BEFORE THE
DEPARTMENT OF TRANSPORTATION
WASHINGTON, D.C.

PROPOSED STATEMENT OF ENFORCEMENT POLICY ON UNFAIR EXCLUSIONARY CONDUCT BY AIRLINES	)	**Docket OST-98-3713**

COMMENTS OF
<u>SOUTHWEST AIRLINES CO.</u>

Communications with respect to this document should be sent to:

Herbert D. Kelleher
Chairman, President and
Chief Executive Officer

James F. Parker
Vice President-General Counsel

Ron Ricks
Vice President - Governmental Affairs

SOUTHWEST AIRLINES CO.
2702 Love Field Drive
Dallas, TX 73235

Robert W. Kneisley
Associate General Counsel -
Federal Affairs
SOUTHWEST AIRLINES CO.
1250 Eye Street, N.W.
Suite 1110
Washington, D.C. 20005
(202) 682-4534

July 24, 1998

BEFORE THE
DEPARTMENT OF TRANSPORTATION
WASHINGTON, D.C.

PROPOSED STATEMENT OF ENFORCEMENT POLICY ON UNFAIR EXCLUSIONARY CONDUCT BY AIRLINES	)	**Docket OST-98-3713**

COMMENTS OF
SOUTHWEST AIRLINES CO.

On April 6, 1998 the Department of Transportation issued a proposed Statement of Enforcement Policy on Unfair Exclusionary Conduct by Airlines. Southwest Airlines Co. ("Southwest") submits these comments on DOT's proposed policy and the important issues of airline competition underlying the statement.[1/]

Southwest applauds the DOT for taking the initiative to address the subject of airline competition, in this the 20th anniversary of economic deregulation of the airline industry. The Department's proposed policy is designed to enhance competition by limiting the ability of major incumbent carriers to drive out "new entrant carriers" from their hubs via deep temporary fare cuts combined with large temporary capacity increases that divert revenue from the incumbent itself. Given the various stakeholders with widely differing interests in the airline industry, it is not

1/ Southwest does not join in the comments filed by the Air Transport Association, of which it is a member, and is expressing its position in these individual comments instead.

surprising that DOT's proposed policy -- or *any* policy designed to enhance competition -- would spark controversy and debate. Southwest believes the Department's proposed policy is a constructive approach to this important subject, and we endorse the Department's goal of enhancing competition by eliminating anticompetitive practices.

Summary of Southwest's Position

Without taking a position on the *specific* guidelines DOT has proposed, Southwest believes there are four fundamental principles that should guide the development of a sound public policy to enhance airline competition:

1. Airline deregulation is a great success on the whole, but significant barriers to competition and expansion of low-fare air service persist in many regions of the country. Those barriers to competition keep air fares too high and travel choices too limited in many important markets, and thus prevent much of the U.S. travelling public from realizing the full benefits of deregulation.

2. DOT has both the responsibility and legal authority to prevent anticompetitive practices in the airline industry. Longstanding precedent makes clear that DOT has authority to act in this case, especially considering that DOT has the power to intervene in the market to prevent unfair competitive practices on a case-by-case basis without issuing prior guidelines.

3. According to DOT's own studies, Southwest is responsible for the great majority of low fares in the United States.[1/] Accordingly, any significant policy regarding airline competition should recognize Southwest's unique role in dramatically reducing the cost of air travel, stimulating new traffic, and increasing competition. The Department's proposed policy has a more narrow objective and will likely apply in only a small number of markets in which Southwest does not participate.

4. If the federal government wishes to enhance airline competition and promote low fares in an effective and lasting manner, it must take both a comprehensive and consistent approach to doing so. Mega-carriers possess numerous competitive weapons and structural advantages against low-fare competition that are much more significant than the practices that DOT has identified in this proceeding. In some cases *the government itself* has taken actions that unfairly penalize low-fare airlines, such as its imposition of "segment fees" in last year's restructuring of transportation excise taxes. If the government wishes to promote airline competition for a broader segment of the public, it will need to recognize these more significant competitive issues.

