APPENDIX B

STATEMENT OF DANIEL M. KASPER

Law & Economics Consulting Group, Inc.

In Re

Enforcement Policy Regarding Unfair Exclusionary Conduct in the Air Transportation Industry

July 23, 1998

Docket OST-98-3713

1. Introduction and Summary

Airline deregulation has been one of the most successful regulatory and economic policy reforms in the late 20th century. Numerous studies by the Department as well as others have concluded that deregulation has produced enormous economic benefits. One of the primary benefits has been substantial fare savings. Measured in real terms, the price per mile of air travel (i.e., "yield") in the United States declined by more than 35 percent between 1978 and 1997. See Exhibit 1.[1] As shown in Exhibit 2, the price of air travel in current dollars has increased considerably less than overall consumer prices since 1978.

Likewise, numerous studies have documented the fact that deregulation has resulted in more frequent flights to communities of all sizes and that "efficiency…has improved substantially as a result of the greater number of departures"[2] made possible by deregulation. Studies by GAO,[3] the Brookings Institution[4] and others show that competition, too, has increased substantially at small, medium and large airports since deregulation. Thus, both the average number of effective competitors per route and the average number of major airlines serving airports have increased significantly since the industry was deregulated. The in-depth independent study published by the

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1 Air Transport Association data, available at www.air-transport.org/data/yield.htm.

2 "Domestic Aviation: Changes in Airfares, Service and Safety Since Airline Deregulation," U.S. General Accounting Office, GAO/T-RECD-96-126, April 25, 1996, p. 7. According to GAO, departures overall have increased by 50% for small community, 57% for medium, and 68% for large community airports since deregulation.

3 Ibid.

4 Morrison & Winston, The Evolution of the Airline Industry, The Brookings Institution, 1995.

Brookings Institution[5] concluded that deregulation was producing overall benefits exceeding $18 billion per year (in 1993 dollars), with more than $12 billion per year arising from fare savings and the balance as a result of increased service (frequency) levels. Department officials – including every DOT Secretary for the last twenty years – have publicly and repeatedly acknowledged the substantial benefits of airline deregulation to travelers and shippers, and to local, state and national economies.

In an imperfect world, however, no policy – including deregulation – can produce results that will always be consistent with perfect competition. The architects and initial implementers of deregulation were certainly aware of this fact.[6] But they also recognized that by permitting airlines to compete and subjecting them to the same antitrust constraints that apply to other unregulated industries, deregulation was far more likely than even the best-intentioned government economic regulation to generate new price and service options, enhance efficiency, spur entry and thereby generate huge benefits for consumers. In fact, these issues, especially predation, were thoroughly debated and carefully considered by the CAB in its decisions implementing the provisions of the Airline Deregulation Act. Thus, President Carter rejected a finding of predation when competitors matched Laker's Sky Train fares, and CAB in 1978 declined to prevent incumbents from matching a new entrant's $99 transcontinental fare.[7]

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5 Ibid., p.10

6 See, for example, Bailey, Kaplan, and Graham, Deregulating the Airlines, MIT Press, 1985, at 65.

7 As a senior official at the Civil Aeronautics Board, from 1979 to 1983, I participated personally in many of these discussions. For example, the Board considered and explicitly rejected arguments that it should

Like the CAB before it, the Department has (up to this point, at least) consistently rejected efforts to re-regulate airlines, most recently in the early 1990s when industry losses of $13 billion led to some calls for re-regulation. It is therefore particularly disheartening that, despite its protestations to the contrary, the Department now advances a Proposed Statement of Enforcement Policy (hereinafter, the "Proposed Policy") that would impose substantial restrictions on the competitive freedom to set prices and establish capacity levels that lies at the heart of airline deregulation's success. Although Department officials have publicly and repeatedly disclaimed any intent to re-regulate the airline industry, if the Proposed Policy is adopted a government agency will once again be the arbiter of whether an airline's pricing decisions constitute "a reasonable alternative response" to a competitor's actions, and the agency will gain control over capacity as well. Thus, regardless of the Department's actual intent, the effect of the Proposed Policy would be to inject the Department into the setting of airline fares to an extent unseen in this country since the CAB, at its regulatory zenith almost 30 years ago, tried to impose its version of "scientific" rate making on airline fares.[8] In short, the Policy would reassert the very bureaucratic control over airline business decisions that deregulation was designed to eliminate.

A careful review of the Proposed Policy demonstrates that the Policy is seriously flawed: The premises used to justify its adoption – that there has been a decline in new entry "since early 1996" and that this perceived decline is attributable "at least in part" to predation by "network

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treat as predatory conduct, pricing that is permissible under the antitrust laws. Cf., *Air Florida vs. Eastern Airlines* (CAB Order 81-1-101).

