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**Before the**  
**SUBCOMMITTEE ON REGULATORY REFORM, COMMERCIAL AND**  
**ANTITRUST LAW**

**of the**  
**COMMITTEE ON THE JUDICIARY,**  
**UNITED STATES HOUSE OF REPRESENTATIVES**

**Concerning**  
**“COMPETITION AND BANKRUPTCY IN THE AIRLINE INDUSTRY: THE**  
**PROPOSED MERGER OF AMERICAN AIRLINES AND U.S. AIRWAYS”**

**February 26, 2013**

Chairman Bachus and members of the Subcommittee, my name is Chris Sagers and I am a professor of law at Cleveland State University in Cleveland, Ohio. With my gratitude I am pleased to offer these thoughts on antitrust aspects of the proposed merger of American Airlines (“American”) and U.S. Airways. I have studied the law of antitrust

and regulated industries throughout my career, and I have published on competition in regulated sectors, including the airlines and other transportation industries.<sup>1</sup>

Two themes have dominated airline competition policy since deregulation, and they have driven discussion of every airline merger. Merging airlines have used them to conceal seriously anticompetitive transactions, preserve pockets of market power, and perpetuate an inefficient, high-cost industrial organization. Those themes are: (1) the industry's purportedly special problems, which are said to relate to its high costs or to technological issues, and (2) its persistently poor economic performance. Each time a new merger is proposed, the merging parties argue that they cannot alone survive the forces of unrestrained competition, explain that inability according to such detailed cost-based arguments as they can muster, and point to their own prior bad performance as proof of it. But each time, despite their predictions to the contrary, the mergers that are then approved are followed by price increases on those city-pair routes where concentration has increased, and by continued poor economic performance.

The industry and its defenders have argued in various ways that the fault is with special problems in airline markets. Indeed, the parties to the present proposed merger allege that American requires it to emerge from bankruptcy. But a much better explanation, which doesn't require believing that airline markets are somehow different than virtually all of the other markets in the United States, is a simple one. The legacy carriers have remained high cost, but through well protected pockets of market power and anticompetitive conduct they have been able to acquire or exclude almost all of the many

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<sup>1</sup> I do not represent any party with any interest in this matter. I have received no compensation in connection with my testimony, I appear here at my own expense, and the views expressed are my own. I submit this testimony at the request of counsel for the Subcommittee.

low-cost carrier entrants (“LCCs”) that have challenged them since deregulation. Failure to enforce the antitrust laws against these many mergers, in other words, has preserved inefficient firms, kept them from performing adequately, and kept prices high, in just the way that basic economics would predict. The great irony is that competitive markets, which the incumbent airlines have kept at bay by stressing their allegedly special problems, could have driven the very efficiencies needed for healthy economic performance.

### **I. Background**

While the airlines are now subject to antitrust like most other firms, and while major airline mergers must be approved by the Department of Justice, there has in effect been little antitrust policy in the airline industry. The industry began its history in the 1920s in a heavily regulated state, stayed that way until the process of deregulation began in the late 1970s, and then entered a period of essentially deregulated competition that has been rocky and quite different than deregulatory planners had anticipated. Since deregulation, the industry’s history has consisted of three, roughly decade-long blocks punctuated by two separate bouts of new entry and vigorous competition which relatively quickly were snuffed out by failure or acquisition of all new entrants.<sup>2</sup>

Deregulation was followed by a frenetic burst of new entry, and the industry experienced vigorous competition for the first time in its history. However, during a short transitional period following deregulation, the merger review authority of the former Civil Aeronautics Board was temporarily transferred to the Department of

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<sup>2</sup> See generally Chris Sagers, “Rarely Tried, and . . . Rarely Successful”: *Theoretically Impossible Price Predation Among the Airlines*, 74 J. AIR L. & COMM. 919, 936-41 (2009).

Transportation (“DOT”), before it was finally vested in the Department of Justice (“DOJ”) in the 1980s. During that brief period, the DOT approved no fewer than twenty-one separate mergers and rejected none, even though the DOJ appeared in an advisory capacity and vigorously opposed several of them. This period also saw certain developments deregulators had not foreseen—most importantly, the rise of the “hub-and-spoke” system and the development (by American, tellingly) of a uniquely sophisticated, highly successful system of price discrimination known in the industry as “yield management.”

