BEFORE THE
UNITED STATES DEPARTMENT OF TRANSPORTATION
OFFICE OF THE SECRETARY
WASHINGTON, D.C.

Enforcement Policy Regarding Unfair Exclusionary Conduct in the Air Transportation Industry	Docket OST-98-3713

COMMENTS OF THE AIR TRANSPORT ASSOCIATION OF AMERICA

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TABLE OF CONTENTS

BEFORE THE
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Enforcement Policy Regarding Unfair)
Exclusionary Conduct in the Air) Docket OST-98-3713
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The Air Transport Association of America submits the following comments on the proposed Statement of the Department of Transportation's Enforcement Policy Regarding Unfair Exclusionary Conduct in the Air Transportation Industry, 63 Fed. Reg. 17,919 (1998) (the "Rules").[1]

INTRODUCTION

The Rules are a fundamentally misguided attempt to bring certain airline fare and capacity decisions under regulatory control. While the justification advanced for the Rules is the promotion of competition, in fact the Rules are demonstrably anticompetitive. They would shackle major carriers' ability to deliver the fares and service that consumers want because of baseless fears that vigorous competition may harm certain competitors that the Department of Transportation ("DOT") wishes to protect. This interventionist philosophy is a huge step backwards that threatens the undisputed benefits that airline deregulation has brought to the U.S. economy and consumers. Moreover, the Rules exceed DOT's statutory authority, and the procedures used to propose them fall short of the legal requirements. In short, the Rules are bad economics, bad policy, and bad law.

DOT has proposed the Rules to promote the entry of newly-formed airlines into the hub routes of major carriers. The Rules are supposed to foster "legitimate" (in the eyes of DOT) competition

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1 The Air Transport Association is an association of 23 United States air carriers and five foreign airlines.

July 23, 1998

between major carriers and new entrants by establishing a new definition of unlawful "unfair exclusionary practices" by major carriers. The Rules create an entirely new standard of conduct for major carriers that, in the most vague and sweeping terms, redefines the legal relationship between major carriers and new entrant airlines. The Rules' legal standards are couched in generalities such as "reasonable competitive alternatives" that fail to provide meaningful guidance to those regulated. Most importantly for competition and consumers, this new definition of unlawful conduct is so constraining, subjective, and inherently vague that it is likely to chill conduct substantially beyond its own sweeping scope.

There can be no mistake—the Rules are re-regulation. DOT proposes to assess competitive fare and capacity offerings by carriers by determining their "reasonableness." That kind of regulatory review is antithetical to U.S. antitrust law and open market principles. The Rules are even more onerous than the Civil Aeronautics Board's ("CAB's") regulation of the industry in two fundamental respects. First, they regulate capacity offerings by carriers, an authority never granted to the CAB. Second, the Rules establish an *ex post facto* regime for determining what is or is not a reasonable competitive decision.

The Rules would intrude into the competitive marketplace for domestic air transportation services in a manner that has never before been attempted in any industry, large or small. In effect, DOT is experimenting in an unprecedented and unpredictable way with a $75 billion consumer industry. Yet DOT has made no attempt—in spite of the requirements of its own regulations—to prepare an economic analysis of the Rules and their likely impact on consumers and the economy. In fact, a host of eminent economists, including two whose work was cited by DOT in support of the Rules, have condemned them as anticompetitive re-regulation.

If the Rules are adopted, they will substantially reduce competition on every route on which a new entrant carrier operates. Whatever a new entrant's cost structure or efficiency, the fares it charges will establish the minimum government-decreed fare for that route, and its traffic will impose a cap on other carriers' ability to offer low-fare travel. The Rules will perversely reward entrants for limiting their price and service offerings on new routes, because such self-limitation will in turn limit the competitive response by major carriers. Fare competition, even between major carriers, will be discouraged on any route on which a new entrant operates.

What the Rules mean, therefore, is that consumers will pay higher fares, have fewer choices and less service, all because DOT chose re-regulation over other options that it failed even to consider. Included in those options, of course, is the enforcement of existing antitrust law—that is, preventing truly "predatory" practices as that term has been defined through long and careful analysis by courts applying the Sherman Act (a definition endorsed in Title 49 itself) and otherwise leaving the determination of price and capacity to the free market where it belongs.

These Comments will show how the Rules will actually work: how, if finalized, the Rules' overbroad and vague standards will likely cripple competition not only between new entrants and major carriers, but also between major carriers themselves. These Comments will also establish conclusively that the Rules are completely inconsistent with the U.S. Supreme Court's rulings on predatory pricing and DOT's statutory mandate. As a result of these substantive flaws and the serious procedural errors described below, the Rules are invalid as a matter of law.

The key to preserving the benefits of competition from the deregulated U.S. marketplace is to maintain carrier incentives to provide the most efficient and cost-effective air services possible to the traveling public. If barred from acting on those incentives, the airline industry will return to the inefficiencies of the regulated industry of yesteryear, a time when regulators were unable to perceive the distinction between the number of competitors and the amount of competition in the marketplace. It would be a tragic mistake for DOT to celebrate the twentieth anniversary of aviation deregulation by attempting to curtail the benefits it has brought to the nation as a whole.

SUMMARY OF ARGUMENT

The first section of these Comments demonstrates how the Rules will chill perfectly appropriate competitive responses and create special pricing and capacity rules protecting new entrant carriers, reducing price competition to the great detriment of consumers. The proposed regulations threaten to label a major carrier's price and capacity decisions as unfair (i.e., predatory), even if those decisions are profitable for the major carrier, even if the price is higher than a new entrant's price, even if there is no evidence that consumers will be harmed, and even if the effect is to restrict artificially the supply of low-fare seats. In short, the Rules protect competitors, not competition or consumers.

The first section also notes that even the most basic assumption of the Rules, that new entrants are being harmed by purportedly unfair and predatory practices, is unsupported by any facts or analysis. The difficulties of new entrants in fact have far more compelling explanations, such as the tragic May 1996 ValuJet crash, the fact that new entry tends to slow during periods when aircraft and experienced airline personnel are in heavy demand, and the poor management practices and choices of some of the failed entrants.

The second section shows that the Rules are flatly inconsistent with U.S. Supreme Court precedent. Over the last three decades, the courts have developed standards that strike a careful balance between, on the one hand, prohibiting genuinely predatory conduct, and, on the other, avoiding the chilling of legitimate and desirable price competition that benefits consumers. The Rules wreak havoc on that delicate balance and in the process injure competition and consumers.

If predatory pricing in this industry has occurred, then the proper enforcement authorities can bring a case and build a record based on evidence that withstands the test of an adversary proceeding. DOT has offered no explanation of why the airline industry should be subjected to special rules or why the well-established, carefully considered antitrust laws of general applicability, which already prohibit genuinely anticompetitive conduct, are not sufficient.

The third section of these Comments establishes that DOT simply does not have the authority under Section 411 to promulgate rules that are inconsistent with the antitrust laws.[2] While Section 411 authority may permit DOT to supplement the antitrust laws in limited circumstances, DOT cannot contradict the underlying policies of the antitrust laws or ban conduct that is demonstrably procompetitive. Moreover, to use Section 411 to regulate prices and capacity more intrusively than is permitted by the standards of predation under the antitrust laws contradicts the clearly expressed intent of Congress in deregulating the airline industry.

The fourth section demonstrates that the Rules' vague standards and terms will make compliance impossible. Critical terms like "very low" fares, "a large volume of seats," and, perhaps most important of all, "a reasonable alternative response" are undefined and hopelessly subjective. At bottom, this regulation by second-guessing is fundamentally inconsistent with basic standards of predictability, certainty, and fairness.

The fifth section of the Comments highlights DOT's failure to follow the procedures required in a rulemaking. The Rules promulgate a substantive rule, and DOT is thus required to make a detailed analysis of the Rules' effects. This analysis appears nowhere in the record. Compounding that error, DOT has failed to provide—despite the requirements of administrative

[2] Former Section 411 of the Federal Aviation Act has been recodified as 49 U.S.C. § 41712. These Comments will use "Section 411" as a convenient shorthand reference.

law and multiple FOIA requests—a meaningful opportunity to analyze the information DOT did rely upon in preparing the Rules. These serious procedural errors have impaired the public's right to participate in this proceeding and made valid adoption of the Rules impossible.

The final section compares the Rules with the procompetitive, free market policies of domestic deregulation and international "Open Skies" initiatives and demonstrates that the Rules undermine long-standing procompetitive goals of United States aviation policy. This unwarranted interference with the free market signals a reversal of the congressionally-mandated deregulation of the airline industry. Further, the anticompetitive principles of the Rules provide a potent weapon to any foreign governments or carriers that might seek to throw up protectionist barriers to U.S. airlines' ability to compete vigorously in international markets.

The Comments conclude by suggesting that the Secretary withdraw the proposed Rules and allow the free market to continue to bring the benefits of deregulated competition to the nation's consumers.

I. THE PROPOSED RULES ARE PROFOUNDLY FLAWED AND ANTICOMPETITIVE.

A. The Proposed Rules Contain Vague and Sweeping Standards.

When a "new entrant" enters a "local hub market," the Rules prohibit the incumbent "major carrier" from responding through any combination of price cuts or capacity increases that: "(1) causes [the major carrier] to forego more revenue than all of the new entrant's capacity could have diverted from it or (2) results in substantially lower operating profits—or greater operating losses—in the short run than would a reasonable alternative strategy for competing with the new entrant." Rules at 17,920.

The Rules contain a separate enforcement policy outlining the criteria DOT will use in determining whether to take enforcement action. DOT will initiate enforcement action when:

> (1) the major carrier adds capacity and sells such a large number of seats at very low fares that the ensuing self-diversion of revenue results in lower local revenue than would a reasonable alternative response;
>
> (2) the number of local passengers that the major carrier carries at the new entrant's low fares (or at similar fares that are substantially below the major carrier's previous fares) exceeds the new entrant's total seat capacity, resulting, through self-diversion, in lower local revenue than would a reasonable alternative response; or
>
> (3) the number of local passengers that the major carrier carries at the new entrant's low fares (or at similar fares that are substantially below the major carrier's previous fares) exceeds the number of low-fare passengers carried by the new entrant, resulting, through self-diversion, in lower local revenue than would a reasonable alternative response.

Rules at 17,922.

It is evident that the Rules propose broad restraints on the pricing and capacity decisions of major carriers. However, the Rules' most important terms are unclear and undefined, providing little guidance in distinguishing prohibited from permitted behavior and little restraint on DOT's ability to classify major carrier conduct as either. In effect, the Rules' vague standards give virtually unbounded authority to DOT to engage in *ad hoc* regulation of the pricing and capacity decisions of major carriers in markets containing new entrants.