[8] *Domestic Passenger Fare Investigation,* U.S. CAB, 1970-74.

airlines" – were simply assumed by the Department. They were not based on any type of systematic analysis.

Since the Department explicitly seeks to justify the Proposed Policy by the alleged existence of a new entry "problem," the failure by the Department to undertake a careful analysis of whether such a problem actually exists would be a critical shortcoming by itself. In the present case, this initial problem has been compounded by the almost total lack of empirical support for the Department's assumptions. On the contrary, the available evidence shows that new airline failure rates do not appear to differ significantly from those of other new businesses, thus calling into question not only the Department's procedures, but also the reliability of its conclusions regarding the existence of predation.

At the same time, a statistical review of new entry since deregulation suggests (1) that the changes in the number of new entrants troubling the Department are, in fact, consistent with past changes in entry and (2) that those changes in the number of new entrants appear be inversely correlated with airline industry profitability over the preceding several years. (See Sections 2(a) and 2(b), below.) Thus, post-deregulation patterns of entry indicate that, based on the strong upward trend in airline profitability since 1994, a decline in the number of new entrants could be expected to occur beginning in 1996. But those same patterns also suggest that such declines are likely to be temporary, and that new entry is likely to rise again following the next industry downturn.

Even if there had been a decline in new entry that could not be explained in terms of the historic relationship to industry profitability, however, the Department would still be wrong to assume – without systematic economic analysis – that predation caused the apparent decline. In fact, at least three other major factors provide a more plausible explanation for temporary decline in the number of new entrants:

- The dramatic decline in traffic and revenues experience by newentrant airlines following the ValuJet crash in May of 1996;
- Heightened levels of regulatory scrutiny (and hence, cost) imposed on prospective and existing new entrant airlines by the Department and the FAA following the ValuJet crash; and
- Poor management decisions by the executives running the new entrant airlines.

The Department defends its Proposed Policy on the grounds that it is needed to protect a specific group of airlines – those that are (1) less than ten years old and (2) pursuing a strategy based on unrestricted low fares – from predation by "network airlines." But whatever its rationale, the Proposed Policy itself is fatally flawed both in terms of sound regulatory policy and because it is inconsistent with both the letter and spirit of the Airline Deregulation Act.[9]

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9 In other public statements, Department officials have said that the Proposed Policy is aimed at preventing the "dumping" of seats by major airlines "at low fares." It is important to note that both anti-dumping policies and the closely-related "infant industries" doctrine -- which the Proposed Policy would effectively impose on domestic airline markets -- have been widely criticized by economists on the grounds that they both raise prices above competitive levels and protect inefficient producers. Dumping is a concept in international trade law used to describe sales of foreign products in the U.S. market at prices below those charged for substantially similar products in the producer's home market. Advocates defend anti-dumping policies on the grounds that they prevent a foreign producer from underselling competitors in the U.S. market on the basis of cross-subsidies from a home market where it is unfairly protected from competition by tariffs or other trade barriers. Whatever the merits of anti-dumping policies in the international trade

To begin with, the Proposed Policy is discriminatory on its face in that it establishes a favored class of airlines (low fare new entrants) whose members are entitled to special protections not afforded to other airlines, including other new entrants.[10] This overt discrimination is compounded by the fact that the members of the favored class are chosen by the Department based solely on whether or not the airlines adopt the pricing strategy (unrestricted low fares) favored by the Department. Simply stated, this Policy represents a blatant attempt by the Department to impose on airline markets its own views as to how market competition should work. If the Department succeeds, it will effectively have *de facto* control over airline pricing and capacity decisions.

Finally, in the interests of sound economic and public policy, the Department should reject the Proposed Policy even if it had the authority to adopt and enforce it. If adopted, the Policy would generate a range of perverse economic results including higher air fares and artificial, regulatory limits on the number of low fare seats available to travelers. It would also raise airline costs, weaken new entrants' incentives to pursue aggressive low-fare strategies, encourage the waste of scarce resources on socially unproductive regulatory gamesmanship, and generally deprive consumers of the benefits of deregulated airline competition. Moreover, by adopting a definition of predatory conduct that is completely inconsistent with the longstanding positions taken by the

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arena, however, there is no intellectually defensible basis for extending them to U.S. domestic aviation markets. Since entry into those markets is open to any licensed entrant, the essential "justification" for an anti-dumping policy – the existence of governmentally-imposed (or sanctioned) barriers to entry in the dumping party's home market – is completely lacking.