Next, beginning in about 1993, as the economy generally emerged from downturn and the then-still small Southwest Airlines began to convincingly demonstrate the possibility of selective, low-cost competition against the majors, another flurry of entry ensued. That period was destined to be short as well, however, and again by late 1990s or early 2000s, the entrants had almost all failed or been acquired by major airlines. Indeed, virtually every new entrant in the industry’s entire history since deregulation has either failed or been acquired.<sup>3</sup> Since then, in any case, competition has been more muted, and the major carriers have also executed a series of large consolidating mergers, but the industry’s economic performance has still been uniformly poor. The legacy carriers have failed to earn profits in all but a handful of the years since deregulation, and several of them have undergone one or more bankruptcy reorganizations or been liquidated entirely.

A persistent theme of this lackluster history has been allegations of anticompetitive conduct by the legacy carriers. Most importantly, it has been alleged by

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<sup>3</sup> *Id.*

private industry participants, federal agencies and even the most esteemed of outside observers<sup>4</sup> that legacy carriers have engaged in selective predatory pricing attacks to exclude entrants from city-pair routes where they enjoy dominance—and especially new industry entrants or LCCs that have operated elsewhere.<sup>5</sup> However unlikely price predation may be in the typical market—a topic of much debate—a number of factors suggests its likelihood in deregulated airline competition. The overwhelming empirical evidence shows that the legacy carriers have each managed to establish pockets of significant market power at their hub airports,<sup>6</sup> and because they compete only in discrete city-pair markets, any act of predatory pricing will expose them to temporary losses on only one route. Moreover, given the high capital outlays of genuinely new airline entry, a relatively few bouts of successful predation are probably sufficient to dry up capital market access to new entrants.<sup>7</sup>

Throughout this period, airlines have proposed many, many mergers and acquisitions, and, even after the DOJ took over their review in the 1980s, the antitrust authorities have approved almost all of them. The DOT never blocked any transactions, and the DOJ has blocked only one large one, the proposed acquisition of U.S. Airways by United Airlines in 2001. In the present period of significant concentration and mostly slack competition, only a handful of major airlines still exist. Following several very

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<sup>4</sup> See, e.g., Statement of Alfred E. Kahn before Comm. on the Jud., Subcomm. on Antitrust, Bus. Rights & Competition, U.S. Senate, *Airline Competition: Clear Skies or Turbulence Ahead?*, 106th Cong., 2d Sess. (May 2, 2000).

<sup>5</sup> Economists and lawyers typically describe pricing as “predatory” if it is below cost (or at least sacrifices some profit) and is intended to force some competitor to exit the market or raise its prices.

<sup>6</sup> See Sagers, *supra* (collecting econometric reports).

<sup>7</sup> See Sagers, *supra* (elaborating these points at length).

large mergers in just the past few years,<sup>8</sup> all of them unchallenged by federal authorities, the proposed American/U.S. Airways deal would leave the sector with only four major players: United, Delta, American and Southwest. Nationally, those four firms will hold more than 70% of airline travel. But much more importantly, they will enjoy discrete pockets of much more power dominance in any number of city-pair routes—specific routes served only by one or two other carriers, where they are known to charge higher rates—and will face meaningful challenge in only some markets by the small number of remaining low cost carriers (“LCCs”).<sup>9</sup>

And above all, the evidence is clear that in those many specific city-pair markets on which legacy firms have been able to keep their competition to only one or a few other carriers, they have increased their prices.<sup>10</sup> Consolidations have also ordinarily been followed by some job losses, in part because merging firms typically close the smallest of the hubs in their combined networks. Job losses and the closing of hubs are described as

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<sup>8</sup> There have been six major mergers since 2005: (a) U.S. Airways/America West in 2005, (b) Delta/Northwest in 2008, (c) Republic Airlines’ acquisitions of both Midwest and Frontier Airlines in 2009, (d) United/Continental in 2010, and (e) Southwest/AirTran in 2010. See Diana L. Moss & Kevin Mitchell, *The Proposed Merger of U.S. Airways and American Airlines: The Rush to Closed Airline Systems* (American Antitrust Institute & Business Travel Coalition, August 8, 2012).

