STATEMENT OF HUBERT HORAN
THE ANTI-COMPETITIVE RISKS OF A DELTA-NORTHWEST MERGER AND EXTREME CONSOLIDATION OF INTERCONTINENTAL AIRLINES

HOUSE COMMITTEE ON TRANSPORTATION AND INFRASTRUCTURE
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Mr. Chairman, the Delta/Northwest merger is part of an organized movement towards extreme consolidation of large Intercontinental airlines. My belief that these mergers will be bad for consumers and bad for the future economic efficiency of the industry is based on 25 years of experience as to how these airlines actually compete and how these types of mergers actually work. In my testimony today, I'd like to focus on the primary sources of the threat to consumers and competition, and why I believe that these mergers can only be financially justified by artificial profits from anti-competitive behavior.

Overview—The Anti-Competitive Risks of Megamergers and Intercontinental Consolidation

- Delta/Northwest and other Megamergers can not be justified by synergies and improved efficiencies; profits from Megamergers will come from highly anti-competitive behavior. The anti-competitive gains will occur in two stages--anti competitive pricing on the North Atlantic made possible by the permanent elimination of competition, followed by serious distortions to domestic US competition
- In the first stage, healthy competition between the US and Europe is completely eliminated, replaced by a duopoly of two collusive alliances, led by Air France and Lufthansa, controlling 90% of all traffic to Continental Europe and a third collusive alliance, led by British Airways, controlling over 60% of all traffic to the UK.
  - "Collusive alliances" are those where airlines have antitrust immunity to collude on prices, capacity, service and marketing (functioning as a single competitor), and where the collusive alliance has the same antitrust implications as a full merger. Other airline alliances that do not have antitrust immunity do not have the same antitrust implications.
  - The Delta/Northwest and United/USAirways mergers focus on the US-Continental Europe market, a highly profitable, strongly growing market of over 30 million passengers that had very healthy competition with low concentration levels as recently as five years ago.

Hubert Horan has been in aviation for 25 years, and offers both the perspective of an analyst who has published extensively on airline competition issues and the first-hand experience working with over a dozen major airline mergers, alliances and restructurings. In addition to consulting work with over 25 carriers, he held strategic planning and network management positions at Northwest, America West, Swissair and Sabena, and was responsible for the original development of the Northwest-KLM alliance network. His articles have analyzed the financial crisis and restructuring of Legacy airlines in both America and Europe, the negotiations leading to the recent US-EU Open Skies treaty, and the competition and economic issues behind recent calls for industry consolidation. He is a graduate of Wesleyan University and the Yale University School of Management and is based in Phoenix, Arizona.

Recent Publications on Airline Competition and Consolidation include:
"Top Ten False Claims About the Need for US Airline Mergers" (Business Travel Coalition, Jan 2008)
"Airline Consolidation: Myth and Reality" (Aviation Strategy, November 2006)
"Update on Industry Consolidation and EU-US Treaty Negotiations" (Aviation Strategy, March 2007)
"Why the US Industry is at a stalemate" (Airline Strategy, January 2005).
"The EU-US Open Access Area" (Aviation Strategy, July 2003)
"United and American: are the turnaround plans viable?" (Airline Strategy, March 2003)
"What is the future of the European Flag-Carrier--An analysis of emerging European business models" (Aviation Strategy, September 2002).
"Is the Big Hub Business Model still viable?-The US network carrier crisis"(Aviation Strategy, July 2002)

- Following approval of the Delta and United mergers, a new collusive alliance is expected to be proposed between British Airways and American (and possibly Continental) that would immediately control 50-70% of the US-UK market. It would not face competition from anyone with more than a 10-12% share, and neither of the two European Duopoly groups would have any incentive to compete aggressively.
- At that point, three collusive groups---the Air France and Lufthansa led groups focused on Continental Europe and the British Airways led group focused on the UK market—will control over 95% of the entire Transatlantic market. Every US Legacy carrier will be a member of one of the three groups. There is no possibility of significant future competitive entry. Healthy, dynamic competition on the North Atlantic will have been completely replaced by airlines groups with full antitrust immunity to collude on pricing, capacity and service levels.
- With overwhelming market dominance and huge entry barriers, the three collusive alliances will be able to raise prices at will for many years to come, with no possibility of marketplace or regulatory discipline.
- This anti-competitive behavior will create a ongoing stream of artificial super-normal profits, large enough to totally justify the costs and risks of these mergers, and to bolster the financial returns of these companies. The improvement in airline profits will have come from price gouging made possible by the elimination of competition and not from synergies, efficiencies, improved service or increased productivity.