10 This action is contrary both to the Federal Aviation Act and the recommendations of The U.S. National Airline Commission contained in its Report to the President and Congress at 18.

United States in international aviation negotiations, the Policy would effectively reverse a key component of the nation's competitive international aviation policy and invite foreign governments to restrict competition by U.S. carriers (on the grounds that a more "reasonable alternative response" was available). As a result, the Policy would undermine U.S. international aviation policy and undercut more than two decades of efforts by U.S. aviation negotiators to increase competition in international markets to and from the United States.

2. The Proposed Policy Is Grounded on Assumptions, Not Analysis

The changes proposed by the Department represent a major and fundamental shift in policies adopted by Congress and followed by four Administrations over a period of 20 years. At a bare minimum, changes of this magnitude should be based on careful and thorough analyses both as to the soundness of the initial determination that a problem exists and as to the likely effects of the proposed remedies. In the present case, however, the Department has eschewed such analyses. Instead it has simply assumed (1) that new entry into the airline business is in jeopardy and (2) that anti-competitive activity (i.e., predation) by "network airlines" is at least partially to blame.

(a) DOT Made No Assessment of Whether The Failure Rate for New Entrants Is Excessive

The first prong of the DOT's argument that forms the basis of the Proposed Statement of Enforcement Policy is that in recent years it has become particularly difficult for new entrants to remain in specific city-pair markets and, more broadly, to remain in business. Yet there is no evidence in the Proposed Policy that the failure rate for new-entrant airlines differs from the failure rate for new businesses generally. Indeed, the Proposed Policy gives no indication that the Department ever considered – or was even aware of – the high failure rates associated with new businesses generally.

If the DOT had compared the failure rates for new entrant jet airlines with Commerce Department data on failure rates for other new businesses, however, it would have found that new airlines fail at a rate somewhat below that experienced in other sectors of the economy. See Exhibit 3.

Likewise, comparing the percentage change in airline failures on a year-over-year basis to overall U.S. business failures shows again that the airline industry is quite comparable to – albeit slightly more cyclical than – the economy as a whole. See Exhibit 4.

By focusing its Proposed Policy on new entry "since early 1996," DOT also fails to adequately consider the overall success and impact of new entrants since the passage of the Airline Deregulation Act. But in an April 1996 study, the Department noted that "markets with low-fare competition accounted for nearly 40 percent of domestic passengers."[11] Likewise, the number of certificated airlines providing service in 1996 (96) was more than double the number of airlines (43) providing such service in 1979.[12]

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11 "The Low Cost Airline Service Revolution," U.S. DOT, Office of Aviation and International Economics, April 1996.

12 Air Transport Association, 1998.

(b) DOT Made No Assessment of Historic Entry Patterns in the Airline Industry

Analysis of entry in the post-deregulation period offers scant support either for DOT's concerns about entry or its attempts to link entry levels to "anti-competitive conduct on the part of some network airlines." A showing that entry has, indeed, been excessively low since 1996 would have required that the DOT examine entry patterns in the airline industry over a significantly longer period of time in order to assess the natural cycles in the market.[13]

As shown in Exhibit 5, new entry peaked in 1979, the first full year after the passage of the Airline Deregulation Act, and declined on a steady downward trend through 1987 when there were no new entrants. Since 1987, however, new entry has been trending steadily upward, as shown in Exhibit 6, albeit at somewhat lower absolute levels than in the years immediately following deregulation.

Moreover, when the analysis of historical entry patterns is broadened to consider the impact of the industry's financial performance, that analysis shows that new entry has tended to increase one to two years after years in which the airline industry's net profits were negative and to decrease following years in which the industry earned profits. In short, financial hard times for the airline industry spur new entry while new entry tends to decrease following periods of industry profitability. These relationships are illustrated in Exhibit 7.

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13 The Department had previously noted that the number of new entrants had varied widely (see, "The Low Cost Airline Service Revolution, Ibid., at 5) but has made no apparent attempt to assess what factors might explain those variations.

The logic of these results is supported by the fact that industry downturns tend to make critical resources – particularly aircraft – available to prospective entrants at bargain prices at a time when established airlines are seeking to reduce their losses and return to profitability. As established airlines lay off trained personnel and return unwanted aircraft to lessors, these resources become available to new entrants, often at bargain rates.[14] Thus, it should not be surprising to find that, in the wake of four years of net airline industry losses totaling nearly $13 billion from 1990-1993, six major airline bankruptcies, widespread employee layoffs and the grounding of hundreds of aircraft by established airlines, new entry increased. Nor, by the same token, should it be surprising to find that new entry has declined more recently following a period of sharply increasing airline industry profits beginning in 1994.[15] Overall, the changes in the level of new entry since 1996 appear to be consistent both with past patterns and economic logic. Analysis of historic entry patterns also suggests that any decline in new entry is almost certainly temporary in duration.