[2/] See, e.g., U.S. Department of Transportation, Office of Aviation and International Economics, The Low-Cost Airline Service Revolution (1996). See also the discussion in section III below.

These fundamental points are elaborated below.

I. Airline Deregulation Has Produced Enormous Public Benefits, But Significant Barriers to Competition and Low-Fare Air Service Continue to Exist in Many Important Markets.

There is no question that airline deregulation has produced enormous public benefits over the last 20 years, as air fares have fallen significantly, on the average, and regulatory controls on domestic route entry have vanished at all but a few slot-controlled airports. Southwest itself owes much of its development into the nation's pre-eminent low-fare carrier to the process of deregulation.

At the same time, however, there is no question that significant impediments to competition exist in many important markets that prevent the public from realizing the full promise of deregulation. As has been well documented by disinterested observers, barriers to entry remain high at many concentrated airports due to the competitive advantages of the incumbent carriers that potential new entrants cannot begin to match.[1/] In this respect, it is significant that barriers to entry and growth of low-fare competition today are no longer primarily a consequence of a shortage of adequate airport facilities. Rather, these barriers to competition are overwhelmingly the result of powerful marketing advantages and tactics used by dominant incumbent carriers to protect their concentrated markets from low-cost competitors. As a result, fares are too high and travel choices too limited for much of the U.S. public.

[3/] See, for example, the General Accounting Office report Airline Competition: Higher Fares and Reduced Competition at Concentrated Airports, GAO/RCED 90-102 (1990); and Testimony of Steven A. Morrison before Committee on the Judiciary, U.S. Senate, April 1, 1998.

It is not surprising that the high level of concentration and lack of adequate competition in many markets has given rise to voluminous consumer complaints over perceived irrationality and unfairness in airline pricing -- why a trip of 300 miles, say, in a market without low-fare competition may cost two or three times more than a flight of 1,000 miles in a market where a low-fare carrier competes.[1/] Those complaints reflect a pernicious practice in this industry which, in Southwest's view, not only infuriates the public but unfairly suppresses competition -- charging excessively high fares to travellers in monopoly or near-monopoly markets to cross-subsidize low (sometimes even below cost) fares in markets in which low-fare airlines are present. Consumers that are increasingly complaining of "price gouging" of captive travellers will not likely be satisfied with an explanation that airlines are simply rational profit-maximizers and that nothing needs to be done about it.

[4/] By way of example only, according to DOT data from fourth quarter 1997, passengers between Richmond and New York City (292 miles) paid an average of $215 (73.6¢ per mile), while passengers between Seattle and Albuquerque (1,182 miles) paid an average of $149 (12.6¢ per mile). Southwest competes in the latter market but not the former. See DOT <u>Domestic Airline Fares Consumer Report</u> (June 1998).

Moreover, the high level of industry concentration which allows this type of pricing could increase significantly in the near future, as the nation's six largest airlines are proposing to combine into three "alliances" that would carry over 80% of domestic traffic. This potentially dramatic rise in the level of industry concentration; the high barriers to entry that already exist at some major airports; and the numerous marketing tactics and structural advantages used by large network carriers to thwart competition from smaller rivals, are indeed cause for real concern for the future of air travel. So long as these problems exist, much of the public will never realize the low prices and new travel choices available in markets where low-fare airlines compete.

II. DOT Has Broad Legal Authority to Prevent Anticompetitive Practices and Has Authority to Act in this Case

It has been settled for several decades that the DOT (as the Civil Aeronautics Board before it) has broad authority to prevent anticompetitive practices in air transportation. To begin with, the DOT's governing statute requires the Secretary of Transportation to consider, in carrying out his responsibilities, that the following objectives are in the public interest:

> the availability of a variety of adequate, economic, efficient, and low priced services without unreasonable discrimination or unfair or deceptive practices.
>
> preventing unfair, deceptive, predatory, or anticompetitive practices in air transportation;

> avoiding unreasonable industry concentration, excessive market domination, monopoly powers, and other conditions that would tend to allow [a carrier] unreasonably to increase prices, reduce services, or exclude competition in air transportation.