- In the second stage, the Megacarriers will use profits from gouging Transatlantic consumers to weaken and distort competition in the domestic market
  - Megacarriers will quickly distort every domestic market where the megacarriers compete with airlines that don't serve intercontinental markets. In Atlanta, Delta competes directly with Airtran which has much lower costs on many domestic routes. But Delta can use the artificial profits from Intercontinental markets to subsidize its domestic flying, blocking Airtran's ability to profitably grow in Atlanta, completely undermining the way competitive markets are supposed to work. Similar threats exist in any markets where the megacarriers compete with JetBlue, Southwest, Hawaiian, Alaska or any other domestic carrier
  - The megamergers would create a situation where 3 or 4 companies control 80% of the total US airline revenue and 100% of many important sectors where low cost carriers do not compete, including most mid-sized and smaller cities, and the large "fortress hub" cities such as Newark, Minneapolis and Cincinnati. While this would not directly create the artificial pricing power one would immediately see on the North Atlantic, it would seriously undermine the competitive market dynamics that have existed since deregulation. These carriers would now be "too big too fail"—lenders and local communities could not afford the costs of any financial or operational breakdowns. Competitors or capital markets would have little ability to discipline bad management or bad service. Costs will rise and quality will deteriorate over time, but no market or regulatory mechanisms will be able do anything about it.
- Over time, extreme consolidation would undermine competition in other intercontinental markets such as Asia, the Middle East and South America. The three collusive megacarrier groups would control all network airline service within the United States and the European Union. Thus any other intercontinental airline would find it increasingly difficult to compete for traffic in the world's two largest and most important markets. Carriers such as Japan Air Lines, Singapore Airlines, Emirates and many others would be forced to limit service to large gateway cities, or to join collusive arrangements with the three megacarrier groups on unfavorable terms.

The balance of this testimony will be limited to the immediate (first stage) risks to consumers from anti-competitive pricing on the North Atlantic, and the antitrust issues raised by the Delta and United merger applications, and will not discuss the serious second stage domestic competitive risks. The following sections will outline the evidence demonstrating the strong existing movement towards extreme concentration, and the evidence of specific actions taken to undermine competition.

1. Delta/Northwest and Other Megamergers Can Not Be Justified By Synergies and Improved Efficiencies

Mergers that significantly reduce competition can sometimes be justified if they produce clear, verifiable efficiency gains that could be passed onto consumers in the form of lower prices, expanded service, innovation or improved quality. The claims that Delta/Northwest and United/USAirways will produce billions in synergies lacks credibility and will not survive any serious, independent scrutiny.

- Megamergers will not achieve cost savings. Delta, Northwest, United and USAirways just went through years of draconian cost cutting while under bankruptcy protection. The overhead and fat was eliminated years ago.
- Megamergers cannot achieve savings from increased scale economies. It is ludicrous to argue that Delta and United are not large enough to be competitive.
- Because of the hugely complex implementation process, Megamergers will actually increase costs and worsen cash flow for several years. The cost of integrating reservations, operations control and maintenance system will easily wipe out most savings from firing redundant staff.
- Some network synergies may be achievable, but the magnitude of revenue synergies needed to economically justify this merger would require both major hub restructuring and major new growth, and these mergers will not achieve either. Delta management has clearly indicated that the size of the combined network won't change, and the size and roles of the individual hubs won't materially change. Tweaking a few routes here and there will not drive billions in revenue away from the competition. Repainting Northwest's red airplanes into Delta Blue will not give consumers any new services or choices that they don't have today.
- The Delta and Northwest networks have enormous overlaps. Claims that this is an "end-to-end" merger are false. The two networks overlap across all of North America, the entire North Atlantic, and from the US to Japan, Korea and China. True "end-to-end" benefits are limited to extremely tiny markets such as South Carolina to Southeast Asia, and North Dakota to South America. Isolated schedule improvements are possible, but most will quickly be neutralized by the United/USAirways merger and other competitive responses.

As shown in Appendix A, almost every US airline merger since deregulation (including every merger remotely comparable to these megamergers) has been a dismal financial failure. Like all of the failed mergers, the proposed Delta/Northwest and United/USAirways mergers have wildly underestimated implementation costs and risks and wildly overestimated cost savings and network synergies. If mergers cannot generate sufficient synergies to provide a return on the capital "invested" in the merger, it cannot possibly provide additional gains to consumers to justify the reduction in competition.