The Rules are designed to protect "new entrants," which are defined as "independent airline[s] that ha[ve] started jet service within the last ten years and pursu[e] a competitive strategy of charging low fares." Rules at 17,920, n.1. However, this restricted and unclear class of beneficiaries of the Rules makes little sense. If a particular practice is predatory, why are only "new entrants" protected from it?[3] Similarly, why are "new entrants" free to engage in these

[3] The Rules use the term "unfair exclusionary practice" in place of "predatory." However, the underlying conduct is obviously that analyzed as "predation" under the antitrust laws. DOT acknowledges as much, conceding that the practices are "analogous to ... predation", citing academic literature referring to "predation", and justifying its decision to

"unfair exclusionary practices"? It is not even clear which airlines are protected by the Rules. The Rules fail to specify what degree of independence is required to be "an independent carrier" eligible for protection, or what qualifies as "a competitive strategy of charging low fares." "Major carrier" is also not defined.[4] Does it include new low-cost subsidiaries of major airlines?

Crucial terms and standards in the Rules provide no more meaningful guidance. The major carriers may not offer "a large number of seats" at "very low fares" or "similar fares" that might be "substantially below" previous fares. But what is "a large number of seats"? What is a "very low fare"? When is a fare "substantially below" a prior fare? How are the airline employees who are responsible for formulating competitive responses, especially in time-sensitive circumstances, to know what fare DOT will later regard as "very low" and what number of seats DOT will think is "large"? Also, if there are two or more major carriers on a route, would DOT take into account major carrier A's response to new entry when determining whether major carrier B's response was "reasonable," and vice-versa? If there are two or more "new entrants" on a route, is their capacity combined for purposes of the Rules? If one major carrier withdraws from a route, can the others expand service proportionally without violating the Rules? What if

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act by reference to "informal allegations of predation." Rules at 17,921. Moreover, courts' analyses of predation under Section 2 of the Sherman Act have been explicitly tied to that statute's "exclusionary conduct" standard. See, e.g., Kelco Disposal, Inc. v. Browning-Ferris Industries of Vermont, 845 F.2d 404, 407 (2d Cir. 1988); Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227, 230 (1st Cir. 1983). The terminological distinction makes no difference. See also Section III, infra (Section 411 must be read consistently with antitrust laws). For clarity and simplicity, these Comments will refer to "predation" and "predatory" practices.

4 The ATA specifically requests clarification of the term "major carrier." According to the Rules, a "major carrier" is a "major carrier" that operates the hub at issue. Rules at 17,920 n.1. The term "major carrier" appears nowhere in 14 C.F.R. Chapter II, although it is used loosely to refer to air carriers having total annual operation revenues that exceed

another major carrier enters the route after the new entrant? This lack of clarity renders the Rules intolerably vague and impossible to apply even after careful analysis, much less in the high-pressure, rapid-response world of airline pricing.

Most importantly, the central governing standard of the Rules has no limiting principle and is wholly subjective. The standard against which all major carrier actions will be evaluated is whether it compares favorably, after the fact and in the eyes of DOT, to an undefined "reasonable alternative strategy" that DOT ultimately believes would have been more appropriate under all the circumstances. A major carrier will be considered to have violated the law if its revenues turn out to be lower than revenues DOT later projects that carrier could have realized from an alternative response, whether (i) because the major carrier's prediction of the revenue effects of its pricing and capacity decisions was simply wrong, (ii) because DOT takes a different view of the best business strategy for the airline, (iii) because DOT makes its decision based on facts not available to the major carrier at the time of the original decision, or (iv) for any one of a host of other unforeseeable reasons. A major carrier simply cannot know in advance what the rules of the game are and will not find out until DOT makes a hindsight judgment months if not years later.[5]

While the precise contours of the Rules' prohibitions are fuzzy and indeterminate, it is at least clear that they are overly broad. Fare reductions and capacity increases could be barred under the Rules if they merely match the entrant's offerings; indeed, fare reductions to levels above the new entrant's fare could still violate the Rules. A few examples illustrate the point:

$1 million. See 14 C.F.R. § 241, Section 04 (1998). Clarification is necessary so that carriers will know whether they are the target of the Rules.

[5] See Statement of Janusz A. Ordover and Robert D. Willig (attached hereto as Appendix A) ("Ordover & Willig Statement") at 14-16.

1. A major carrier could violate the Rules even if all it does is match the fare and the seat capacity of a new entrant. Suppose the new entrant has three 100-seat flights a day at $99, and the major carrier does no more than match that offer with 300 seats a day at $99. However, it later turns out that more consumers preferred the major carrier, and it sold an average of 275 seats a day while the new entrant sold only 250. Although it could not have known it ahead of time, the major carrier would have violated the Rules and triggered enforcement action because it carried more low-fare passengers than the new entrant.

2. Virtually any price cut could potentially violate the Rules. Suppose the same new entrant offers 300 seats a day at $99. The major carrier responds by lowering prices on 200 seats a day to $129. DOT later decides that a more profitable "reasonable alternative strategy" would have been to offer 150 seats at $149, based on DOT's after-the-fact judgment of how the market would have reacted to such a strategy and the level of "self-diversion" that would have resulted. The major carrier would have violated the Rules, though again it had no way of knowing this in advance.

3. The Rules could deny consumers the right to fly at low fares even if it would be rational and profitable for the major airline to carry them. Again, suppose that the new entrant has three 100-seat flights a day at $99. The new low fare greatly increases consumer demand for tickets, and 1,000 people a day want to fly at that fare. Assume that it would be profitable for the major carrier to carry the other 700 because its revenues would exceed its costs and the higher volume would offset the lower margin on each ticket. Under the Rules, however, the major carrier could only offer and sell 300 seats at the new fare without triggering enforcement action, and at least 400 customers must be denied the opportunity to purchase a seat at that low fare.

B. The Proposed Rules Substitute Faulty Assumptions for Facts.

The most basic assumptions of the Rules are that there has been a decline in new entry "since early 1996" and that this perceived problem is attributable "at least in part" to predation by major carriers.[6] There are no facts or analyses provided to support these assumptions, however. In fact, the available data suggest that they are simply wrong.

[6] U.S. Department of Transportation, News Release on the Proposed Statement of Enforcement Policy Regarding Unfair Exclusionary Conduct by the Air Transportation Industry, Apr. 6, 1998, at 1.

First, it is not at all clear that there has been an unusual increase in new entrant failures. Available evidence demonstrates that the failure rate of new airlines does not differ substantially from those of other forms of business, and, perhaps more importantly, that the changes in the numbers of new entrant airlines over the past several years are consistent with what could be expected under historical patterns of post-deregulation entry.[7] On the one hand, industry downturns tend to make resources—aircraft and trained personnel—available at bargain rates, spurring entry. On the other hand, industry upturns, such as that experienced by the industry during the period of concern to DOT, tend to make the resources more expensive because of heavy demand by incumbent carriers and thus deter entry.[8]

Second, even with respect to those new entrants that have failed, there is no evidence to support DOT's assumption that unfair or predatory practices by major carriers were a significant factor in their failure. Independent empirical analysis has concluded that new entrants fail because of poor business decisions: badly chosen routes and markets, failure to create a sensible network, unsustainably low prices, and hiring executives with track records of failure. Darryl Jenkins, An Examination of Why New Entrant Airlines Fail (1998). The presence or absence of allegations of predation has historically had no effect on a new entrant's ability to stay in a market. Id. at 6.

Third, the tragic ValuJet crash in 1996 had a strong adverse effect on the public perception of start-up carriers and made it more difficult for them to compete effectively. Id. at 7. The FAA publicly announced a tightening of safety standards for new entrants, further reinforcing

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7 See Statement of Daniel M. Kasper (attached hereto as Appendix B) ("Kasper Statement") at 8-11.

8 Id.

the perception of those carriers' inadequate attention to safety.[9] Indeed, DOT's own Inspector General caused an uproar immediately after the crash by stating that she "would not fly on marginal airlines" and had avoided ValuJet. Mary F. Schiavo, "I Don't Like to Fly," Newsweek, May 20, 1996, at 32. Traffic on the small carriers DOT terms "low-fare"[10] (excluding Southwest) declined nearly 20% between the first and third quarters of 1996—and this during a time when the total number of air passengers was increasing.[11] New entrants' own SEC filings cite the ValuJet disaster—and do not cite unfair practices or predation—as a significant contributor to poor financial performance.[12] To counter this strong evidence from independent observers and the new entrants themselves, DOT provides only bald assertions.

The Rules are also full of conclusory allegations of anticompetitive conduct and intent by major carriers.[13] However, DOT fails either to identify the evidence upon which it relies or give

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9 Kasper Statement at 13.

10 These Comments in no way endorse DOT's arbitrary classification of certain carriers as "low-fare" carriers. See, e.g., U.S. Department of Transportation, Domestic Airline Fares Consumer Report, Fourth Quarter 1997 (1998). All carriers compete on fares, and the consumer does not choose among carriers based on any regulatory classification but rather on the combination of price and quality of service offered to him or her.

11 Department of Transportation, Origin-Destination Survey, Calendar Year 1996.

12 See, e.g., Vanguard Airlines, Inc. Form 10-K (December 31, 1996) ("Aircraft accidents ... such as the recent plane crashes involving ValuJet and Trans World Airlines, have had an adverse effect on airline passengers' perceptions regarding the safety of low cost carriers...."); Western Pacific Airlines, Inc., Form 10-K (December 31, 1996) (identifying "consumer backlash against start-up carriers in the aftermath of two airline accidents during 1996 and the ensuing government controversy concerning the safety of start-up carriers"); Kiwi Int'l Airlines, Inc., Form 10-Q (September 30, 1996) (ValuJet crash "caused a general concern about the safety of discount carriers, affecting the number [of] passengers electing to fly low-fare airlines").

13 See, e.g., Rules at 17,920 ("[T]he major carriers have increasingly responded with strategies of price reductions and capacity increases designed not to maximize their own profits but rather to deprive the new entrants of vital traffic and revenues.") The failure to

the carriers in question an opportunity to respond. If DOT believes it has compelling evidence of predatory practices, the proper place for that evidence is an enforcement action under the antitrust laws.

The Rules assume as well that major carriers have a "higher cost structure," but again DOT provides no evidence. Rules at 17,921. The assumption is demonstrably untrue; for example, both Southwest Airlines (universally acknowledged to be highly efficient) and the low-cost affiliates of major carriers are apparently "major carriers" for purposes of the Rules. Even if the assumption were true, however, the assumption would lead inexorably to the conclusion that the Rules are bad policy. If the major carriers in fact have a higher cost structure, then efficient new entrants should be able profitably to undercut the major carriers' prices in every case unless a major carrier prices below its own costs. Conversely, if major carriers are in fact more efficient than new entrants, the Rules prohibit them from passing that efficiency on to consumers in the form of lower prices in response to competition. In prohibiting major carriers from dropping their prices to levels still above their own costs, the Rules penalize consumers and major carriers unnecessarily.