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14 In December of 1988, for example, there were 51 727s, 737s, and DC-9s available for sale or lease. By December of 1990, the number was up to 319. (*Aviation Daily*, February 7, 1991, p.249) In January of 1997, however, there were fewer than 80 of the same models available. (Airfax web page, as updated January 21, 1997.)

15 "The cost of aircraft has climbed, limiting the ability of start-up carriers to obtain inexpensive planes that are a staple of fledgling carriers. With the U.S. airline industry in its fourth straight year of profitability, demand for labor has grown and hiked the cost for small carriers to hire and retain experienced people." Glenn Engel, Goldman, Sachs and Co., in the *Airline Financial News*, December 30, 1996.

(c) DOT Has Assumed – Not Assessed – The Factors Affecting New Entry and Has Failed to Consider Alternative Explanations for a Slowing of New Entry

The Department's release announcing the Proposed Policy contains with the following statement: "Since early 1996, however, the growth of this new source of competition in the form of new-entrant airlines has slowed. DOT now believes that anti-competitive activity on the part of some network airlines is part of the reason."[16] This single, conclusory statement is the only reference in the Proposed Statement to any factor which might affect new entry and contains no indication that DOT has sought to assess systematically what factors might explain patterns of entry and exit for the airline industry. In short, DOT appears to base its proposed enforcement policy largely on the slender reed of an untested and unproven hypothesis regarding the cause of a recent decline in the number of new entrant airlines (predation by network airlines) despite the fact that several other factors would appear to provide a more plausible explanation for the apparent slowdown in new entry.

The statement is particularly noteworthy for its failure even to acknowledge two significant events in 1996 – both unrelated to major airlines – that had clear, large, unmistakably negative effects on new entry into the airline business. The first of these events was the crash of a ValuJet DC-9 resulting in the loss of more than 100 lives in May of 1996. As widely reported in news accounts at the time and subsequently confirmed by data filed with the Department,[17] the crash itself was

16 U.S. Department of Transportation, News Release on the Proposed Statement of Enforcement Policy Regarding Unfair Exclusionary Conduct by the Air Transportation Industry, April 6, 1998, p.1.

17 DOT T100 data for Spirit Airways , for example, show that its load factor fell from 84% in April of 1996 to 54% in September, a decline of more than 35 percent. Other new entrants reported similar declines.

quickly followed by dramatic declines in both traffic and revenues for new entrants and low fare carriers. Then, following widespread criticism of the Department and the FAA, the agencies increased significantly the regulatory scrutiny of prospective new entrants.[18]

The impact of the crash and the resulting dramatic shift in consumer perceptions of low-fare airlines was to reduce both current and prospective future revenues that new entrant airlines could reasonably anticipate and to increase the cost and time required to obtain the necessary authorizations from DOT and FAA. According to one leading industry analyst:

"The crash [of ValuJet] led to tightening FAA scrutiny of start-up carriers and began a trend for airline passengers to select brand-name carriers. The ValuJet disaster symbolized a shift in the industry's playing field from small start-up carriers to big ones."[19] The negative effects of the ValuJet crash on low fare airlines have apparently persisted, thus impeding efforts by low-fare airlines to regain traffic and revenues.[20]

Sharply declining revenues, increasing costs and negative consumer perceptions of low-fare new entrants are not conditions likely to encourage new entry. But these were – and to a large extent remain – the conditions that exist in the marketplace. As a direct result, new airlines have become

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18 See, e.g., ValuJet Ceases Operations, FAA Toughens Oversight of Airlines. Also, in October of 1996, the GAO publicly issued its recommendation that the FAA increase substantially its scrutiny of new airlines and to target agency resources on airlines with the greatest safety risks. See Aviation Week and Space Technology, Oct. 28, 1996, p.33

19 Glenn Engel, Goldman, Sachs & Co., as quoted. in Airline Financial News, December 30, 1996, V. 11, No. 50.

20 See Edwin McDowell, "Start-up and low-fare airlines continue to remain out of favor for corporate fliers, despite savings, *The New York Times*, July 23, 1997.

considerably less attractive to prospective investors than they had been prior to the ValuJet crash. Not surprisingly, the number of new airline applications has slowed, as has the number of applicants that obtained the necessary DOT/FAA authorizations.[21]

(d) <u>DOT Has Failed to Adequately Consider Alternative Explanations for New Entrant Failures</u>

In addition to its failure to assess whether new airlines fail at a rate exceeding that for other businesses, the Proposed Policy also does not consider whether alternative reasons might provide a better explanation for the failures of new entrant airlines. The academic literature on business failures attributes new business failures overwhelmingly to a few recurring factors, the two most important of which are inadequate capitalization and mistakes made by management.