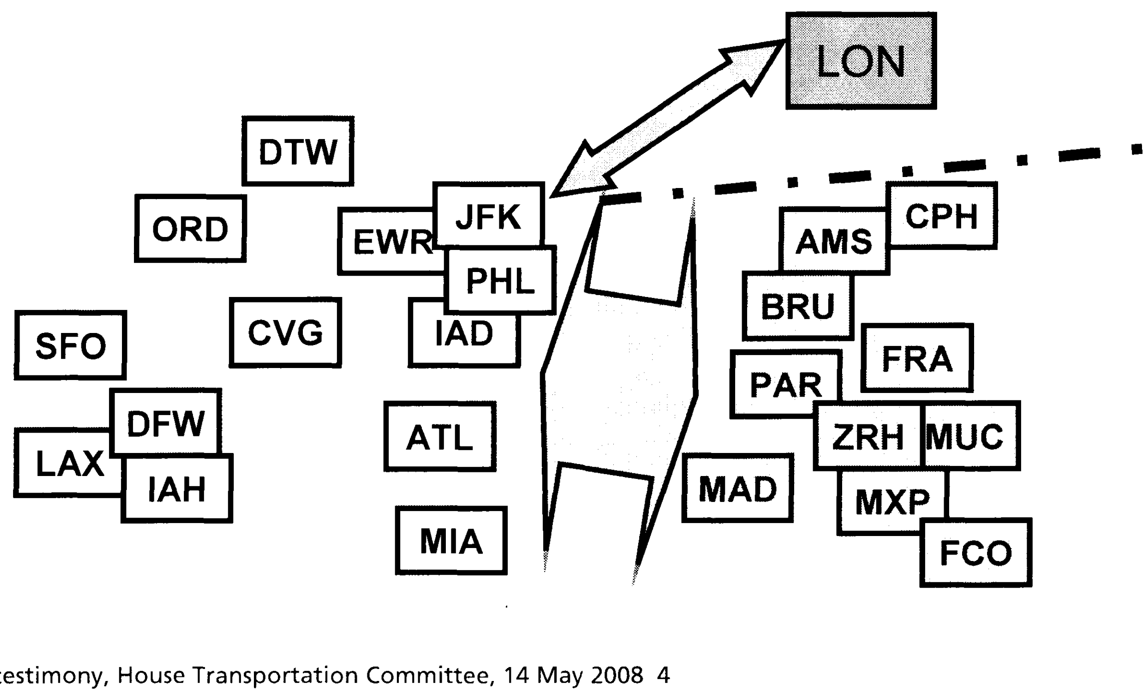
The synergy/efficiency issue involves factual questions that must be one of the first priorities of the Department of Justice investigation. Approval of these megamergers should not be granted unless Delta and United fully document their synergy claims and find a way to convince independent, objective experts that these billions in efficiency gains are readily achievable, and how they uncovered synergy opportunities that no previous airline merger had ever been able to find. Past DOT decisions have taken airline claims of synergy at face value, without any attempt to independently evaluate whether claims had been inflated by gains that would have occurred without the merger, whether all implementation and transaction costs had been properly included, or to understand the legitimacy of merger synergy claims in light of the horrible historic track record of past mergers.

Delta and United have no hope of achieving the synergies they have forecast, but they were never the real source of merger profits.

2. <u>The US-Continental Europe Market is Large, Growing, Highly Profitable and Never Needed Mergers.</u>

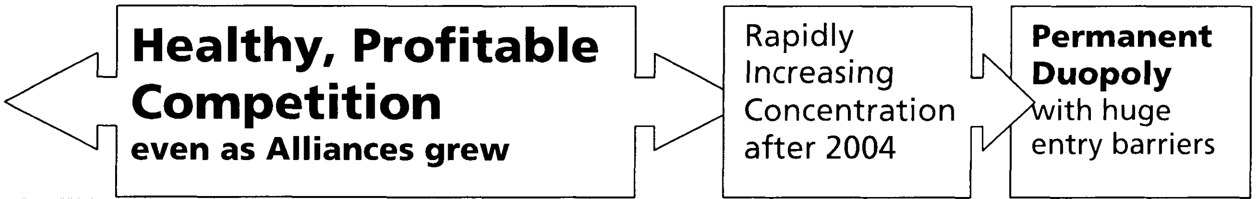
- The USA-Continental Europe Market that is the central focus of the Delta/Northwest merger is a large, healthy, highly profitable market that was never in any need of mergers or a major competitive shakeout. It is one of the largest international markets in the world, with over 30 million passengers each year. The market grew at an annual average rate of 4% over the last 15 years, and grew at an average rate of 6% in the last 4 years
- Intercontinental markets have been the most important recent source of airline profitability and growth; they have significant entry barriers and there has been very little growth in the number of competitors over the years. Domestic US, intra-EU and similar shorthaul markets have few entry barriers, and have experienced strong actual entry and price competition, leading to overcapacity and poor profitability. Mergers such as Delta/Northwest and United/USAirways could not address these domestic problems without major capacity cuts and hub restructuring, which would not be possible outside of bankruptcy protection. Advocates of "industry consolidation" focus on domestic competition hoping to create the impression that Megamergers pose no threat to consumers (because of abundant existing competition) and to divert attention from the much more restrictive and profitable longhaul markets where consolidation poses much greater threats to consumers.