C. The Proposed Rules Prohibit Demonstrably Procompetitive Behavior and Encourage Anticompetitive Behavior, Thus Harming Consumers.

As Professors Willig and Ordover's analysis makes clear, the Rules bar behavior that is clearly procompetitive and encourage behavior that is clearly anticompetitive.[14] The Rules

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disclose the facts upon which the Rules are based is not only unfair but illegal. See Section V.D., infra.

14 The Rules cite a 1981 paper by Professors Willig and Ordover as purported support for a portion of DOT's analysis. Rules at 17,921 n.5. Appendix A, however, shows that these eminent economists believe that the Rules are fatally flawed.

sidestep economic analysis in favor of facile assumptions—many demonstrably false—and do not require any showing of anticompetitive effect before a practice is barred.

1. The Proposed Rules Prohibit Proconsumer Competitive Responses.

First, the Rules prohibit a major carrier from expanding capacity to accommodate the inevitable increased demand resulting from lower prices.[15] Market forces compel a rational carrier to base its capacity decisions on an analysis of total demand for local and beyond travel under prevailing fare structures, the portion of demand likely to be served by other competitors (including new entrants), and its own costs in serving the remainder. See The Low Cost Airline Service Revolution at 21 (recognizing that elasticity of demand and cost are key elements in capacity decisions). Carriers often expand capacity without experiencing a steep decline in load factor, because the capacity expansion is in line with the demand expansion. The revenue generated by expansion also generally exceeds the cost of expansion. The Rules require the major carrier to ignore these factors and instead base its capacity decisions solely on the absolute level of the new entrant's capacity and thus prohibit rational and procompetitive behavior.

Indeed, the Rules are generally indifferent to the procompetitive justifications for major carrier fare and capacity changes, simply because a new entrant has entered a route. Even if an incumbent major carrier were to plan a price cut or capacity increase before a new entrant appeared, the plan would be subject to regulatory restriction, scrutiny, and second-guessing under the Rules if not implemented before the new entrant began service. Similarly, if the major carrier were reallocating capacity for reasons having nothing to do with the new entrant (for example,

15 See Ordover & Willig Statement at 26-28, 30-33. DOT itself recognized only two years ago that "substantially lower fares result in remarkable traffic increases" and that major carriers that "amplify their competitive responses" provide "very substantial consumer

macroeconomic changes affecting patterns of demand), its decisions would still be questioned.[16] In short, conduct that would clearly be legitimate with respect to any other competitor or in any other market would suddenly become suspect solely because a specially-protected new entrant was involved. The prospect of scrutiny under the vague and unpredictable standards of the Rules will undoubtedly chill competition.[17]

Second, the Rules require the major airlines to act as though the capacity of the new entrant is always fixed, which of course is not the case.[18] New entrants can—and frequently do—continue adding capacity to a route as demand continues to grow. Under the Rules, before competing to protect its business a major carrier is required to wait for the new entrant to make the first move to snap up new traffic, because the major carrier is not allowed to carry more low-fare passengers until the new entrant does (assuming the major carrier is already equaling the new entrant's traffic). The first chance at any growth in capacity on the route is thus assigned by regulatory fiat to the new entrant, regardless of the market's preferences.

Third, the Rules' exclusive focus on short-run profit maximization is economically irrational.[19] The narrow view taken by the Rules excludes the procompetitive, proconsumer benefits of long-term investments. Again, the legitimate justifications for focusing on anything other than short-term profits are simply ignored.

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benefits." U.S. Department of Transportation, The Low Cost Airline Service Revolution 10, 16 (1996).

16 See Kasper Statement at 20-21.

17 See Ordover & Willig Statement at 23-24.

18 Id. at 10-18, 23-35

19 Id. at 20-21.

Finally, the Rules assume that the least costly competitive response for the major carrier is a low fare targeted at only the passengers who might otherwise be lost to the new entrant (otherwise, "self-diversion" will allegedly result).[20] Such precise targeting of unidentified and unidentifiable lost customers is impossible. Indeed, if such targeting were possible, the major carrier could recapture the passengers lost to a new entrant without adding a single new seat by providing incentives only to those passengers. In reality, however, the only practical method of competing for the lost customers is a broadly-targeted response, which benefits a broader group of consumers. In fact, DOT consumer rules require carriers offering a low fare to make a reasonable number of seats available at that fare, thus conflicting with the Rules' prohibition of a broad response.[21]

2. The Proposed Rules Create Anticompetitive Incentives.

The Rules blunt competition by creating incentives for new entrants to compete far less vigorously than they otherwise might. To obtain the maximum protection from the Rules, a new entrant would limit its capacity and charge higher fares. The higher the price and the smaller the capacity a new entrant offers, the higher the price and the fewer the seats a major carrier can offer

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[20] Id. at 28-30.

[21] See, e.g., DOT Order 93-10-49 (Oct. 29, 1993); DOT Order 93-9-1 (Sept. 1, 1993); 14 C.F.R. § 399.84; Industry Letter from Secretary Peña, Dec. 20, 1994. The conflict arises as follows: Suppose major carrier X operates 10 daily round trips in a market, with a total of 1,460 daily seats, and new entrant Y enters the market with a single daily round trip with 135 seats. Under the Rules, X at the very least would have to limit the low-fare seats available to 135 seats per day, which is Y's total capacity. But the Rules also require X to limit the matching fare to no more than the total number of passengers Y carries. X must guess at Y's actual traffic in real time, and might apply an assumed load factor of 65 percent to conclude that it must limit its matching fare to 88 seats per day. X would then likely run afoul of DOT's policy on advertising, since DOT probably would not consider it reasonable for X to limit its low fare to six percent of capacity available. The only safe course for X is to refrain from competing.

in response.[22] Rather than competing vigorously to carry the most passengers at the lowest price, a new entrant can simply rely upon price and market share protection and rest secure in the knowledge that its major carrier rival is fighting with one hand tied behind its back. DOT even explicitly states that its vision of the way in which major carriers can "choose to co-exist with the low-fare carriers" is "by not competing aggressively for local passengers." Rules at 17,921. One can understand why the new entrants favor such a regime of economic control, but it is hardly procompetitive or proconsumer.

The Rules will generate additional anticompetitive effects by discouraging a major carrier's vigorous competitive responses to new entry.[23] Any initiative by a major carrier designed to bring more seats to consumers at a lower price would at best face scrutiny under the Rules. The results of that scrutiny will be wholly unpredictable, as they depend upon prognostications of future market outcomes involving not only the actions of the major carrier itself, but also the unknown and changeable plans of the new entrant, the responses of other carriers and consumers, and whatever hypothetical "reasonable alternative strategies" are subsequently imagined by regulators.

The prospect of such *post hoc* regulatory scrutiny will dampen the vibrant competitive dynamics of this industry. Because airlines will have no desire to be in constant adversarial administrative proceedings with the agency that regulates them (or to incur the negative publicity that governmental charges of predation would undoubtedly bring), the Rules will give the major carriers strong incentives to err on the side of avoiding possible enforcement action by dampening their competitive responses to new entry. This means higher prices for consumers.

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[22] See Ordover & Willig Statement at 18-19, 24-26; Kasper Statement at 19.

Finally, the Rules assume that major carriers could obtain the type of competitively sensitive data about their competitors' pricing and capacity decisions that could, as a practical matter, lead to suspicions of improper coordination among competitors. Under the Rules, a major carrier's competitive response must depend not upon its internal competitive assessment, but on the plans and actions of the new entrant and the effects of its own and competitors' responses on the new entrant's traffic. The only way for a major carrier to avoid adverse action under the Rules would be to obtain accurate knowledge of such matters ahead of time and to continue to monitor its competitors' planning and results, which may be mischaracterized as suspicious even though lawfully accomplished. This creates a Catch-22: successfully obtaining knowledge of such competitively sensitive information could lead to suits alleging collusion in violation of the Sherman Act (even if wholly unfounded), and failing to do so is likely to lead to charges of illegal behavior under the Rules. Airlines seeking to compete legitimately will be left with no option that does not expose them to significant risk of a legal challenge by either DOJ or DOT. Again, the major carriers are pressured not to compete at all.

II. THE PROPOSED RULES UNDERMINE RATHER THAN PROMOTE THE PROCOMPETITIVE GOALS OF ANTITRUST LAW AND POLICY.

The Rules are completely inconsistent with the standards established under the antitrust laws for analyzing allegedly predatory conduct. That inconsistency is fatal to the Rules.[24]

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[23] See Ordover & Willig Statement at 19-20.

[24] The Rules' analysis appears to be closer to that of the antidumping laws, a fundamentally different and wholly inapposite set of principles that does not share the procompetitive focus of the antitrust laws and has never been applied to any domestic market, much less one for services rather than goods.

First, as will be demonstrated in Section III, DOT does not have statutory authority under Section 411 to adopt a standard that contradicts the policies of the antitrust laws. A detailed understanding of those policies is therefore essential to understanding the limits of Section 411.

Second, and more fundamentally, the underlying analysis of the courts in determining what is and what is not a proper standard for identifying predatory conduct is a road map to the anticompetitive effects of the Rules. The theories and arguments DOT advances are not new. Courts have been thinking long and hard about how to address these issues for nearly thirty years. After decades of painstaking analysis and a step-by-step evolution of legal and economic doctrine, courts (including the Supreme Court) have reached the firm conclusion that proposals like those contained in the Rules are anticompetitive for one simple but powerful reason: the costs they impose in destroying competition far outweigh any marginal benefit they might provide in preserving competitors. Put another way, government interference in price and capacity decisions for the benefit of certain competitors is inherently anticompetitive. It is justified only where absolutely necessary to prevent a clearly greater competitive harm, and only to that extent.

The courts' rejection of the policies underlying the Rules does not depend at all upon a technical statutory analysis, but rather upon the policies' competition-destroying effects. DOT should not—indeed cannot—ignore the courts' conclusion that the policies of the Rules harm competition (and, therefore, violate DOT's mandate).

A. The Proposed Rules are Flatly Inconsistent with the Supreme Court's Prerequisites for a Finding of Predatory Pricing.

Current antitrust law strikes a careful balance between protecting procompetitive, proconsumer low pricing and preventing truly anticompetitive conduct. The Supreme Court has highlighted the importance of that balance, warning that

> cutting prices in order to increase business often is the very essence of competition. Thus, mistaken inferences in cases such as this one are especially costly, because they chill the very conduct the antitrust laws are designed to protect. We must be concerned lest a rule or precedent that authorizes a search for a particular type of undesirable pricing behavior end up by discouraging legitimate price competition.