It is widely recognized in the airline and financial communities (supported by reported financial data) that failed airlines – both new entrants and established carriers alike – are chronically undercapitalized when compared to successful airlines.[22] Yet the Department has made no apparent effort to assess the extent to which inadequate capitalization might explain the failure of new entrant airlines. Likewise, the Proposed Policy indicates no effort by the Department to assess the extent to which management mistakes or misjudgments by new entrants might explain their business failures.

21 See Exhibits 6 and 7, supra.

22 Cf., for example, the testimony of the panel of airline industry financial analysts to the U.S. National Airline Commission, May 1993. Also, testimony of the panel of bankruptcy experts to the Commission, June 1993.

The Department's failure to consider management errors is particularly noteworthy in light of numerous acknowledgments by failed airlines in a wide range of documents filed in bankruptcy courts, with the Securities and Exchange Commission, presentations to securities analysts and in other public statements that management mistakes, not predation, caused the failure of their respective new entrant airlines. Indeed, a recently published study of airline failures confirms the key role of management mistakes in causing the failures of start-up airlines.[23]

3. The Proposed Policy Is Severely Flawed and Constitutes an Attempt to Re-Regulate the Airline Industry

(a) The Definition of New Entrants is Artificially Narrow

By defining new entrant "to mean an independent airline that has started jet service within the last ten years and pursues a competitive strategy of charging low fares," the Statement unreasonably and artificially excludes the largest and most successful of the post-deregulation new entrant carriers – including Southwest, America West, American Trans Air, Midway II and Midwest Express – from consideration. Further, the Department's definition of new entrants defies common usage and is inconsistent with the understanding and usage of the terms in the airline industry. In addition, the definition is unreasonable in that it would arbitrarily exclude carriers

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[23] Darryl Jenkins, Director, The Aviation Institute, George Washington University, "An Examination of Why New Entrant Airlines Fail", June 30, 1998.

such as Midway II and Midwest Express, regardless of how recently they instituted service, solely on the basis of the pricing strategy they have adopted.[24]

(b) The Definition of New Entrants is Discriminatory

In addition to the fact that the definition of new entrants appears to have been tailored to exclude the most successful new entrants in the post-deregulation era, it also excludes from the category of "new entrants" airlines that have adopted a strategy that is not based principally on low fares. But it is neither logical nor reasonable to exclude airlines from the category of new entrants based on the pricing strategies they choose to adopt, and neither economic theory nor law provides any basis for such an arbitrary distinction.

By protecting only new entrants that adopt a strategy based on low fares, the Proposed Policy would unfairly discriminate in favor of one group of airlines based solely on the Department's preferences as to pricing strategy. The Department has not attempted, and would find it impossible in fact, to make a principled distinction between its attempt to give preferred treatment to airlines pursuing strategies the Department favors and the authority exercised by the CAB during four decades of airline regulation during which time the Board routinely disapproved applications by prospective entrants and existing airlines to charge fares that differed from those the CAB considered to be reasonable.[25]

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24 Statement of Enforcement Policy, Fn. 1, page 2.

25 See, e.g., CAB Regulation of Domestic Air Fares in Hearings before the Subcommittee on Administrative Practice and Procedure of the Committee on the Judiciary, United States Senate, 94th Congress, February 25, 1975. Also, Bailey et al. op. cit.

(c) The Definition Shows Intent by DOT to Impose on the Deregulated Airline Industry Its Current View of How Competition Should Work

Defining "new entrants" based on whether or not an airline follows a specific pricing strategy is particularly problematic for another reason: It reveals an attempt by the Department to impose its own views as to how competition should work in a deregulated market (i.e., that low-fare carriers should thrive in competition with network carriers, continually forcing the latter to reduce prices and costs in order to survive). But the fact that deregulated airline competition did not unfold according to the Department's preconceived notions is not a legitimate reason to substitute regulatory tinkering for competitive market outcomes even if those outcomes include the failure of some low-fare and other airlines in competition against established "network" airlines – so long as the competition is consistent with antitrust standards. Rather, the attempt to substitute a regulator's idea of the "right" outcomes reflects exactly the same mindset used to justify 40 years of economic regulation under which the CAB imposed its views as to what pricing and other conduct by airlines was "reasonable."