- The USA-Continental Europe Market is a highly integrated market that can only be served by large hubs and cannot be served by "point-to-point" airlines
  - only a very tiny fraction of market demand is in city pairs (such as New York-Paris) large enough to support nonstop widebody service without heavy reliance on connecting feed traffic.
  - because of the highly fragmented O&D markets, because of entry barriers at the largest transatlantic airports (Newark, Kennedy, Paris, Frankfurt, etc.) and because of the need for a large fleet of modern widebody aircraft, there is no possibility that low cost carriers such as Southwest, Jetblue, Ryanair or Easyjet could ever enter the market and establish a meaningful overall US-Europe competitive presence.
- The hub-based US-Continental Europe market must be considered separately from the US-UK/Ireland market, which is exclusively served by nonstop flights, predominately to London. Nobody flies from the US to London, Glasgow or Dublin via Paris or Amsterdam. British Airways no longer seriously competes for US-Europe traffic. For the last decade it downsized transatlantic aircraft that used to carry low-yield European connecting traffic and has reallocated its Heathrow slots to more profitable uses. Competitive and concentration issues in the UK/Ireland markets are largely separate from the competition and concentration issues in the Continental Europe market.



3. <u>EU-Continental Europe Concentration Levels Have Dramatically Increased Since 2004 and the Drive Towards Permanent Market Duopoly Is Nearly Complete</u>

The chart below uses various common measures of concentration to illustrate the radical shift away from healthy, profitable competition that began in 2004, and the permanent duopoly concentration that consumers will face after these Megamergers are implemented.



	1993	1995	1997	1999	2001	2003	2005	2007	2009(?)
US-Continental Europe concentration levels									
top 2 share	32%	38%	44%	45%	50%	55%	77%	76%	92%
top 3 share	41%	47%	55%	56%	61%	67%	85%	86%	97%
top 4 share	51%	56%	64%	63%	68%	74%	92%	93%	99%
# competitors with minimum departure share of									
5%	7	7	6	6	7	6	4	4	2
2%	12	12	10	10	10	8	5	5	3

Departure share of the US-Continental Europe market, DOT Form 41 T100 data

forecast 2009 levels assume the elimination of Continental as an independent competitor

The US-Continental Europe market enjoyed vibrant competition with low levels of concentration until 2004. Increases in concentration through 2003 reflected the normal workings of a dynamic market and posed no threat to consumers.

- The three original alliances with antitrust immunity to collude on price and service (KLM-Northwest in 1993, Delta-Swissair-Sabena in 1995 and United-Lufthansa in 1997) developed without damaging the overall market dynamic. Although the alliances initially reduced the number of competitors, they developed in an environment with low concentration, and consumer losses from collusion were offset by improved schedules and expanded price discounting in alliance markets, and by the major expansion of two smaller competitors, (Continental at Newark, USAirways at Philadelphia).
- Several carriers exited the market in the decade prior to 2004, but these were either the weakest/worst run competitors (Pan Am, TWA, Sabena) or extremely small carriers linking up with one of the larger groups.

The shift to extreme consolidation was triggered by the Air France-KLM merger in 2004. Prior to Air France-KLM, there were six strong, viable competitors in the market. The Air France and Lufthansa groups each had 20-25% of the market, the KLM-Northwest alliance had 10-15%, three large US carriers—American, Continental and USAirways, each had 5-10% of the market, and various smaller niche carriers competed independently. Because each carrier (or alliance) had a slightly different geographic focus, actual levels of competition were even higher than these aggregate numbers suggest. The KLM alliance was fully competitive with the Air France and Lufthansa alliances for traffic from the large pool of "interior" European and US cities. Continental, American and USAirways were strong competitors in the larger O&Ds from the US to the main European gateways.

The 2004 Air France-KLM merger was designed to destroy this healthy competition by making it impossible for most mid-sized airlines to remain competitive, and forcing the market towards an inevitable Air France/Lufthansa Duopoly. The entire move towards extreme concentration is explained by mergers and external pressures. None of the movement to permanent Duopoly since 2004 can be attributed to the normal workings of a healthy competitive market.