Matsushita Electric Industrial Co. v. Zenith Radio Corp., 475 U.S. 574, 594 (1985). A year later, the Court again emphasized the danger of overdeterring competition in a case alleging that a defendant intended to lower its competitors' profits by "squeezing" prices toward cost:

> The kind of competition that [plaintiff] alleges here, competition for increased market share, is not activity forbidden by the antitrust laws. It is simply, as petitioners claim, vigorous competition. To hold that the antitrust laws protect competitors from the loss of profits due to such price competition would, in effect, render illegal any decision by a firm to cut prices in order to increase market share. The antitrust laws require no such perverse result, for it is in the interest of competition to permit dominant firms to engage in vigorous competition, including price competition.

Cargill, Inc. v. Monfort of Colorado, Inc., 479 U.S. 104, 116 (1986) (emphasis added). Thus, the policies of the antitrust laws require that any measure of predation be carefully calibrated so as to preserve the benefits of competition for consumers. The Rules flout the standards developed to accomplish that goal.

The Supreme Court has established a test for predation that steers the law between the twin threats of a market shackled by competition-deadening rules and conduct that is unambiguously predatory. The Court recognized "two prerequisites to recovery" that must be shown in every predatory pricing case:

(1) Proof that the defendant set prices "below an appropriate measure of its ... costs"; and

(2) Proof that the defendant has "a reasonable prospect, or, under § 2 of the Sherman Act, a dangerous probability, of recouping its investment in low-cost prices."

Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 224-26 (1993). These two requirements are completely absent from the Rules.

Moreover, courts and commentators have long recognized that traditional antitrust principles are flexible enough to account for the varying market dynamics of highly diverse industries and products.[25] Accordingly, industry-specific rules have been avoided in favor of the application of general antitrust principles across all industries and products. Other federal agencies have issued guidelines interpreting traditional antitrust principles in the context of a particular industry without creating new substantive standards applicable to that industry.[26] DOT offers no justification for departing from traditional regulatory policy, nor has it articulated any reason why the predation standards of the antitrust laws are inadequate for the airline industry alone among all others. Indeed, as demonstrated in Appendix A, sound economic analysis indicates that special regulation of competition in the airline industry is wholly inappropriate.[27] If the airline industry were not subject to its own regulatory agency, there would be no suggestion whatever of creating a separate legal standard for it.

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[25] See, e.g., Silver v. New York Stock Exchange, 373 U.S. 341, 360 (1963) (finding antitrust exemption unwarranted given that "traditional antitrust concepts are flexible enough to permit the Exchange sufficient breathing space within which to carry out the mandate of the Securities Exchange Act"); Los Angeles Memorial Coliseum Commission v. National Football League, 726 F.2d 1381, 1401 (9th Cir. 1984) ("We believe antitrust principles are sufficiently flexible to account for the NFL's structure. To the extent that the NFL finds the law inadequate, it must look to Congress for relief."); MCI Communications Corp. v. American Telephone and Telegraph Co., 708 F.2d 1081, 1106 (7th Cir. 1982) ("[A]ntitrust courts can and do consider the particular circumstances of an industry and therefore adjust their usual rules to the existence, extent, and nature of regulation.")

[26] See, e.g., 1996 Department of Justice and Federal Trade Commission Statements of Antitrust Enforcement Policy in Health Care.

[27] Ordover & Willig Statement at 8-11.

B. The Proposed Rules Bar Above-Cost Pricing that Is Unquestionably Legal under the Antitrust Laws.

The Rules would permit DOT to find above-cost pricing to be an unfair exclusionary practice, because the Rules contain no reference at all to a major carrier's costs in evaluating whether one of its fares is predatory. The first prong of the Brooke test, however, makes it absolutely clear that prices above cost cannot be predatory.[28] The Federal Reporter is replete with cases in which a failure to allege or prove pricing below cost results in dismissal as a matter of law.[29] Furthermore, the Rules appear to examine pricing practices only with respect to the major carriers' lowest fares, ignoring the courts' clear directive that all of a firm's prices must be considered in the price-cost comparison.[30] The Rules are therefore flatly inconsistent with prevailing antitrust law.[31]

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[28] Note that this statement does not imply that prices below cost are automatically predatory. Below-cost pricing is a necessary but not a sufficient condition to predation; recoupment is also necessary. There can also be legitimate business reasons for temporary below-cost pricing. See, e.g., A.A. Poultry Farms v. Rose Acre Farms, 881 F.2d 1396, 1400 (7th Cir. 1989).

[29] See, e.g., C.B. Trucking v. Waste Management, Inc., 137 F.3d 41, 45 (1st Cir. 1998); International Travel Arrangers v. NWA, Inc., 991 F.2d 1389 (8th Cir. 1993); Arthur S. Langenderfer, Inc. v. S.E. Johnson Co., 729 F.2d 1050 (6th Cir. 1984); Northeastern Tel. Co. v. AT&T, 651 F.2d 76, 88 (2d Cir. 1981).

[30] In a situation virtually identical to that posited in the Rules involving claims of predatory pricing by a major carrier, the Eighth Circuit held that it was impermissible to examine only the carrier's lowest fares in determining whether the requirement of below-cost pricing had been met. International Travel Arrangers v. NWA, Inc., 991 F.2d 1389, 1396 (8th Cir. 1993); see also Bayou Bottling, Inc. v. Dr. Pepper Co., 725 F.2d 300 (5th Cir. 1984).

[31] Indeed, some courts have concluded that meeting a competitor's price constitutes a complete defense to allegations of predatory pricing regardless of a firm's cost. See, e.g., Richter Concrete Corp. v. Hilltop Basic Resources, 691 F.2d 818, 826 (6th Cir. 1982) ("It is not anticompetitive for a company to reduce prices to meet lower prices already being charged by competitors."); Transamerica Computer Co. v. IBM, 481 F. Supp. 965, 996 (N.D. Cal. 1979) (prices below cost may be warranted and reasonable where reduced to

Cost-based tests are sound policy.[32] They provide a workable standard for distinguishing between pricing that might harm consumers in the long run and pricing that simply delivers the benefits of vigorous price competition to consumers. The only way for a firm to drive out an equally or more efficient rival through price cuts is to price below its own costs, because a rival that is at least equally efficient could profitably match any other price cut. Compelling an incumbent firm to maintain high prices in the face of new entry would create a "price umbrella," inviting inefficient firms to enter the relevant markets or permitting already operating inefficient firms to survive. The danger is especially great if the incumbent is forced (as under the Rules) to keep its prices up for a significant time after entry has occurred. The Supreme Court has warned against creating such a price umbrella: "It would be ironic indeed if the standards for predatory pricing liability were so low that antitrust suits themselves became a tool for keeping prices high." Brooke, 509 U.S. at 226-27.

Prior to Brooke, plaintiffs frequently argued that some other measure of predation, usually involving a short-term profit-maximization test like that of the Rules, should be employed. In

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meet competition); ILC Peripherals Leasing Corp. v. IBM, 458 F. Supp. 423, 434 (N.D. Cal. 1978) ("A company should not be guilty of predatory pricing, regardless of its costs, when it reduces prices to meet lower prices already being charged by its competitors."), aff'd mem. sub nom. Memorex Corp. v. IBM, 636 F.2d 1188 (9th Cir. 1980).

[32] Even the Ninth Circuit—traditionally the court most receptive to arguments that prices above cost might be predatory—has recognized that such arguments cannot survive Brooke. See, e.g., USA Petroleum Co. v. Atlantic Richfield Co., 13 F.3d 1276, 1285 (9th Cir. 1993) (op. of D. Nelson, J.) ("[A]bove cost below-market level pricing, even when coupled with a structural showing such as recoupment, cannot constitute predatory pricing."); Vollrath Co. v. Sammi Corp., 9 F.3d 1455 (9th Cir. 1993) (citing Brooke, granting judgment as a matter of law for defendants where plaintiffs failed to show below-cost pricing). Certain Fifth Circuit cases also contained dicta concerning circumstances in which pricing above average variable cost might be found predatory. See, e.g., International Air Indus. v. American Excelsior Co., 517 F.2d 714, 723-24 (5th Cir. 1975).

rejecting these tests, courts consistently pointed to the detrimental competitive effects of barring conduct that tended to reduce prices toward cost. The language of three separate federal courts of appeals could not be clearer:

> [W]e must reject such a 'profit maximization' theory as incompatible with the basic principles of antitrust. A rule of predation based on the failure to maximize profits would rob consumers of the benefits of any price reductions by dominant firms facing new competition. [MCI v. AT&T, 708 F.2d 1081, 1114 (7th Cir. 1982).]

> Any definition of predatory pricing, however, must also accommodate the economic policies of the antitrust laws to promote efficiency, encourage vigorous competition, and maximize consumer welfare. The rule advocated by Langenderfer [sacrificing short-term profits with predatory intent] would work contrary to those goals by forcing a larger, more efficient firm to maintain artificially high prices to the detriment of the public. [Arthur S. Langenderfer, Inc. v. S.E. Johnson Co., 729 F.2d 1050, 1057 (6th Cir. 1984).]

> A firm that cuts its prices or substantially reduces its profit margin is not necessarily engaging in predatory pricing. It may simply be responding to new competition, or to a downturn in market demand. Indeed, there is a real danger in mislabeling such practices as predatory, because consumers generally benefit from the low prices resulting from aggressive price competition. [Morgan v. Ponder, 892 F.2d 1355, 1358-59 (8th Cir. 1989).]

Courts have held fast to the cost-based test even if competitors are harmed by price cuts to levels that remain above cost. "It is axiomatic that the antitrust laws were passed for 'the protection of competition, not competitors.'" Brooke, 509 U.S. at 224 (citation omitted).[33] Thus, numerous lower courts have held that the law of predation does not prohibit undercutting a

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To the extent the Fifth Circuit's reasoning could be construed to reach prices above average total cost, it too conflicts with and fails to survive Brooke.

33 Indeed, the Supreme Court has twice applied the principle that harm to competitors is insufficient to demonstrate predation, holding that claims that dominant firms "squeezed" competitors by reducing prices toward cost or engaged in "limit pricing" just below competitors' costs failed to implicate the sort of "injury" that the antitrust laws were designed to prevent. Atlantic Richfield Co. v. USA Petroleum Co., 495 U.S. 328, 337-38, 347 n.2 (1990); Cargill, Inc. v. Monfort of Colorado, Inc., 479 U.S. 104, 116 (1986).

rival's costs, even if the low price makes it impossible for that rival to stay in business and results in a more concentrated market.[34] Even a dominant position does not carry with it an obligation to stop competing and passively cede market share to potential rivals. Northeastern Tel. Co. v. AT&T, 651 F.2d 76, 87 (2d Cir. 1981).