It is worth noting in this context that nothing in the CAB's governing statutes required the Board to rely on administrative regulation rather than market forces to establish prices. This is demonstrated by the fact that the Board effectively deregulated airline pricing on its own initiative in 1977-1978, prior to the passage of the Airline Deregulation Act. Rather, the complex, burdensome and inefficient regulatory system which the Act sought to terminate resulted from the

Board's (no doubt well-intentioned) efforts to ensure that the market behaved in a fashion that a majority of the Members at any given time considered to be reasonable.[26]

4. Enforcement of the Policy Would Result in Perverse Economic Outcomes Counter to the Department's Stated Intentions

The Proposed Policy flies in the face of sound economic and public policy. The reasons for this can be summarized briefly. The enforcement of the proposed measures against "unfair exclusionary practices" would, *inter alia*, inject tremendous uncertainty into airline pricing decisions, encourage inefficient strategic behavior, discourage price decreases and/or capacity increases justified by changing market conditions, protect less efficient airlines from more efficient competitors, unfairly discriminate among airlines based arbitrarily on their pricing strategies, and deprive travelers of the benefits of deregulated competition. It would also undermine the nation's international aviation policy.

Tremendous uncertainty would be engendered by reserving to DOT the right to determine *ex post facto* whether or not a more "reasonable alternative response" to a competitive incursion existed at the time the response was initiated. "Reasonable" is an inherently regulatory concept, not an economic one. By eliminating the defense that the challenged fare exceeded the relevant measure of cost, DOT may hope to ease its burden of proof in challenging conduct it disfavors. But it

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[26] The flaws inherent in such an arbitrary system were extensively documented in Senate hearings that led to the passage of the Airline Deregulation Act. See, for example, Overview of Federal Economic Regulation of Domestic Air Transport in the Hearings Before the Subcommittee on Administrative Practice and Procedure of the Committee on the Judiciary, United States Senate, 94th Congress, February 6, 1975.

does so by injecting bureaucrats, lawyers and administrative law judges squarely into the heart of airline pricing decisions, a development that can only serve to discourage the type of aggressive competition that has produced the huge efficiency gains and fare reductions that are the hallmark of airline deregulation to date.

The Proposed Policy would also encourage inefficient strategic behavior ("gamesmanship") by both entrants and established airlines. New entrants, for example, would likely choose to enter incumbents' markets not with Southwest style low fares (based on low costs) but rather with only modestly lower prices and limited capacity based on the knowledge that DOT regulations (rather than superior efficiency) would protect them from a major carrier's response. In order to protect their network flows, major airlines could also be expected to respond by introducing new fares (and conditions) designed to preserve their base of traffic by fitting through the inevitable regulatory loopholes. Such responses would lead to the squandering of scarce resources by making it worthwhile for airlines to shift resources from competing in the marketplace to competing in the regulatory arena. Regulations like those contained in the Proposed Policy that encourage the shift of resources from product, service and pricing innovations (which benefit consumers) to regulatory proceedings (which benefit lawyers, consultants and bureaucrats) are widely and properly condemned because they inevitably raise producer costs and consumer prices.

The Proposed Policy will also have perverse economic consequences in a wide range of circumstances likely to occur (or recur) with some frequency in the airline industry. In past economic downturns, including the severe downturn which afflicted the airline industry from 1990 through 1993, excess capacity spawned by weakening traffic and deliveries of previously ordered aircraft has induced airlines to reduce sharply both fares and fare conditions in an effort to retain traffic and thereby minimize their losses. Yet this type of competitively sound, economically rational response would be vulnerable to attack (second-guessing) by the Department under its proposed guidelines if it involved markets served by new entrants.

Likewise, when deteriorating economic and political conditions reduced demand in U.S.-Mexico markets, airlines were free to redeploy their aircraft to domestic markets and, if necessary, reduce fares in order to make the most efficient use of their resources. In future economic crises, however, major airlines could be precluded by the Proposed Policy from taking such actions in markets where they compete with a low-fare new entrant. If the Asian economic situation deteriorates further, major airlines such as United and Northwest may be forced to redeploy aircraft from Asia to European or domestic U.S. markets. But to the extent the markets they would serve with redeployed assets are served by a low-fare new entrants, the major airlines could be required to make less efficient redeployments or face possible prosecution by the DOT for predatory conduct.

