furthermore, the merger needs to be examined against the backdrop of the cumulative consolidation that has already occurred and the harm left in its wake, and with due regard for the important dynamic and macro effects of adding yet one more mega-merger into the mix.

Certainly, the Department’s customary market-by-market scrutiny is critical to identifying specific city-to-city routes that are likely to suffer an immediate reduction in competitive choice for travelers. But isolated market-by-market divestitures, even assuming they can succeed in the short term in keeping viable competition in the specific routes, which is by no means a given, do not in our view adequately take into account the larger anticompetitive dynamics that come into play as the number of competing airline networks is reduced below a critical threshold, and choices for consumers are squeezed out of the market in the name of corporate efficiency.

The individual trees are important, but they cannot thrive in the absence of a healthy forest.

An appropriately thorough investigation will go far beyond just a snapshot look at the hubs, routes, and flights directly in play. It will also consider whether this level of consolidation is changing the structure of the market in broader, more fundamental, perhaps more subtle and insidious ways that undermine the prospects for a competition-based future for the airline industry.

The Need for Public Accountability

The stakes are so high, and the indicators of possible harm to consumers, communities, and the economy so unmistakable, that the Justice Department needs to be clear at the end of its investigation, not only in its

conclusions regarding this merger, but in its justification for whatever conclusions it reaches. We do not here prejudge the Department's investigation. We do ask that, when the investigation is completed, the Department explain its conclusions in a way that gives confidence to all Americans – consumers as well as antitrust experts – that those conclusions are based soundly on a thorough review of all the ways the merger could impact competition.

That could come in the form of the documents and evidence filed in a case challenging the merger, in the competitive impact statement filed with a consent decree, or in a detailed closing statement that explains why the Department has seen fit to close the investigation without the need for an enforcement action.

Again, we do not pre-judge the Justice Department's ongoing investigation, but we hope we have made clear why we are concerned. This merger has many signs of potential for substantial harm to competition and consumers. At the completion of the Department's investigation, whatever the result, we want there to be no room for doubt that we are being fully protected under the law.

Conclusion

Thank you for calling this hearing on an issue of great importance to consumers. I would be happy to answer any of your questions.