In short, the courts have fully considered alternatives to the price/cost test of predation, including tests like those of the Rules, and have rejected them as inconsistent with antitrust law and policy. The Supreme Court in Brooke recognized that the cost-based rule it laid down might immunize some arguably anticompetitive behavior, but concluded that as a policy matter the risks of chilling competition posed by any other rule were greater:

> As a general rule, the exclusionary effect of prices above a relevant measure of cost either reflects the lower cost structure of the alleged predator, and so reflects competition on the merits, or is beyond the practical ability of a judicial tribunal to control without courting intolerable risks of chilling legitimate price cutting.

Brooke, 509 U.S. at 223 (emphasis added). The Supreme Court has thus foreclosed the interpretation of antitrust principles upon which the Rules are based.[35]

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[34] See, e.g., C.B. Trucking, Inc. v. Waste Management, Inc., 137 F.3d 41 (1st Cir. 1998); Arthur S. Langenderfer, Inc. v. S.E. Johnson Co., 729 F.2d 1050, 1055-56 (6th Cir. 1984). Courts have explicitly held that a pattern of low prices and profits followed by higher prices and profits once a competitor leaves the market—precisely the "evidence" cited by DOT—does not itself establish predation. "There is little doubt that this is the typical pattern of a successful predator. Yet, it is just as plainly the pattern of a successful competitor in a concentrated market....Although evidence that the Ponders are able to earn substantial profits in the absence of direct competition may assist in showing that they presently possess monopoly power, it offers no help in establishing the prong of the monopolization test at issue here: whether monopoly power was achieved by predatory conduct." Morgan v. Ponder, 892 F.2d 1355, 1359-60 (8th Cir. 1989).

[35] The Rules' references to changes in capacity, moreover, do not alter the predation analysis. Capacity is relevant, of course, but only as it relates to the supply and demand equation: an increase in capacity will either be accompanied by a fall in price and corresponding increase in demand, or by declining load factors and thus an increase in average costs. Either change could be evaluated under traditional predatory pricing tests.

Then-Judge (now Justice) Breyer examined this issue in detail in a leading appellate decision, Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227 (1st Cir. 1983).[36] Justice Breyer rejected the plaintiff's attack on above-cost but allegedly non-profit-maximizing prices, despite recognizing that there might be certain hypothetical situations in "in which even 'above total cost' price cutting might not be procompetitive and might, in theory, hurt the consumer." Id. at 233-34.

Justice Breyer explained that, despite these theoretical objections, courts have made a deliberate policy choice not to create exceptions to the rule that pricing above cost cannot be predatory:

> Nonetheless, while technical economic discussion helps to inform the antitrust laws, those laws cannot precisely replicate the economists' (sometimes conflicting) views. For, unlike economics, law is an administrative system the effects of which depend on the content of rules and precedents only as they are applied by judges and juries in courts and by lawyers advising their clients. Rules that seek to embody every economic complexity and qualification may well, through the vagaries of administration, prove counterproductive, undercutting the very economic ends they seek to serve....[W]e must be concerned lest a rule or precedent that authorizes a search for a particular type of undesirable pricing behavior end up by discouraging legitimate price competition.

See, e.g., Structure Probe, Inc. v. Franklin Institute, 450 F. Supp. 1272, 1287 (E.D.Pa. 1978), aff'd mem., 595 F.2d 1214 (3d Cir. 1979) (expansion of capacity not predatory where capacity not intended to be operated at a loss, i.e., at below-cost levels); cf. International Telephone & Telegraph Corp., 104 F.T.C. 280, 1984 FTC LEXIS 44 at *282 (1984) ("The fact that an alleged predator may have recently increased its individual capacity is not likely to be . . . helpful" in determining whether predation has occurred.)

[36] In that case, a new entrant into the manufacture of specialized pipe fixtures alleged that a monopolist blocked its entry by undercutting the entrant's prices and by securing large-volume orders to foreclose the potential market. The dominant firm's prices were concededly above its average total cost, but the plaintiff argued that they were intended to, and in fact did, sacrifice short-term profits in order to drive the plaintiff from the market and maintain the monopoly.

Id. at 234.[37]

Justice Breyer went on to catalog a number of undesirable aspects of creating exceptions to the rule that above-cost pricing is always legal: (1) Definite price reductions (the alleged "predation") would be sacrificed for a speculative hope of lower future prices. (2) Profit-maximization tests are simply unworkable. Difficulties of measurement and market complexity make it impossible for a court (or even a business) to determine whether a price cut is in fact profit-maximizing in the short run, and fact-finders run a high risk of deciding cases wrongly. (3) Exceptions to cost-based rules create strong incentives for rivals to complain about procompetitive above-cost pricing in hopes of protecting themselves from competition. (4) In concentrated industries, rules condemning above-cost pricing would tend to dampen price competition and deter individual firms from undercutting supracompetitive prices. Businesses will find it difficult to distinguish legitimate from illegitimate price cuts *ex ante*, and all price cuts will therefore be chilled. Id. at 234-35. Other courts have cited similar considerations in their rejection of profit-maximization tests.[38]

Justice Breyer's indictment of profit-maximization rules could have been written with the Rules in mind.

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37 See also Ordover & Willig Statement at 7, 10-11 (emphasizing administrative costs and potential for error in regulation).

38 In rejecting a profit-maximization principle for predatory pricing, the Seventh Circuit pointed to the "complexity and uncertainty" of calculating market responses to price initiatives and the impracticality of ongoing monitoring of business strategies to ensure profit maximization, concluding that "[s]uch supervision is incompatible with the functioning of private markets." MCI v. AT&T, 708 F.2d 1081, 1114 (7th Cir. 1982); see also Arthur S. Langenderfer, Inc. v. S.E. Johnson Co., 729 F.2d 1050, 1057 (6th Cir. 1984) (rejecting short-term profit-maximization rule); Northeastern Tel. Co. v. AT&T, 651 F.2d 76, 88 (2d Cir. 1981) (noting importance of clear predation rules). And, of course, profit-maximization tests directly conflict with Brooke.

C. The Proposed Rules Also Ignore the Recoupment Test Necessary for a Finding of Anticompetitive Effect.

Brooke establishes the requirement of proof that the alleged predator could recoup its losses through the acquisition and abuse of market power before pricing practices can be barred as predatory: "Evidence of below-cost pricing is not alone sufficient to permit an inference of probable recoupment and injury to competition." Brooke, 509 U.S. at 226. The Rules stand Brooke's recoupment analysis on its head: rather than requiring proof of a dangerous probability of recoupment before condemning a practice as predatory, as Brooke requires, the Rules simply assume from the existence of the allegedly predatory behavior that "the major carrier can readily recoup the revenues it has sacrificed." Rules at 17,920. That assumption is both factually unsupported and contrary to law.

The Supreme Court has made it quite clear in Brooke and Matsushita that the proper presumption is precisely the opposite: recoupment is difficult and uncertain, and absent evidence of recoupment, aggressive price competition—even at below-cost levels—is proconsumer and should not be prohibited. The recoupment analysis must be carried out through a fact-intensive, case-by-case analysis: "Determining whether recoupment of predatory losses is likely requires an estimate of the cost of the alleged predation and a close analysis of both the scheme alleged by plaintiff and the structure and conditions of the relevant market." Brooke, 509 U.S. at 226; see also Kelco Disposal, Inc. v. Browning-Ferris Indus. of Vermont, 845 F.2d 404 (2d Cir. 1988), aff'd, 492 U.S. 257 (1989).

DOT has simply assumed away the market- and fact-specific analysis of recoupment required by Brooke. Rather than evaluating market conditions and impact on a case-by-case basis, the Rules impose blanket rules that assume all carriers and all routes are the same. That assumption is patently false, and the mistaken anticompetitive emphases of the Rules are compounded by this "one size fits all" approach.

To take the simplest example, the Rules fail to take account of competitors other than the complaining new entrant and the major carrier whose pricing and capacity decisions are being scrutinized. For example, there could be one or two other major carriers, a low-fare subsidiary, and another new entrant serving the same route, but the additional competition makes no difference under the Rules.

Indeed, DOT itself recognized only days ago that the ability to charge supracompetitive prices is uncertain and market-specific:

> Air carriers are only able to raise fares above competitive levels when competitors are unable to enter a market or expand service. We recognize that the ability of an air carrier to provide new service at an airport depends upon numerous factors, including the expected growth of passenger demand, the ability to gain access to gates and other critical facilities, the cost and marketing advantages the incumbent air carriers enjoy, and the size of the irreversible ("sunk") investment an entrant would incur if forced to withdraw from the market.

Department of Transportation, Request for Public Comment on Competitive Issues Affecting the Domestic Airline Industry, 63 Fed. Reg. 37,612 (1998). By DOT's own admission, the Rules' unsupported assumption that a major carrier could readily charge supracompetitive prices in any market from which a new entrant departed is simply false.[39]

Competition will only be harmed in the long run if the alleged predator can successfully drive out its rival, later raise prices to supracompetitive levels, defend those prices against new entry or expansion by competitors, and maintain them for long enough that the discounted present

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[39] See also Acquisition of Muse Air by Southwest Airlines, DOT Order 85-5-28, 1985 DOT Av. LEXIS 758, at *43-44 (1985) (recognizing difficulty of recoupment in airline industry); made final DOT Order 85-6-79, 1985 DOT Av. LEXIS 548 (1985).

value of its future gains outweighs its original losses from pricing below its costs. Absent such recoupment, price wars fought even at below-cost levels are a benefit to consumers regardless of their effect on competitors:

> Predatory pricing schemes that fail at the recoupment stage may injure specific competitors ... but do not injure competition (i.e. they do not injure consumers) and so produce an antitrust injury. Such futile below-cost pricing effectively bestows a gift on consumers, and the Sherman Act does not condemn such inadvertent charity.

Advo, Inc. v. Philadelphia Newspapers, Inc., 51 F.3d 1191, 1200 (3d Cir. 1995) (citation omitted).[40] Courts have consistently rejected attempts to substitute alternative theories of anticompetitive effect for the recoupment analysis mandated by Brooke. For example, the Third Circuit recently rejected a "strategic entry deterrence" theory under which the plaintiff argued market structure was irrelevant because a reputation for predation was itself a barrier to future entry. Advo, 51 F.3d at 1202; cf. Rules at 17,921 ("Having observed this [predatory] behavior, other potential new entrants refrain from entering....").

The Rules have thus abandoned a test critical for establishing anticompetitive effect. Without the "critical discipline" of an analysis of anticompetitive effect, restriction of competitors' unilateral conduct cannot be economically justified.[41] Moreover, without proof of anticompetitive effect, there can be no violation of the antitrust laws. Spectrum Sports, Inc. v. McQuillan, 506 U.S. 447, 458 (1993).[42]

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40 See also Rebel Oil Co. v. Auto Flite Oil Co., 51 F.3d 1421, 1433 (9th Cir. 1995) (injury to rivals from below-cost pricing "of no concern to the antitrust laws" absent proof of recoupment); A.A. Poultry Farms v. Rose Acre Farms, 881 F.2d 1396, 1401 (7th Cir. 1989) (below-cost pricing irrelevant absent proof of recoupment).