Similarly, and perhaps most significantly, the Proposed Policy could be used to effectively prevent a major airline from responding to a new entrant by means of price reductions and capacity increases even when the diversion of traffic by the new entrant would force the major to reduce service to – and hence the competitive effectiveness of – its hub. The Department itself has previously acknowledged that in the case of entry by low-fare carriers into hub markets, “the stakes for the network carrier typically are much greater than the local markets the new entrants have entered…[because] network carriers have to be concerned that the loss of local traffic and revenue could lead to service reductions that would ultimately result in loss of flow traffic and revenue that supports their network operations overall.“[27] Notwithstanding its recognition that network carriers must consider the network-wide implications of local market entry by a competitor, the Proposed Policy would nonetheless prevent them from responding to those threats even when such responses were fully in accord with the established antitrust standards for preventing predation.

In addition, the Proposed Policy would create other significant uncertainties as to what conduct is acceptable to the Department. Since the major carriers' low-cost divisions do not appear to be included in the Policy's definition of "new entrants," for example, the ability of a major airline to establish an "airline within an airline" or, in the case of United, Delta, and USAirways, to extend the scope of their existing operations, would be significantly constrained under the terms of the Proposed Policy whenever their intended services included markets already served by low-fare new entrants. Not only is such a policy clearly discriminatory, but it would also bog down competition (and the Department) in the procedural and regulatory swamp from which the Deregulation Act freed them in 1978. It was to avoid such consequences that the National Airline Commission specifically recommended that "[n]ew carriers be required to meet the same requirements for fitness, operations and maintenance…as existing airlines."[28]

By focusing only on what it describes as "self-diversion of local revenue," the Proposed Policy also ignores the adverse effects of local-market competition on the efficiency and competitiveness

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27 "The Low Cost Airline Service Revolution," Ibid., p. 31

28 "Change, Challenge and Competition," A Report to the President and Congress, August 1993, p. 18.

of hub networks. (Even its terminology betrays the regulatory nature of the Proposed Policy: The term "self-diversion" is a regulatory artifact, left over from the era of domestic route cases when the term was routinely used to disparage the traffic forecasts and deny the applications of would-be entrants.) Given the existence of significant network economies, however, it is often likely to be the case that a hub carrier serving the market is more efficient than other carriers – including new entrants – that may seek to provide service on routes into that hub.

Since airline competition today predominantly occurs across networks, any policy that does not take account of that fact will almost certainly produce outcomes that range from merely inefficient to downright perverse. The Department has previously acknowledged that hub-based networks offer a differentiated, higher-quality service to consumers than is typically provided by low cost carriers and "that overall the network dominated domestic system provides superior competitive service."[29] Thus, it is not clear why the Department now seeks to adopt a Policy that would substantially erode the very benefits of hub-based competition that it has so recently hailed.

The inevitable result of these and other effects too numerous to detail here will be to impose unproductive rigidity and massive uncertainty into airline decision making. Since the resolution of these uncertainties will require case by case determinations by the Department, the Policy will necessarily lead to a shift in the locus of decision making regarding prices and capacity from airline managements to DOT regulators. While Department officials will, no doubt, disclaim any intent to take actions that would generate such perverse results, the Proposed Policy would

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[29] "The Low Cost Airline Service Revolution," U.S. Department of Transportation, Office of Aviation and International Economics, April 1996, p. 26

clearly give them the discretion to do so. But even the prospect of such bureaucratic intervention will discourage capital flows into the airline industry, lead to reduced investment in new capacity and ultimately drive up consumer prices.

5. The Proposed Policy Conflicts with Established U.S. International Policy

The Proposed Policy would impose on U.S. airlines precisely the kind of government price regulatory regime that the Department and the U.S. Government have strongly opposed in international aviation markets for more then twenty years on the grounds that such a regime would be contrary to this nation's competitive international aviation policy. In implementing U.S. international aviation policy, DOT is required to emphasize "the greatest degree of competition" possible as well as the "freedom of air carriers and foreign air carriers to offer prices to correspond to consumer demand."[30] This language was included in recognition of the fact that foreign governments had often sought to use price and capacity regulations to protect their flag carriers from U.S. carrier competition, and to ensure that U.S. policymakers could not in the future adopt a highly regulatory and protectionistic international aviation policy without a change in statutory authority. [31]

U.S. bilateral air service agreements since deregulation have thus put strict limits on the ability of governments to intervene in the establishment of fares. The more recent U.S. "Open Skies"

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30 49 U.S.C. Section 40101(e).