- The merger eliminated competition from KLM, the profitable #3 Intercontinental competitor in Europe, which provided the major source of price competition against Lufthansa and Air France (the #1 and #2 competitors)
- The merger eliminated the KLM-Northwest alliance as a competitor on the North Atlantic, so that only two US airlines could possibly have access to the huge European traffic base beyond the large gateway hubs
- Northwest was no longer viable as an independent competitor, although sham competition was "preserved" with an interim agreement to maintain the appearance of an "independent" KLM-Northwest entity in the market. Northwest faces a "merge-or-die" dilemma at the end of this interim agreement, since it would have to abandon most (if not all) of its profitable European flying without an collusive alliance arrangement, and the loss of this large, profitable network could easily drive Northwest back into bankruptcy.
- Other mid-sized competitors including USAirways, Austrian, LOT and Aeroflot felt they had no choice but to sign up as junior members of the Air France or Lufthansa groups, and the European Union actively supported these efforts towards higher concentration. Swiss and Alitalia were forced into these groups as part of efforts to stave off financial difficulties.
- American Airlines found it increasingly difficult to compete for Continental Europe traffic against the growing dominance of the Air France/Lufthansa led groups and its market share declined from 11% in 1995 to 7%. The Air France and Lufthansa groups also discontinued many interline agreement with smaller competitors, blocking these carriers access to connecting traffic.
- Continental and Iberia, the only other carriers with a market share greater than 2%, were under constant pressure to merge with one of the Duopoly partners.

4. <u>The Delta and United Mergers Are Part of a Concerted, Well Organized Five Year Effort To Eliminate Competition on the North Atlantic</u>

The rapid movement from healthy competition to extreme concentration between the US and Continental Europe since 2004 did not result from "market forces" such as the exit of uncompetitive carriers or the rapid growth of highly productive airlines. It resulted from proactive, carefully planned efforts by the European Union and the largest carriers to artificially reduce competition and increase concentration. Major steps in this proactive campaign included:

- Early this decade European Union aviation policy shifted from a hands-off "led the market decide" view of airline competition, to an active advocacy for mergers between Intercontinental airlines, and support for Air France and Lufthansa (and to a lesser extent British Airways) as "national champions" in their competition with Intercontinental airlines based outside Europe.
  - While the EU's advocacy is stated in terms of favoring "industry consolidation", it has only taken active steps in the longhaul Intercontinental sector (which is highly profitable, and where there had never been any significant growth in the number of competitors) while largely ignoring the shorthaul intra-European market, which experienced explosive competitive entry in recent years, and is arguably much more fragmented, much less profitable, and is hypothetically much more in need of "consolidation")
- With the active support of the EU, Air France acquired KLM in 2004, immediately driving a major reduction in Intercontinental competition
  - As noted earlier, the merger eliminated the major competitor to the Air France/Lufthansa Duopoly, made it impossible for more than two US airlines to have access to the majority of the European market (cities that were not major intercontinental gateways), eliminated the possibility of serious competition from Northwest and most other mid-sized competitors