41 Ordover & Willig Statement at 12-13.

42 See also Association of Discount Travel Brokers, DOT Order 92-5-60, 1992 DOT Av. LEXIS 369, at *26-27 (May 29, 1992) (allegedly unfair practices that do not harm

By dispensing with a particularized analysis of anticompetitive effect, the Rules create a *per se* prohibition against the targeted conduct. The Rules' *per se* approach flies in the face of a decades-long trend in antitrust law in which such sweeping prohibitions have been replaced by case-by-case evaluations of the competitive implications of the challenged conduct on a detailed factual record.[43] The Supreme Court has stated that *per se* treatment is appropriate only "[o]nce experience with a particular kind of restraint enables the Court to predict with confidence that the rule of reason will condemn it." Arizona v. Maricopa County Medical Soc., 457 U.S. 332, 344 (1982). The use of a *per se* rule is thus particularly inappropriate with respect to purportedly predatory pricing, which the Supreme Court has said is "rarely tried, and even more rarely successful." Matsushita Electric Industrial Co. v. Zenith Radio Corp., 475 U.S. 574, 589 (1985). The use of a regulatory approach cannot be justified on economic grounds either.[44] If DOT believes that price predation poses a true threat to consumers, it should challenge such conduct before a neutral factfinder and develop the appropriate principles through the deliberative process of the common law rather than using its rulemaking authority to evade the requirement of analyzing and proving its case.

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competition do not violate Section 411); In re General Motors, 103 F.T.C. 641, 1984 FTC LEXIS 51, at *129 (1984) (Sec. 5 requires showing of anticompetitive effect).

43 Even with respect to arrangements that were once considered "obvious" antitrust violations, the clear trend has been away from *per se* prohibitions. See, e.g., State Oil Co. v. Khan, 118 S. Ct. 275 (1997) (vertical maximum price restraints); Jefferson Parish Hosp. Dist. No. 2 v. Hyde, 466 U.S. 2 (1983) (tying arrangements); National Collegiate Athletic Association v. Board of Regents of the University of Oklahoma, 468 U.S. 85 (1984) (certain horizontal restraints); Broadcast Music, Inc. v. Columbia Broadcasting System, 441 U.S. 1 (1979) (price restraints); Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36 (1977) (vertical non-price restraints).

44 Ordover & Willig Statement at 6-8.

III. THE PROPOSED RULES EXCEED DOT'S SECTION 411 AUTHORITY.

The preceding sections demonstrate that the Rules fail spectacularly to live up to DOT's statutory mandate of "placing maximum reliance on competitive market forces ... to encourage efficient and well-managed air carriers to earn adequate profits." 49 U.S.C. § 40101(a)(6). The Rules indicate a fundamental mistrust of market forces and in fact restrict competition in order to insure "adequate profits" for new entrants, whether or not they are "efficient and well-managed." The anticompetitive nature of the Rules is alone enough to invalidate them as a matter of law.

However, the Rules' conflict with DOT's statute does not stop there. As analyzed below, the Rules exceed DOT's Section 411 authority.

A. DOT's Authority to Bar "Unfair Methods of Competition" Must Be Exercised in a Manner Consistent with the Antitrust Laws.

DOT lacks authority under Section 411 to adopt a rule that is inconsistent with the antitrust laws. The Supreme Court has held that Section 411 is the equivalent of Section 5 of the Federal Trade Commission Act and that cases interpreting Section 5 are to be used in interpreting Section 411. Pan American World Airways v. United States, 371 U.S. 296, 303-04 (1963); American Airlines v. North American Airlines, 351 U.S. 79, 82 (1956). Cases under Section 5 make it clear that the antitrust authority granted by Section 411 permits DOT to bolster and strengthen established antitrust principles but not to supplant them.

The Rules ban conduct that has been evaluated and explicitly found to be procompetitive and lawful under the antitrust laws. As discussed in Section II above, courts have considered the sorts of pricing decisions at issue here and have ruled them legal because they are inherently proconsumer and because any attempt to expand the definition of predation would do far more competitive harm than good.

The FTC itself has held that it cannot use Section 5 to reach practices that have been held substantively lawful under the antitrust laws. In circumstances similar to those present here, the FTC held that Section 5 did not reach allegedly "predatory" price-cutting conduct that did not violate the Sherman Act:

> In short, we are asked to expand the reach of the prohibition against attempted monopolization in the Sherman Act by condemning less offensive conduct under the purview of the Federal Trade Commission Act.
>
> It is true that the broad language of Section 5 of the Federal Trade Commission Act permits the Commission to supplement the more specific terms of the antitrust laws. Exactly how far that authority extends, however, is an issue the Commission should treat cautiously. While Section 5 may empower the Commission to pursue those activities which offend the "basic policies" of the antitrust laws, we do not believe that power should be used to reshape those policies when they have been clearly expressed and circumscribed.

In re General Foods, 103 F.T.C. 204, 1984 FTC LEXIS 69, *352 (1984).[45] The Rules attempt precisely such an inappropriate reshaping of the antitrust laws. That attack on established antitrust law exceeds DOT's authority under Section 411 and renders the Rules invalid as a matter of law.

Nor is the FTC's self-restraint merely a matter of agency discretion. Rather, that position reflects judicial interpretation of the limits on FTC authority under Section 5. For example, the Second Circuit has held that the FTC could not use its Section 5 authority to prohibit unilateral acts by a monopolist that were permissible under applicable Sherman Act doctrine, even assuming

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[45] DOT's interpretation of predation under Section 411 is irreconcilable with the FTC's interpretation of Section 5. The FTC has held that "[s]ales at prices that equal or exceed average variable cost should be strongly, often conclusively, presumed to be legal" and that "[s]ales at prices that equal or exceed average total cost should be conclusively presumed to be legitimate." International Telephone & Telegraph Corp., 104 F.T.C. 280, 1984 FTC LEXIS 44, at *273-74 (1984); see also id. at *253-54, *269-74.

that the challenged conduct reduced competition. Official Airline Guides, Inc. v. FTC, 630 F.2d 920, 927-28 (2d Cir. 1980).

Other courts have also unhesitatingly reversed the FTC when it exercised its Section 5 authority in a manner inconsistent with other antitrust laws and the policies underlying them. The Ninth Circuit rejected the FTC's attempt to ban pricing practices that were not collusive or illegal under the antitrust laws despite the FTC's argument that such practices would inevitably lead to lessened competition. Boise Cascade Corp. v. FTC, 637 F.2d 573, 581 (9th Cir. 1980). Similarly, the Second Circuit rejected an interpretation of Section 5 under which "the FTC could, whenever it believed that an industry was not achieving its maximum competitive potential, ban certain practices in the hope that its action would increase competition," warning that such a standardless warrant would leave the door open to arbitrary and capricious enforcement. E.I. Du Pont de Nemours & Co. v. FTC, 729 F.2d 128, 137-39 (2d Cir. 1984). Section 411 thus does not give DOT permission to adopt any rule it pleases simply because, in its opinion, competition would be enhanced.

Even DOT recognizes that its authority to prohibit unfair methods of competition is tied to the antitrust laws. DOT describes Section 411 as providing "authority to prohibit airlines from engaging in conduct which could be considered anticompetitive under antitrust principles." The Low Cost Airline Service Revolution at 33 (emphasis added); see also Rules at 17,921. In promulgating the Rules, DOT is now ignoring principles enunciated by the Supreme Court. If the reference to antitrust principles means anything, surely it means that DOT cannot overthrow carefully elaborated and definitively settled policies of the antitrust laws.

In simplest terms, the procompetitive analyses underpinning Sherman Act jurisprudence do not vary simply because a different statute is technically at issue. As Professor Areeda put it:

"[I]nsofar as sound policy condemns or permits given conduct under the Sherman or Clayton acts, then sound policy requires the same result under the Federal Trade Commission Act." 2 Phillip E. Areeda & Herbert Hovenkamp, Antitrust Law ¶307a (1995); see also Peter C. Ward, Federal Trade Commission: Law, Practice and Procedure § 4.03[3](b) (1997) (standard of proof under FTC Act should not differ from Sherman or Clayton Act). Indeed, the Supreme Court itself made clear in Brooke that the rationale for its analysis was not limited to the particular terms of the statutes before it: "Low prices benefit consumers regardless of how those prices are set, and so long as they are above predatory levels, they do not threaten competition.... We have adhered to this principle regardless of the type of antitrust claim involved." Id. (emphasis added).

In the face of this precedent, DOT has stated that it has the authority to prohibit conduct "even if it does not amount to a violation of the antitrust laws." Rules at 17,921. However, there are clear limits on whatever authority DOT may have under Section 411 to prohibit anticompetitive practices that do not technically violate the antitrust laws, as there are under Section 5 of the FTC Act.

When the FTC's Section 5 authority is exercised to prohibit conduct as unfair based on "the classic antitrust rationale of restraint of trade and injury to competition," the conduct must violate "either the letter or the spirit of the antitrust laws." FTC v. Sperry & Hutchinson Co., 405 U.S. 233, 246, 249 (1972). Such cases are typically grouped in two categories: "incipient violations" of the antitrust laws and violations of the "spirit" or "policy" of the antitrust laws. See, e.g., Chuck's Feed & Seed Co. v. Ralston Purina Co., 810 F.2d 1289, 1292-93 (4th Cir. 1987); National Petroleum Refiners Ass'n v. FTC, 482 F.2d 672, 684 (D.C. Cir. 1973); Ward, supra, at § 4.03[1]. Neither line of precedent can salvage the Rules.

Section 5 has long been held to permit the FTC to act against incipient violations of the antitrust laws, as in the case of invitations to collude.[46] But DOT is not attempting to prohibit incipient conduct at all. It is not contending that the banned above-cost pricing is likely to lead to below-cost pricing; such a proposition is absurd. The Rules instead bar behavior that is, in its fully-realized form, legal and procompetitive under the Sherman Act's standards.

Even more significantly, the Supreme Court's Brooke decision precludes any reliance on an "incipiency" argument to defend the Rules. The Robinson-Patman Act also reaches incipient violations, an argument explicitly before the Brooke Court.[47] Nevertheless, the majority held that the predatory pricing standards under the Robinson-Patman Act are precisely the same as those under the Sherman Act. Brooke, 509 U.S. at 222. (Indeed, given the protectionist bias and lower standards of proof of the Robinson-Patman Act, it is difficult to imagine any legitimate standard that would be more favorable to questionable predatory pricing claims.) The Supreme Court has thus directly held that statutory authority to prevent "incipient violations" does not justify a departure from the standards enunciated in Brooke.