<sup>9</sup> Among the LCCs that remain, really only three are large and secure enough to offer serious fare competition—JetBlue and Spirit, along with Frontier following its forthcoming spin-off from Republic. See *id.*

<sup>10</sup> Some sympathetic to the industry have defended the present merger by observing that *average* airline fares risen at a rate roughly comparable to inflation for the past several years. See Pablo T. Spiller, *Why American-US Airways Deal Is Good*, CNN OPINION, Feb. 18, 2013, available at <http://www.cnn.com/2013/02/18/opinion/spiller-airline-merger>. But a focus on national average prices is *extremely* misleading. Airline markets are not national in scope. An airline does not set one fare price for all its flights nationally; it sets rates for each individual city-pair route that it serves, and rates are known to vary depending on how many other carriers serve that route. So it is very possible for overall average airline rates to advance at a pace like prices in other markets, even though discrete city-pairs lacking much competition see much faster rate increases.

“synergies” or the achievement of “efficiencies,” but they are best understood as simply the reductions in output predicted by elementary economics in any case of increasing market power.

## **II. The Effects of an American/U.S. Airways Merger**

### *A. Expect Higher Fares in Specific City-Pair Markets, and Some Job Losses*

There is no reason to expect an outcome any better in the proposed deal than has followed the many other airline mergers during the thirty-five years since deregulation. That is to say, the merged firm’s financial performance is unlikely meaningfully to improve, but it is likely to raise fares and limit service over significant portions of its network, as well as to reduce its workforce and close one or more of its hubs.

Unfortunately, it is not a terribly good answer that the DOJ may be able to impose more limited remedies on the merging parties than blocking their play completely. The major problem with the existing antitrust approach to airline consolidation is that the antitrust agencies and the courts lack any resolve actually to stop major mergers, but the limited alternative remedy they are willing to support is likely to be ineffective. On the one hand, neither government officials nor the American public has any stomach for business failure. And it superficially seems, given the airlines’ poor performance, that without continued consolidation the legacies’ only option is consolidation. But without blocking transactions completely, the DOJ’s only alternative is to require the parties to divest some of their “slots” on particular city-pair routes where competition would be unacceptably reduced by the particular transaction. (DOJ will surely require at least that in this particular transaction as to about a half-dozen city-pairs, on which the parties would otherwise enjoy complete monopoly.) The problem is that the only potential

purchasers While there are a few remaining LCCs that have some wherewithal to compete, the only LCC whose entry has ever persistently driven down fares in city-pair markets is Southwest, and Southwest has now achieved a nationwide presence of its own, and its costs are believed to have risen as well. All other LCCs to have seriously challenged a legacy carrier on a city-pair that it dominated has exited, or indeed has been acquired or failed completely. And while slots might be offered to other legacy carriers, instead of an LCC, the post-merger legacies will effectively be operating within a four-firm oligopoly, and widely accepted economic theory predicts that they cannot be expected to seriously compete on any except their most competitive routes.<sup>11</sup>

*B. Poor Economic Performance Is Perfectly Consistent With Market Power and High Prices*

Finally, there is little significance in the fact that American is emerging from bankruptcy or that either carrier has faced financial difficulty. First, that legacy carriers have found vigorous price competition difficult is explained less well by any special characteristic of their markets or technology, and much better by the persistence of their high costs relative to most firms to have entered since deregulation. Second, poor financial performance is perfectly consistent with market power or even full monopoly, because efficiency typically suffers firms acquire market power. As a commonplace of economic theory, where there are supracompetitive profits to be found, firms can be expected make socially wasteful investments to acquire or maintain it,<sup>12</sup> and to indulge in

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<sup>11</sup> See generally George Stigler, *A Theory of Oligopoly*, 72 J. POL. ECON. 44 (1964).

<sup>12</sup> See Richard A. Posner, *The Social Costs of Monopoly and Regulation*, 83 J. POL. ECON. 807 (1975);

organizational “slack” once it is gotten.<sup>13</sup> In fact it is now generally taken for granted in the theory of corporations or the theory of the firm that the only force that can effectively preserve internal productive efficiency is product market competition.<sup>14</sup>

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<sup>13</sup> See Harvey Leibenstein, *Allocative Efficiency vs. X-Efficiency*, 56 AM. ECON. REV. 392 (1966); Harvey Leibenstein, *X-Inefficiency Xists—Reply to an Xorcist*, 68 AM. ECON. REV. 203, 211 (1978); Harvey Leibenstein, *On the Basic Proposition of X-Efficiency Theory*, 68 AM. ECON. REV. 328 (1978).

<sup>14</sup> See generally Einer R. Elhauge, *Defining Better Monopolization Standards*, 56 STAN. L. REV. 253, 299–300 (2003).