49 U.S.C. §§ 40101(a)(4), (9) and (13).

Beyond these general responsibilities, the DOT has specific statutory authority to take action against deceptive and anticompetitive practices in air transportation. Under 49 U.S.C. Section 41712 (formerly Section 411 of the Federal Aviation Act of 1958):

> The [DOT] may, upon its own initiative or upon complaint . . . if it considers that such action would be in the interest of the public, investigate and determine whether any air carrier, foreign air carrier or ticket agent has been or is engaged in unfair or deceptive practices or unfair methods of competition in air transportation . . .

If the Department finds such deceptive practices or unfair methods of competition exist, Section 41712 empowers the Department to "order such air carrier . . . to cease and desist" from the violation. The courts have repeatedly held that this broad statutory authority empowers DOT not only to enforce the antitrust laws in air transportation but also to prohibit conduct that is anticompetitive under antitrust principles even if it does not amount to a violation of the antitrust laws. As the U.S. Supreme Court stated many years ago:

> [Section 411] was designed to supplement the Sherman Act by stopping in their incipiency those methods of competition which fall within the meaning of the word 'unfair.' . . .

> Whatever the unfair practice or unfair method employed, Section 411 of this Act, like Section 5 of the Federal Trade Commission Act . . . *was designed to bolster and strengthen anti-trust enforcement*.

Pan American World Airways v. United States, 371 U.S. 296, 306 (1963), emphasis added. More recently, in upholding CAB regulations governing CRS displays, the U.S. Court of Appeals expressed the same point:

> This finding [that airline CRS owners have substantial market power] would bring their competitive practices within the broad reach of section 411. We know from many decisions under both that section and its progenitor, section 5 of the Federal Trade Commission Act, that *the Board can forbid anticompetitive practices before they become serious enough to violate the Sherman Act*.

United Air Lines v. Civil Aeronautics Board, 766 F.2d 1107, 1114 (7th Cir. 1986), emphasis added.[1/]

Significantly, in both the Airline Deregulation Act of 1978, as well as the Civil Aeronautics Board Sunset Act of 1984, Congress did not curtail any of the Department's powers and responsibilities to prevent anticompetitive practices. On the contrary, Congress believed that authority was essential to maintaining vigorous

[5/] See also American Airlines v. Wolens, 513 U.S. 219 at 228 (1995) ("We note again . . . that the DOT retains authority to investigate . . . unfair methods of competition by airlines and may order an airline to cease and desist from such practices . . .").

competition and the success of deregulation. As the House committee stated during passage of the CAB Sunset Act:

> There is also a strong need to preserve the Board's authority under Section 411 to ensure fair competition in air transportation . . . . Although the airline industry has been deregulated, this does not mean that there are no limits to competitive practices. As is the case with all industries, carriers must not engage in practices which would destroy the framework under which fair competition operates. Air carriers are prohibited, as are firms in other industries, from practices which are inconsistent with the antitrust laws or the somewhat broader prohibitions of Section 411 of the Federal Aviation Act (corresponding to Section 5 of the Federal Trade Commission Act) against unfair competitive practices. [H.R. Rep. No. 98-793, 98th Cong.; 2nd Sess. 1984 at 4-5.]

In fact, over the years the DOT (and CAB) have relied on this authority numerous times to investigate and prevent anticompetitive practices by air carriers. In some cases the Department has adopted guidelines spelling out its enforcement policy on a prospective basis,[1/] while in other cases the Department has intervened directly in the marketplace to prevent anticompetitive practices that threatened to harm the public. The choice of whether to proceed by prospective guidelines or by individual ad hoc litigation to carry out this authority is a choice "that lies primarily

---

[6/] For example, the DOT has adopted policy guidelines regarding deceptive practices of ticket agents; unrealistic scheduling of flights; unfair practices by air carriers in issuing confirmed reservations; deceptive advertising and sales of air transportation; and the failure of airlines to properly disclose their code-sharing relationships to consumers. See 14 C.F.R. Sections 399.80-88. In addition, the Department's regulations governing carrier-owned computer reservations systems (CRSs) are premised on the authority of §41712. See 14 C.F.R. Part 255.

in the informed discretion of the administrative agency." SEC v. Chenery Corp., 322 U.S. 194, 201 (1947).