Likewise, there is no basis to argue that the Rules somehow proscribe conduct that violates the "spirit" of the antitrust laws but is not subject to challenge under them because of some technical or jurisdictional defect. The conduct in question is fully subject to scrutiny under the Sherman Act's prohibitions against predatory pricing. The Rules prohibit conduct that is legal under established predatory pricing law not because of some technicality, but because courts have carefully considered arguments like those in the Rules and rejected them on the merits. If the Supreme Court has held that a given class of conduct does not give rise to so much as a

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46 FTC v. Brown Shoe Co., 384 U.S. 316 (1966).

"reasonable possibility of substantial injury to competition," Brooke at 222, there can be no basis for prohibiting it as injurious to competition under Section 411.

In short, the Rules do not supplement or support antitrust law. They subvert it, and they are therefore an invalid exercise of DOT's Section 411 authority. To again quote Professor Areeda, "to say that § 5 is not limited by the other statutes is no excuse for sloppy thinking or a failure to show whether, how, and the degree to which any peculiarities of § 5 proceedings call for a divergence from Sherman Act analysis of antitrust policies and their application to the particular case." Areeda & Hovenkamp, supra, ¶307f. The same is true in applying Section 411.

B. DOT's Interpretation of Section 411 Exceeds DOT's Statutory Authority and Conflicts with Congress's Deregulatory Intent.

An examination of the history of congressional action in this area also establishes that DOT lacks authority to go beyond the antitrust laws in restricting airlines' competitive conduct as allegedly predatory. Congress specifically imposed that restriction on the CAB, which also had the same Section 411 authority that is now cited to justify the Rules. The substance of Section 411 has not changed, and there is no reason to think Congress intended DOT to have any broader authority than the CAB did to regulate pricing and capacity decisions as "predatory." Until now, neither DOT nor the CAB had claimed the power to interfere with carrier capacity decisions. Indeed, since 1938 Congress has explicitly denied the agencies such authority.[48] Moreover, DOT's present attempt to regulate fares based on the "reasonableness" of the revenues derived

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47 Brooke, 509 U.S. at 252 (Stevens, J., dissenting).

48 49 U.S.C. § 41109(a)(2) ("The Secretary of Transportation may not prescribe a term preventing an air carrier from adding or changing schedules [or] equipment . . . to satisfy business development and public demand."). This language is essentially the same as appeared in the original Federal Aviation Act of 1958, Pub. L. No. 85-726, § 401(e), 72 Stat. 737 (1958), and the Civil Aeronautics Act of 1938, Pub L. No. 75-706, § 401(e), 52 Stat. 973 (1938).

from them is an arrogation of authority specifically revoked by Congress and withheld from DOT in the Airline Deregulation Act of 1978 ("ADA") and the Civil Aeronautics Board Sunset Act of 1984.[49] This is re-regulation through the back door.

The Rules' tests require an analysis of whether the carrier has adopted a "reasonable" strategy for maximizing operating profits given its price and capacity offerings. That is precisely the kind of rate-of-return analysis that absorbed the CAB's resources in the Domestic Passenger Fare Investigation between 1970 and 1974.[50] Before deregulation, airlines wishing to change their fares had to seek CAB approval. If the CAB believed a proposed fare would result in unacceptably low revenue or might pose a greater threat to the stability of another carrier's service than would a different, higher fare, it could prescribe the fares to be charged. The Rules return the industry to a world in which DOT will necessarily substitute its own judgment of the reasonableness of prices for that of the carrier.

This is effectively fare regulation.[51] Indeed, it is worse than the traditional CAB system. The Rules' imprecise and undefined standard of "reasonable alternatives" will regulate major carrier fare decisions in a way far more unpredictable and burdensome than the old CAB regime,

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49 See Pub. L. No. 95-504, 92 Stat. 1705 (1978); Pub. L. No. 98-443, 98 Stat. 1703 (1984).

50 Civil Aeronautics Board, Domestic Passenger Fare Investigation, Docket 21866 (1970-1974).

51 See also Kasper Statement at 4 ("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."); Ordover & Willig Statement at 8 ("Nevertheless, it is critical to recognize that DOT's proposed new standards and guidelines would represent a major step towards the reimposition of economic regulation on the major airlines.")

and do so through the imposition of penalties based on after-the-fact judgments. Congress clearly intended to sweep away that anticompetitive system of price control, noting that "the Board has developed a general domestic fare policy which appears to stifle whatever incentive previously existed for carriers to be more price competitive."[52] Moreover, the Rules add capacity controls to the CAB's powers of price regulation.

Between 1978 and 1985, Congress deregulated domestic aviation in phases. The ADA removed the CAB's power to use the relationship among fares, revenues, and costs as a basis to review the "justness" and "reasonableness" of fares during the phase-out period.[53] Under the early phase of deregulation, carriers were permitted generally to raise their fares up to five percent above the standard industry fare level without CAB approval, and to lower their fares to 50 percent below the standard industry fare level without CAB approval. The CAB could <u>only</u> disapprove of such lowered fares if it determined that the decrease would be "predatory."[54]

In allowing the CAB to determine whether fare decreases were predatory during that phase of deregulation, Congress made clear that it did not intend for the CAB

> to strike down a low-fare level which represents genuine competition simply because it would tend to decrease the revenues of less efficient carriers in the market or perhaps force from a given market carriers who were not able to provide the price and service mix which the passengers in the market desired.

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52 S. Rep. No. 95-631, at 3 (1978).

53 S. Rep. No. 95-631, at 106.

54 ADA § 37(a)(2).

S. Rep. No. 95-631, at 107. More to the point, Congress left no doubt as to the standards that CAB must apply in evaluating predation, explicitly defining "predatory" in the ADA as "a practice that violates the antitrust laws."[55]

The CAB itself recognized the limit of this delegation, determining that the predecessor to Section 411 did not give it the authority to declare fares "unfair" unless the pricing conduct violated the antitrust laws. In Air Florida v. Eastern Air Lines, Inc., the CAB directly addressed the issue:

> In dismissing the complaint the [Enforcement Bureau] assumed that such allegations of anticompetitive conduct would not warrant investigation unless there were reason to believe that Eastern's conduct was predatory and thus violated the Sherman and Clayton antitrust acts. . . . As a result of the [ADA], the Board must rely primarily on competition rather than regulation as the means of obtaining the best possible air transportation system. . . . Congress did not intend us to hold fare reductions unfair which did not violate the antitrust laws.

CAB Order 81-1-101 at 2-3 and n.4; see also In re American Airlines., CAB Order 80-12-59, 1980 CAB LEXIS 33, at 5 (1980) (Congress defined "predation in such a way as to require an affirmative showing that the complained of pricing behavior had risen to the level of an actual violation of the antitrust laws.").

In 1984, Congress continued the process of deregulating the airline industry by passing the CAB Sunset Act, specifically finding that

> deregulation has generally benefited both consumers and the industry and that there should be no change in the major reforms of the 1978 Act, the deregulation of domestic airline routes and rates.[56]

The CAB Sunset Act "clarif[ied] the status of some of the CAB's authority after sunset."[57] In particular, Congress repealed the authority granted to the CAB under the ADA to review fare

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55 ADA § 2.

changes.[58] It also transferred the CAB's authority to proceed against unfair or deceptive practices or unfair methods of competition under Section 411 to DOT.[59] In doing so, Congress nowhere suggested that it intended to expand DOT's authority to regulate "predatory" air fares through Section 411 beyond that possessed by the CAB; indeed, such an expansion would have run counter to the whole thrust of deregulation. Congress was fully aware of Section 411 when it eliminated the CAB's authority to regulate carrier fare offerings and restricted its interventions to predatory conduct as defined in the antitrust laws. An interpretation of Section 411 under which DOT inherits authority from the CAB that Congress elsewhere specifically repealed is plainly untenable.

The ADA and the CAB Sunset Act removed all authority to go beyond the standards of the antitrust laws in regulating carrier fares. Adoption of the Rules would be a flagrant violation of DOT's statutory mandate.

IV. THE PROPOSED RULES ARE SO VAGUE AS TO BE UNLAWFUL.

The Rules are riddled with vague and undefined terms, and no carrier can know in advance whether its response to a new entrant will later be judged unreasonable by DOT. As discussed in Section I.A, critical elements of the Rules' substantive requirements—most notably the "reasonable alternative response," but including many other terms such as "very low fares" and "large number of seats"—are completely undefined and provide no meaningful guidance to carriers in distinguishing prohibited from permitted conduct. Accordingly, the Rules fail to

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56 H.R. Rep. No. 98-793, at 3 (1984).

57 Id.

58 CAB Sunset Act § 3(c).

59 Id. § 3(e); see also H.R. Rep. No. 98-793, at 5-6.

provide fair notice of prohibited conduct and are thus invalid under judicial precedent interpreting Section 5 of the FTC Act, basic principles of administrative law, and basic constitutional principles of due process.

Clarity of rules and notice of the conduct prohibited are integral requirements of Section 5 (and thus Section 411) analysis. A proposed rule of decision that requires a company to assess not only its own conduct but also the reaction of its rivals and the effect of each on the market—based on undefined terms and unavailable information—is so difficult to comply with that it exceeds Section 5 authority.

In terms directly applicable to the DOT's purported exercise of Section 411 authority here, the Second Circuit condemned the FTC's promulgation of such a vague standard under Section 5:

> [T]he Commission owes a duty to define the conditions under which conduct...would be unfair so that businesses will have an inkling as to what they can lawfully do rather than be left in a state of complete unpredictability. The Commission's decision in the present case does not provide any guidelines; it would require each producer not only to assess the general conduct of the antiknock business but also that of each of its competitors and the reaction of each to the other, which would be virtually impossible.

<u>E.I. Du Pont de Nemours & Co. v. FTC</u>, 729 F.2d 128, 139 (2d Cir. 1984). The Rules demand the same "virtually impossible" task and will result in the same "complete unpredictability."

Second, the Rules are so vague as to be unconstitutional.[60] The Eighth Circuit recently summarized the due process requirements laid down by the Supreme Court as follows:

> A vague regulation is constitutionally infirm in two significant respects. First, the doctrine of vagueness "incorporates notions of fair notice or warning," <u>Smith v. Goguen</u>, 415 U.S. 566, 572 (1974), and a regulation "violates the first essential of

[60] The Rules may well be unconstitutionally vague in all applications and at a minimum are certain to be unconstitutionally vague as applied in a large number of cases.

> due process of law" by failing to provide adequate notice of prohibited conduct. Connally v. General Constr. Co., 269 U.S. 385, 391 (1926) (citations omitted). In short, a regulation is void for vagueness if it "forbids or requires the doing of an act in terms so vague that [persons] of common intelligence must necessarily guess at its meaning and differ as to its application...." Id. Second, the void-for-vagueness doctrine prevents arbitrary and discriminatory enforcement. Goguen, 415 U.S. at 573. "A vague law impermissibly delegates basic policy matters to policemen, judges, and juries for resolution on an ad hoc and subjective basis...." Grayned v. City of Rockford, 408 U.S. 104, 108-09 (1972).