- The European Union actively campaigned for other EU Intercontinental airlines (such as Iberia, Alitalia, Swiss, LOT and TAP) to join either the Air France or Lufthansa led collusive groupings, and aggressively opposed Ryanair's efforts to enter the North Atlantic via a merger with Aer Lingus
  - The EU was willing to subvert traditional antitrust standards out of explicit favoritism to Air France and Lufthansa. Even though the Air France-KLM merger eliminated competition in tens of thousands of Intercontinental markets their antitrust review looked at nothing except a tiny handful of nonstop O&Ds. When the Aer Lingus-Ryanair merger threatened to establish a new low fare Intercontinental competitor, they used radically different antitrust standards, banning the merger by claiming that the simple reduction in the number of market competitors was an irremediable violation of competition law.
- A major press/public relations campaign in the United States advocating "industry consolidation" was spearheaded by United Chairman Glenn Tilton
  - As with the EU's campaign, the claimed need for "industry consolidation" was strictly limited to profitable, high entry barrier Intercontinental markets, not to the more intense competition in most domestic US markets.
  - All of the public advocacy of "industry consolidation" in the last five years has come from either the EU, the dominant airlines in the emerging Air France/Lufthansa led groups, or Wall Street analysts beholden to those airlines. There has been no support for Intercontinental "industry consolidation" from small or mid-sized airlines in America or Europe, from Intercontinental airlines based in Asia, the Middle East or South America, or from any independent economists or industry analysts.
- Air France began an active drive for its US partner (Delta) to acquire Northwest, Lufthansa began an active drive for its partner (United) to acquire Continental, the last remaining independent competitor on the North Atlantic
  - Air France and Lufthansa were the only two parties to ever express a willingness to invest in either of these two mergers
  - Delta's claim that the Northwest merger is a response to today's high fuel prices is false; it had been conceived and planned when fuel prices were less than half of today's prices
- The European Union delayed agreeing to a new Open Skies treaty with the United States for over five years while it demanded (unsuccessfully) the right for Lufthansa and Air France to take much larger ownership positions and to directly control the management of their US partners
  - This five year delay kept the EU in violation of a 2002 European Court of Justice ruling which had invalidated traditional bilaterals that did not grant equal rights to all EU-based airlines. The final 2007 treaty was virtually identical to terms that the United States would have accepted in 2002 but for the EU's pursuit of full Transatlantic mergers
- Following the Delta (Air France) and United (Lufthansa) applications, industry observers have long expected that British Airways and American would apply for the same full antitrust immunity on North Atlantic services that the Air France and Lufthansa led groups enjoy.
- Recent events follow the pattern of a careful PR strategy designed to minimize public awareness and discussions about extreme concentration. By announcing Delta-Northwest first, fewer alarm bells about "competitive issues" (compared to other Megamergers) because of superficial appearances about domestic route overlap and slots at constrained airports. If press reports emphasized claims that Delta/Northwest didn't require serious antitrust review, there would be less pressure for a rigorous, independent analysis of the Delta's claims and the actual consumer and competitive impacts. Rapid approval of Delta/Northwest makes the approval of all subsequent Megamergers virtually certain. If Delta's claim of huge synergies and efficiencies driven by increased scale and network scope is accepted, there would be no plausible basis for denying the same benefits to United. Once the immunized Air France and Lufthansa led groups have secured permanent dominance of the Continental Europe market, there is no logical basis for denying immunity for similar collusive practices to American and British Airways.

In five years, these actions will have transformed the Transatlantic market from one with vibrant, profitable competition, to one where three collusive groups will have permanent control of over 95% of all traffic, and will have the ability to raise prices at will without the possibility of any competitive or regulatory discipline.

The "endgame" of this five year process is the question of whether Continental Airlines joins the Lufthansa led group (via either collusive alliance or merging with United) or whether it joins the British Airways-led collusive group focused on the UK market. United/Lufthansa aggressively pursued the merger option for four years, knowing this would eliminate the last independent competitor on the North Atlantic and give the Lufthansa group a market share edge over the Air France group. While Continental decided not to take on the enormous risks of a full United merger at this time, it remains extremely unlikely that it would remain independent--its current 10% market share would be not be sustainable over time against an 85% Duopoly position. Whether Continental decides to join one of the collusive groups on an alliance basis, or decides to wait until more favorable terms for a United merger, the result would lock-in permanent control of the North Atlantic for the three collusive groups.

Megamergers Drive Extreme Transatlantic Concentration Levels

Continental Europe	2003 actual		2009 post-merger	UK/Ireland market	2003 actual		2009 post-merger
AF group	30%	LH group	48%	BA	33%	BA group	63%
LH group	26%	AF group	44%	AA	18%	LH group(UA)	11%
KL group	11%	BA group(AA)	6%	VS	12%	VS	11%
AA	7%	other	2%	UA(LH group)	11%	AF group(DL)	9%
CO	7%	*assumes CO joins LH*		CO	8%	EI	4%
US	5%			DL(AF group)	5%	other	2%
other	15%	Duopoly	92%	EI	5%	*assumes CO joins BA*	
				US	5%		
				other	3%		

2003 data from DOT Form 41 T100

5. <u>Megamergers Fail Every Important Antitrust Test</u>

Megamergers and the extreme consolidation of Intercontinental airlines violates all of the following basic tests used to evaluate whether mergers that eliminate competition might be in the public interest

- Is concentration increasing in markets with low entry barriers?
  - NO—these transatlantic markets have huge barriers to new entry—there is absolutely no possibility that future entrants could ever achieve the market presence needed to discipline anti-competitive abuses by either the Air France/Lufthansa led Duopoly in Continental Europe or the prospective British Airways led group in the US-UK market
- Is concentration increasing because of marketplace success?
  - NO—all of the movement towards extreme concentration since 2004 results from mergers and government interference favoring the interests of the very large carriers over the broader interest of consumers or industry efficiency. None of the movement towards Duopoly since 2004 results from carriers with lower costs, more efficient operations, lower prices or superior service displacing less productive, less competitive airlines.
- Can regulators rely on "market forces" to discipline any future anti-competitive behavior?
  - NO—these markets are not "contestible"—the Air France/Lufthansa Duopoly would be permanent, as would be the dominance of the prospective British Airways/American/Continental collusive alliance
- Would marginal losses in competition be offset by efficiency gains, that could yield tangible consumer benefits in terms of lower prices or improved service?