In light of the Department's longstanding power and responsibility (expressly sanctioned by Congress) to prevent unfair competitive practices, there is no real doubt that the Department possesses the legal authority to issue the proposed guidelines at hand. Moreover, the fact that DOT has chosen to act by issuing *proposed guidelines* coupled with a lengthy comment period, rather than by intervening immediately in the marketplace to prevent competitive abuses as it is empowered to do, merely illustrates that the Department's approach in this proceeding is quite open and conservative.

III. Southwest Airlines Generates the Great Majority of Low Fares in the United States. In Fashioning Its Policies the DOT Should Recognize Southwest's Unique Role in Enhancing Competition Throughout the Industry.

Southwest takes no position on whether the particular guidelines DOT has proposed are an effective means of remedying the unfair competitive practices it has identified. It is clear, however, that, whatever their effectiveness, those guidelines will have little or no impact on the most pervasive and serious impediments to greater competition and low fares in the airline industry. The proposed policy appears designed to address only the most flagrant cases of predatory conduct at a few large hubs, and thus has a limited purpose. Southwest itself expects to be neither helped nor hurt by the guidelines, for it is neither a "new entrant" as defined by DOT ("an independent [low-fare] airline that has started jet service in the last 10 years", according to the policy) nor a "major carrier" in this context (a major airline operating a hub in competition with a new entrant).[1/]

[7/] DOT proposed policy, footnote 1 (63 Fed. Reg. 17920, April 10, 1998).

A policy designed to enhance airline competition and expand low-fare service will be of limited value, we believe, if it ignores the specific role of Southwest in revolutionizing airline competition and reducing the cost of air travel. By the Department's own reckoning, Southwest alone generates the great majority of fare savings realized by the public. In its 1996 study, The Low-Cost Airline Service Revolution, the Department calculated that low-cost airlines collectively generated $6.3 billion in fare savings annually to American consumers. What the study did not explicitly state, however, is that Southwest alone generated $4.7 billion, or 76% of the total fare benefits DOT identified (Attachment 1). Southwest's contribution to fare savings is undoubtedly higher today, both in relative and absolute terms, as Southwest has grown significantly since the study was done while new entrant carrier service has declined.[1/]

8/ The competitive significance of Southwest has been aptly described by one publication as follows:

> What has happened [under deregulation] is that two distinct travel markets have evolved: one in which Southwest Airlines, by far the most successful low-cost carrier, competes, and another, in which it does not. Where Southwest flies, fares are low. But in the rest of the U.S. competition ranges from limited to non-existent. New entrants have all but given up trying to penetrate the market. The established airlines are taking full advantage of their dominant position to push fares to record highs.

"Airlines: When Fares Aren't Fair," Financial Times, February 10, 1998.

The Low-Cost Revolution study also understates the favorable impact of Southwest's service on the public by calculating only the savings produced by each carrier's fares alone, rather than including the fare reductions of major incumbent carriers in response to Southwest's entry. As the Department itself found in its Southwest Effect study, Southwest's entry into a new market produces long-term price reductions by all competitors in that market, as well as in nearby airport markets:

> . . . when Southwest entered its first California Corridor airport pair -- OAK-ONT -- prices declined by 60 percent and traffic tripled. The traffic increase did not come at the expense of traffic in other airport pairs, because . . . prices in all 8 airport pairs [between Los Angeles and San Francisco] dropped dramatically, leading to traffic increases in each.

The Airline Deregulation Evolution Continues: The Southwest Effect, U.S. Department of Transportation Office of Aviation Analysis, May 1993 at p. 5. Factoring in these market-wide fare reductions, the public benefits generated by Southwest are obviously much greater. In fact, one commentator has estimated that, based on the Department's average fare data, Southwest saves U.S. consumers almost $18 billion annually![1/]

[9/] "Southwest Saves American Passengers $17.873 Billion Annually," MBA Aviation Oracle, May 1998. See Attachment 2.