31 As a senior official at the CAB during this time, I was personally involved in the development of international aviation policy and the CAB's input in the development of this legislation.

agreements further restrict governmental authority over fares by eliminating even alleged predation as a basis for denying a fare precisely because of the potential for governments to define predation more expansively than established antitrust standards and then use that standard to protect their flag carriers from U.S. competitors. These longstanding U.S. concerns were not misplaced. During my tenure as Director of the Bureau of International Aviation at the CAB, the Board rejected attempts by the United Kingdom, Germany and Japan, among others, to impose standards for predation strikingly similar to those contained in the Proposed Policy. And U.S. negotiators for the past twenty years have consistently rejected efforts by the United Kingdom to include provisions in the bilateral agreement which would permit governments to intervene in fare setting and capacity matters beyond established antitrust standards for predation. At least up to the point the Proposed Policy was promulgated, I believe that U.S. negotiators would have rejected out of hand a trading partner's proposal to permit it to reject a fare or to impose sanctions on the basis that the U.S. carrier should have chosen a more "reasonable alternative strategy."

The Proposed Policy's focus on the self-diversion of local market revenues also conflicts directly with well-established U.S. international aviation policy on exactly the same issue. Following domestic deregulation, U.S. airlines developed strong and highly efficient hub-based route networks that significantly increased their competitiveness vis-à-vis foreign carriers. Since most foreign airlines remained subject to strict entry and price regulation within the catchment areas logically served from their own hubs, foreign airlines found it increasingly difficult to compete effectively with aggressive competition from deregulated U.S. airlines and often turned to their governments to seek protection from that competition.[32] As a result, U.S. negotiators have consistently resisted, for a period of almost two decades, efforts by some trading partners to restrict U.S. airlines based on the argument that strong hub networks provide U.S. airlines with an unfair competitive advantage in competing for traffic on routes between those foreign nations and the United States.

As recently as this past April, the Department reasserted the longstanding U.S. position that in assessing competition in a market characterized by hub networks, the appropriate analysis must consider the entire range of markets served by the hub rather than focusing simply on a few local markets.

> "U.S. approval of these alliances is based on the conclusion that the appropriate frame of reference for evaluating their competitive impact is their overall effect on competition in the transatlantic market, not merely on traffic between any given city-pair. It is important that this pro-consumer aspect of alliance not be blunted by restrictions aimed at protecting a small number of passengers in hub-to-hub markets."[33]

Notwithstanding this forceful assertion of longstanding U.S. policy to EU policymakers, the Department's Proposed Policy focuses solely on self-diversion of revenues in local markets without any assessment of the overall effects on competition or of the effects on the major carrier's total revenues. The gaping inconsistencies between the Proposed Policy and longstanding U.S. policy in international negotiations can only serve to undermine on-going U.S. efforts to secure the adoption of more open, competitive international aviation agreements with

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32 For a detailed discussion, see D. Kasper, Deregulation and Globalization: Liberalizing International Trade In Air Services, American Enterprise Institute/Ballinger, Cambridge, 1988.

33 Letter from DOT Assistant Secretary Charles Hunnicutt to EU Commissioner Karel Van Miert, April 1998.

our trading partners including the United Kingdom. [34]

6. Conclusion

Despite its acknowledgment that the domestic airline market is highly competitive and that, since the advent of deregulation, "the domestic airline industry has generally evolved in ways that have increased competition, improved the convenience and usefulness of air service to most people and lowered inflation-adjusted fares for the nation as a whole,"[35] the Department nonetheless proposes to adopt a Policy that would effectively destroy deregulation in order to "save" it.

Even if the Proposed Policy is motivated by a desire to prevent predation, good intentions are not an acceptable substitute for careful analysis. Nor can they provide an acceptable basis for the adoption of a Policy that is inconsistent with the Airline Deregulation Act, counterproductive to its stated intent, inconsistent with established U.S. international aviation policy and that would contravene established legal principles for dealing with conduct alleged to be predatory.

Because it failed to systematically assess the nature, extent (if any) and causes for a change in the number of new entrant airlines, the Department has almost certainly misdiagnosed the new entry "problem" and prescribed a "remedy" that is far more likely to kill deregulation than to cure it.

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[34] The United States and the United Kingdom have been actively engaged in negotiations for a new air services agreement for a number of years. One of the primary stumbling blocks to obtaining agreement has been the insistence by the United Kingdom on provisions that would permit unacceptably extensive governmental intervention in airline pricing.

[35] U.S. Department of Transportation, News Release on the Proposed Statement of Enforcement Policy on Unfair Exclusionary Conduct by Airlines, April 6, 1998, p.1?

The acknowledged benefits of airline deregulation are too substantial to be put at risk by a Proposed Policy, however well-intentioned, that would reestablish bureaucratic control over airline pricing and capacity. Rather than taking this risky step backward, the Department should instead withdraw its proposal and reconsider both the need for and the nature of a DOT policy for dealing with predation.