- NO—at the carrier level, true synergies and efficiencies are very limited, and could not possibly justify the cost and risks of these Megamergers to the carriers shareholders, and thus could not possibly provide tangible consumer gains offsetting the loss of competition. The carrier claims about synergy/efficiency gains cannot be taken at face value since no comparable airline merger in North American history has ever justified shareholder costs (much less risks to consumers) based on synergies and efficiency gains.

- Would mergers lead to a shakeout of structurally uncompetitive, unprofitable industry capacity leading to a much more efficient allocation of capital across the industry?
  - NO—at the industry level, Megamergers and extreme industry consolidation are designed to make the shakeout of unprofitable industry capacity more difficult and to increase the misallocation of capital. Delta management is committed to retaining all of its unprofitable domestic capacity. The market capitalization of Delta and Northwest fell by $1 billion after the merger announcements because Wall Street felt that the merger would make needed capacity changes more difficult. By using artificial North Atlantic profits from anti-competitive pricing to distort domestic competition (as discussed earlier), Megamergers would make competitive and capital misallocation problems across the industry even worse.
- Would mergers create clear, tangible service and pricing improvements for consumers?
  - NO— these mergers are explicitly designed to screw consumers. The entire economic rationale depends on artificial pricing power. If you take away the anti-competitive impacts in International markets Delta and United would have no interest in a merger. If these Megamergers are implemented prices will increase and service will continue to decline, especially to Europe. Consumers will have fewer choices. Consolidation will not drive meaningful improvements in schedule frequency or hub operations. Over time the loss of market competition will lead to a steady deterioration in service, cost efficiency and innovation.

6. <u>Extreme Consolidation on the North Atlantic Could Not Have Happened Without Direct Government Interference With Open-Market Competition</u>

"Market Forces" did not drive the rapid movement from healthy competition and low concentration to permanent domination of the European market by a Duopoly of collusive groups and permanent domination of the UK market by a third collusive group—it was driven by the carriers, themselves, in pursuit of profits from market power and anti-competitive pricing. But it could never have happened without the full support of the European Union and the US Department of Transportation. As noted earlier, the EU's made an explicit, public policy decision to abandon its previous focus on the general public interest in open-market Intercontinental competition and to actively intervene in airline competition and industry structure in favor of the interests of the shareholders of Air France, Lufthansa and British Airways. EU decisions and actions over the last five years have been clearly aligned with its stated pro-"industry consolidation" and pro-"national champions" policies. However, the DOT's ongoing support for artificial consolidation has not been based on any stated policies, and has not been the subject of public comment and review much less Congressional oversight.

DOT has approved, with minimal analysis or review, every Legacy carrier application to increase North Atlantic market concentration in recent years, including every requested expansion of Lufthansa/United antitrust immunity to a wider group of airlines, and the recent merger of the previously independent Air France/Delta and Northwest/KLM alliance. It is unclear whether these decisions represent gross negligence on the DOT's part (a total disinterest in protecting the public interest in healthy market competition, or a refusal to assign the required resources and expertise needed to address these issues) or a willful attempt to undermine existing competition policies in favor of the interests of companies like Delta. At no point in any decision or analysis has the DOT acknowledged either the clear historical evidence of rapidly growing consolidation since 2004 (as shown in the table in section 3), or publicly acknowledged the possibility that extreme consolidation might threaten consumers, or attempted to define any objective analytical framework for evaluating the tradeoffs between increasing airline concentration, industry competition and efficiency, and consumer welfare.

The DOT issues are illustrated by its recent decision on Air France's application to merge the Air France and KLM alliances (Docket OST-2007-28644). It rapidly rubber-stamped the alliance merger without any scrutiny of merger claims and without any attempt to independently analyze any of the competitive/consumer issues, and would be extremely dangerous to assume to use it as precedent in future cases . The two alliances that were "merged" by this decision have greater route overlap and would achieve higher concentration in their core markets than a merger between United and American at Chicago would achieve, but the DOT failed to conduct anything similar to the serious merger/antitrust analysis such cases would require.