Southwest's competitive significance transcends even these extraordinary numbers, however. As the Department recognized in the Southwest Effect, Southwest's low-fare service has revolutionized the nature of airline competition. It has produced dramatic and permanent fare reductions that triggered huge traffic increases in all markets where it competes; forced increases in productivity by virtually all U.S. carriers; and spawned numerous attempts to replicate Southwest's style of service both by established large airlines and by new entrant carriers.

Southwest's growth over the last 27 years demonstrates a profound lesson for airline competition: when Southwest enters a new market, fares drop and traffic rises -- *dramatically*. As illustrated in Attachment 3, Southwest's extraordinary price reductions in cities across the country have allowed many millions of U.S. consumers, who would otherwise not fly, to travel at affordable fares. As the Department itself observed, in commenting on Southwest's entry into Providence, Rhode Island:

> Southwest Airlines began offering service out of Providence's T.F. Green Airport on October 27, 1996. The effect on average fares and passengers out of Providence was immediately evident . . . Average fares dropped 47% between the 2nd quarters of 1996 and 1997 in markets served by Southwest. Over the same period, average fares dropped by 14% in markets not served by Southwest . . . [T]he 47% fare decrease in Southwest markets was accompanied by a 260% growth in passenger traffic. Non-Southwest markets also fared well, growing at a rate of 43% . . . .

Special Report, DOT Domestic Airline Fares Consumer Report, Second Quarter 1997 (January 1998). The report went on to note that *the Providence-Baltimore market enjoyed a 71% average fare decrease and a resulting 884% increase in passenger traffic due to Southwest's entry* (see Attachment 4)!

In short, Southwest provides a market-based discipline on high fare service wherever it flies. The surest pathway to enhancing competition and to making air transportation more affordable to the U.S. public, therefore, is a climate which allows Southwest to expand its service and maintain its low costs. As Southwest has a choice of markets to serve, it naturally tends to avoid those where the barriers to entry and costs of serving are highest, whether due to the marketing advantages of the incumbent carrier, government-imposed costs, or artificial constraints on growth such as slot controls. Unfortunately, so long as those conditions persist, the public in those markets will not have the benefit of the vigorous competition and extraordinarily low fares that Southwest provides elsewhere.

IV. If the Federal Government Wants to Enhance Airline Competition and Expand Low-Fare Service in a Broadly Effective Way, It Will Require a Much More Comprehensive and Consistent Approach.

If the federal government wants to seriously address the competitive problems discussed above and thereby promote lower fares and more choices for large numbers of U.S. consumers, it will need to do so in a more comprehensive and consistent manner than the limited steps the Department is proposing to take in this proceeding. If competition is to be enhanced in a meaningful and lasting manner, Southwest respectfully suggests that what might be addressed are the marketing practices and other competitive weapons -- much more significant than the practices that DOT is currently targeting -- that large network carriers use to unfairly impede competition from smaller, low-fare rivals.

There are many such practices which deserve scrutiny, including the following:

- The use of travel agency override commissions to enhance mega-carrier traffic at the expense of smaller competitors, particularly at concentrated hubs;

- The role of carrier-owned computer reservations systems (CRSs) in unfairly protecting their airline owners from new entry and low-fare competition;

- The large numbers of takeoff and landing slots grandfathered to incumbent carriers, free of charge, for use at slot-controlled airports;

- Domestic and international code-sharing arrangements which produce duplicate or even multiple CRS listings for single code-shared flights, and which make fortress hubs even more impenetrable by depriving independent airlines of traditional interline opportunities; and

- Mega-carriers' use of frequent-flyer programs to create brand loyalty and impede competition from smaller challengers.