- DOT totally ignored all historical evidence of rapidly increasing US-Europe concentration, and the artificial causes of this concentration, and the specific risks that concentration levels this high could lead to anti-competitive pricing behavior
- DOT accepted undocumented carrier claims of consumer benefits and cost efficiencies without any independent objective analysis or any attempt to explain why the alleged gains offset consumer risks from reduced competition, and
    - yet DOT rejected evidence of higher prices and other anti-competitive behavior because it didn't provide definitive proof of "a substantial reduction in competition"
- DOT deliberately ignored the consumer risks created by high barriers to entry, asserting that "Open Skies" treaty conditions automatically ensured fully contestible market conditions
- DOT deliberately understated actual concentration impacts by including the separate 10 million passenger US-London market (which KLM and Air France have never served)
- DOT ignored the fundamental economics of the DL/AF/NW/KL hub-based networks by ignoring the extreme concentration of the connecting markets that drive US-EU competition. Aside from its deliberately understated comparisons of aggregate Transatlantic shares, its only competitive analysis (simple tables that counted nonstops) was limited to country-by-country nonstop service. Over half of all traffic on Air France/KLM transatlantic flights connect to other cities beyond the gateway. The Air France/Lufthansa Duopoly will control almost 100% of this huge traffic base, and it is a critical factor in Transatlantic competition, but the DOT did not even acknowledge its existence.
- DOT did not consider any evidence except what was presented by the large Legacy airlines

Appendix A

Almost All Mergers Between Large Airlines Since Deregulation Have Been Dismal Financial Failures

In almost every case, airline mergers have failed to generate positive returns for shareholders, which is to say profit improvements (above and beyond what the carriers would have earned absent the merger) that fully justified the financial costs and risks. Mergers that cannot earn positive returns for shareholders cannot possibly justify the risks (from reduced competition) imposed on consumers. The rare successes, involved either

---Major restructuring of hubs whose development had been artificially blocked before deregulation

---Very Small acquisitions that were easily integrated into the parent airline

---Mergers implemented under chapter 11 or bankruptcy-like conditions

The proposed Delta/Northwest and United/USAirways mergers have none of the characteristics of any successful merger and have many of the characteristics of the failed mergers.

Large Airline Mergers	Category	**Were merger acquisition and implementation costs fully justified by improved profitability?**
80: Pan Am/National	1-Post Dereg	**FAILURE**—NA network largely liquidated
82: Texas Intl/Continental	1-Post Dereg	**FAILURE**—carrier quickly went bankrupt
85: Southwest/Muse	2-Quasi-BK	Profitable—cheap acquisition in lieu of MC bankruptcy
85: People Exp/Frontier	4-Synergy/Scope	**FAILURE**— carrier quickly went bankrupt
86: TWA/Ozark	1-Post Dereg	Profitable—Restructured STL into a competitive hub
86: Northwest/Republic	1-Post Dereg	Profitable—Restructured DTW/MSP into competitive hubs
86: American/Aircal	4-Synergy/Scope	**FAILURE**—OC network totally liquidated
87: Continental/PE/NY/FL	4-Synergy/Scope	**FAILURE**—carrier soon bankrupt, FL/NY networks liquidated
87: Delta/Western	4-Synergy/Scope	**FAILURE**—WA network largely liquidated
87: Continental/Eastern	4-Synergy/Scope	**FAILURE**—CO soon bankrupt, EA network liquidated
88: USAir/PSA	4-Synergy/Scope	**FAILURE**—PS network largely liquidated
88: USAir/Piedmont	4-Synergy/Scope	**FAILURE**—US soon bankrupt, PI partially liquidated
94: Southwest/Morris	3-Small Acquis	Profitable—easy fit with SWA network/operations
99: American/Reno	4-Synergy/Scope	**FAILURE**—QQ network largely liquidated
00: American/TWA	4-Synergy/Scope	**FAILURE**—TW network largely liquidated
00: United/USAir (plan)	4-Synergy/Scope	**FAILURE**—both carriers went quickly bankrupt
05: America West/USAir	2-Quasi-BK	Jury Still Out—favorable bankruptcy terms, but struggling

Note: 2000 United/USAir merger reached regulatory review process but was never implemented
All Canadian airline mergers during this time frame were also failures

Merger Categories, based on the economic rationale for pursuing the merger

1—Post Deregulation Network Restructuring: integrating routes and hubs that had been artificially constrained under CAB regulations

2—Quasi-Bankruptcy Asset Restructuring: sale/integration of assets under chapter 11 protection (or a transaction in lieu of chapter 11) where only assets were acquired at highly favorable rates and assets not required post-merger were not acquired

3—Very Small Acquisitions: mergers involving very small fleets, where operations could be easily and quickly integrated into the parent company

4---Cost Synergies/Network Scope—mergers (outside of bankruptcy) justified by cost synergies, scale economies and network scope synergies.

5—Highly Anti-Competitive (no USA examples in the 1980-2005 timeframe) mergers designed to create and exploit market dominance and pricing power in environments with high entry barriers