Even more significantly, if the government really wants to enhance competition and reduce the cost of air travel, it should critically examine *its own actions and policies* that unnecessarily raise the costs of low-fare carriers and impede them from competing with the mega-carriers. The most flagrant example of this phenomenon, under the guise of so-called "user fees," was the restructuring of the transportation excise tax system by Congress last year to reduce the ticket tax from 10% to 7.5% over three years while adding "segment fees" of up to $3 during the same timeframe. This tax restructuring is particularly damaging to low-fare, high frequency short haul air service -- precisely Southwest's style of operations since 1971.

Southwest estimates that the financial impact of these excise tax changes on Southwest alone is an *additional* $450 million in taxes over the next six years. This added tax burden is the equivalent of 15 new Boeing 737 aircraft -- which, based on Southwest's traditional productivity, would add about 120 flights daily to Southwest's system that would carry over 3.3 million passengers per year. Based on DOT's conservative estimates,[1/] *those flights would produce fare-savings to U.S. consumers of more than $200 million annually, or more than $1.2 billion over six years* -- benefits that will now be lost to the public because of the new segment fees.

10/ In The Low-Cost Airline Service Revolution, DOT estimated that low-cost carriers *as a group* saved consumers an average of $58 per ticket (in 1995). As Southwest was the lowest-cost and lowest-fare member of that group, its own fare savings were greater than the group average in 1995, and are greater still in 1998.

Indeed, the imposition of segment fees is the single most damaging action to airline competition that has occurred since deregulation,[1/] and, ironically, this was done by the government itself (in response to a massive lobbying and public relations campaign by the same airlines now complaining most vociferously about the Department's current proposal). As a result of this severe and disproportionate penalty, Southwest has already increased its average stage length and will focus its future growth less heavily on the short-haul, high-frequency flights that have proven so popular with the travelling public over the last 27 years.

This tax change will have other harmful effects as well, as the loss of prospective short-haul flights forces travellers into the automobile and other modes of ground transportation that are far less safe and much more environmentally damaging than air travel. It is doubtful that the Administration and Congress, in their development of this new tax policy, seriously considered its deleterious impact on airline competition, much less on safety and the environment.

[11/] For similar reasons, Congress should reject efforts to raise PFC levels. Like the segment fee, flat PFC charges hurt low-fare carriers disproportionately vis-à-vis high-fare carriers.

Finally, the DOT (as well as the Department of Justice and Congress) should be especially skeptical of efforts by the largest carriers to increase industry concentration through “alliances” or other means, and should be vigilant against concerted efforts by mega-carriers to gain competitive advantages through manipulation of the regulatory and legislative processes.[1/] Should any such attempt to manipulate government policy arise in the future, DOT should to remain keenly sensitive to the disproportionate and harmful impact such policies can have on Southwest and other low-cost, low-fare carriers, and the inevitable reduction in airline competition that occurs as a result. As with segment fees, the government must be mindful that its actions in one area, such as tax policy, can have disastrous consequences in another area, such as competition policy.

[12/] By way of grievous example, during the last session of Congress the “Big Seven” airlines initially labored, in open concert, to totally replace the excise tax with “user fees” that would have shifted over $600 million per year in costs to their smaller competitors, predominately Southwest. As another example, several of those same carriers are currently attempting to persuade the DOT to change its CRS regulations in a manner that would require Southwest to participate in all CRS systems against its will, and thereby incur many millions of dollars annually in booking fees.

CONCLUSION

The Department's proposed competition guidelines are well-intentioned and legally well-founded measures designed to promote low-fare competition among airlines. They will apply in limited markets and under limited circumstances, however, and will therefore have little or no effect on the more serious marketing practices, competitive weapons, and structural advantages used by the largest carriers to impede low-fare competition. If the promise of deregulation is to become a lasting reality for the public at large, the government will need to develop broader policies that reduce the costs and promote the growth of Southwest Airlines and other low-fare airlines.

Respectfully submitted,

SOUTHWEST AIRLINES CO.

By: ________________________________

Robert W. Kneisley
Associate General Counsel - Federal Affairs

1250 Eye Street, N.W., Suite 1110
Washington, D.C. 20005

July 24, 1998