Stephenson v. Davenport Comm. Sch. Dist., 110 F.3d 1303 (8th Cir. 1997) (alterations in original).[61] As demonstrated above, there can be no question that carriers attempting to comply with the Rules "must necessarily guess at [their] meaning and differ as to [their] application." The Rules thus deprive carriers of the "fair notice or warning" of prohibited conduct that due process and administrative law require, and their amorphous standards will necessarily result in "ad hoc and subjective" DOT decision making.

V. DOT HAS FAILED TO COMPLY WITH THE MINIMUM LEGAL REQUIREMENTS APPLICABLE TO RULEMAKING PROCEEDINGS.

A. The Proposed Rules Would Make Specified Carrier Conduct Unlawful, and They Therefore Propose a Substantive Rule.

The Rules create a substantive rule within the meaning of the APA.[62] Substantive rules are those agency pronouncements in which the agency intends to create new law, rights or duties,

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61 See also General Electric Co. v. EPA, 53 F.3d 1324, 1328 (D.C. Cir. 1995) ("The Due Process Clause ... prevents ... the application of a regulation that fails to give fair warning of the conduct it prohibits or requires."); Timpinaro v. SEC, 2 F.3d 453, 460 (D.C. Cir. 1993); Satellite Broadcasting Co. v. FCC, 824 F.2d 1, 3-4 (D.C. Cir. 1987) (administrative law incorporates fair notice requirements).

62 Despite the failure of DOT to provide clear notice of the intended legal effect of the Rules, every indication is that the Rules promulgate a substantive rule. These Comments therefore treat them as such. Notwithstanding this treatment, however, the ATA and its members do not waive their right to challenge the binding effect of the Rules in any later proceeding.

as opposed to either general statements of policy or interpretive rules.[63] General statements of policy are those agency pronouncements that "advise the public prospectively of the manner in which the agency proposes to exercise a discretionary power without binding the agency or those regulated."[64] Interpretive rules, for which neither notice nor opportunity for comment is required, clarify existing law,[65] give policy guidance to agency staff and affected parties in administering the law,[66] or advise the public of the agency's construction of the law.[67] In determining whether an agency pronouncement is a substantive rule, the substance, and not the label given by an agency, controls.[68]

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63 See, e.g., Clarry v. United States, 85 F.3d 1041, 1048 (2d Cir. 1996); General Motors Corp. v. Ruckelshaus, 742 F.2d 1561, 1565 (D.C. Cir. 1984).

64 Attorney General's Manual on the Administrative Procedure Act, 30 n.3 (1947). See also Pacific Gas & Elec. Co. v. Federal Power Comm'n, 506 F.2d 33, 42-43 (D.C. Cir. 1974) (order was a policy statement where it did not have an "immediate and significant impact" on individuals and it did not have the "force of law"); 1 Kenneth C. Davis & Richard J. Pierce, Jr., Administrative Law Treatise § 6.1 et seq. (3d ed. 1994).

65 See, e.g., Clarry, 85 F.3d at 1048-49; Taunton Mun. Light. Plant v. Department of Energy, 669 F.2d 710, 715 (Temp. Emer. Ct. App. 1982) (citations omitted) (where the definition set forth in the regulations is nearly identical to statutory definition, the rule is interpretive).

66 McCown v. Secretary of Health and Human Servs., 796 F.2d 151, 157 (6th Cir. 1986) (policy statement was an interpretive rule because it provided guidance to the agency staff).

67 Attorney General's Manual at 30 n.3 (defining an interpretive rule "as agency's construction of existing law").

68 See, e.g., Columbia Broad. Sys. Inc. v. United States, 316 U.S. 407, 416 (1942); Alaska v. Dep't of Transportation, 868 F.2d 441, 446 (D.C. Cir. 1989) (rejecting DOT's characterization of agency actions as interpretive, non-legislative rules); Cerro Metal Products v. Marshall, 620 F.2d 964, 981-82 (3d Cir. 1980); Lewis-Mota v. Secretary of Labor, 469 F.2d 478, 481-82 (2d Cir. 1972).

The Rules' language, DOT's other substantive rules implementing Section 411, and public comments by DOT officials all evidence DOT's intention to create a new rule of law by defining a specific new category of unlawful conduct.

First, the Rules would proscribe specific conduct by major carriers, using a two-part test:

> [A]s a matter of policy, we propose to consider that a major carrier is engaging in unfair exclusionary practices in violation of 49 U.S.C. 41712 if, in response to new entry into one or more of its local hub markets, it pursues a strategy of price cuts or capacity increases, or both, that either (1) causes it to forego more revenue than all the new entrant's capacity could have diverted from it or (2) results in substantially lower operating profits—or greater operating losses—in the short run than would a reasonable alternative strategy for competing with the new entrant.

Rules at 17,920 (emphasis added). Thus, if a major carrier violates either portion of the test, it is considered to have violated Section 411.

Second, the Rules' language is virtually identical to language DOT has used in other regulations implementing Section 411 that DOT regards as substantive rules.[69] For instance, the regulations outlawing unrealistic scheduling provide:

> It is the policy of the Board to consider unrealistic scheduling of flights by any air carrier providing scheduled passenger air transportation to be an unfair or deceptive practice and an unfair method of competition within the meaning of section 411 of the Act.[70]

Similarly, DOT used the following language in its regulation for code-sharing:

> It is the policy of the Department of Transportation to consider the use of a single air carrier designator code by two or more air carriers to be unfair and deceptive and in violation of section 411 of the Act . . . .[71]

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69 14 C.F.R. pt. 399, subpt. G, Policies Relating to Enforcement. *See* 14 C.F.R. § 399.80 (Ticket Agent Practices); 14 C.F.R. § 399.81 (Unrealistic Scheduling); 14 C.F.R. § 399.82 (Carrier Identity); 14 C.F.R. § 399.83 (Reserved Space); 14 C.F.R. § 399.84 (Price Advertising); 14 C.F.R. § 399.88 (Code Sharing).

70 14 C.F.R. § 399.81(a) (emphasis added).

71 14 C.F.R. § 399.88 (emphasis added).

The language underlined in these two substantive rules is virtually identical to the language of the Rules underlined above. DOT enforcement cases have held that violating a Subpart G rule, such as the unrealistic-scheduling and code-sharing rules quoted above, constitutes a *per se* violation of Section 411.[72] As DOT itself stated in an unrealistic-scheduling action, "[a]ny failure to comply with these provisions [of Subpart G] constitutes a violation of Section 411 of the Act, which prohibits 'unfair or deceptive practices or unfair methods of competition.'" DOT Order 93-3-24.[73] Thus, the Rules use language that DOT considers to establish a rule of law.

Indeed, the D.C. Circuit has described language similar to that in the Rules as "mandatory," indicating a substantive, legislative rule requiring notice and comment. In Alaska v. Dep't of Transportation, 868 F.2d 441, 446-47 (D.C. Cir. 1989), the court analyzed a provision stating that "[t]he Board considers any advertising or solicitation.... to be an unfair and deceptive practice, unless the price stated is the entire price to be paid by the customer to the air carrier, or agent...." Id. at 447. Based in part on its characterization of the provision as mandatory language obligating compliance, the court held that it was a substantive rule. Id.

Third, statements made to the public and Congress by DOT officials since the Rules' publication confirm that the Rules would identify carrier conduct that the agency considers unlawful. In her May 19, 1998 testimony before the House Judiciary Committee, Nancy McFadden, DOT's General Counsel, said:

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72 See, e.g., Order 93-4-40 (Fare Advertising); Order 89-4-25 (Price Advertising).

73 The fact that there is no proposed codification of the Rules' language does not change this result. For example, DOT's low-fare advertising rules exist only in industry letters and DOT orders.

> Our proposed policy statement identifies the behavior that we will consider to be an unfair exclusionary practice.... [W]e propose to find this unlawful. (Emphasis added.)

Again, it is clear that a rule of law is proposed.

Fourth, the Rules would have "palpable" effects on carriers, if adopted.[74] DOT says that it would order a carrier to cease and desist before levying penalties. Rules at 17,922. However, the law allows DOT to assess civil penalties for the breach of a rule or to seek criminal penalties in a proper case, and carriers must be mindful of this possibility.[75] Even a cease-and-desist proceeding imposes substantial costs in negative publicity and regulatory friction upon a carrier, and the threat will force carriers to comply with the Rules. Indeed, DOT appears to be relying on carriers' concerns about the consequences of violating the Rules—concerns heightened by the Rules' vague and subjective nature—to compel compliance with their standards. As DOT has stated, it expects that the industry will "simply cease" behavior proscribed by the Rules when faced with the threat of enforcement action.[76]

Lastly, the Rules contain a separate three-part test for initiating enforcement action.[77] This three-part enforcement policy statement within the Rules highlights the fact that the separate two-part test in the Rules is not a policy statement but a substantive rule.

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74 Standard Oil Co. v. Department of Energy, 596 F.2d 1029, 1061 (Temp. Emer. Ct. App. 1978) (regulatory amendment was a substantive rule because it had "palpable effects" upon the regulated industry).

75 49 U.S.C. § 46301(a)(1)(B) (civil penalties for rule violations); 49 U.S.C. § 46316(a) (criminal penalties for knowing and willful rule violations).

76 Letter dated June 18, 1998 from Charles A. Hunnicutt, Assistant Secretary for Aviation and International Affairs, to Mr. Hugh Davis, President, Chattanooga Metropolitan Airport Authority.

77 Even though the three-part test is not enforceable as a rule of law, for the reasons stated in the preceding paragraph it will force carriers to comply with its standards and is therefore

B. DOT's Own Regulatory Policies and Procedures Order Requires DOT to Prepare a Regulatory Analysis.

DOT's Regulatory Practices and Procedures Order—which applies to all DOT rules and regulations—requires the office initiating a regulatory action to place in the public docket a draft regulatory analysis for any rule or regulation that will:

- result in an annual effect on the economy of $100 million or more;
- result in a major effect on the general economy in terms of costs, consumer prices or production; or
- have a substantial impact on the U.S. balance of trade.[78]

The proposed Rules meet the criteria for conducting a regulatory analysis set forth in the DOT's Order, yet DOT has failed to place the requisite regulatory analysis in the docket.

The Rules, which regulate the fares that airlines may charge customers, would clearly result in an effect on the economy of more than $100 million. Morrison and Winston have estimated that the lower fares resulting from deregulation save passengers alone $12.4 billion annually.[79] If DOT adopts the Rules, major carriers seeking to avoid the risk of enforcement action will be pressured to constrain their low-fare offerings. It is of course difficult to predict accurately the potential loss to passengers, but the Rules' chilling effect could quite plausibly discourage carrier aggressiveness sufficiently to reduce those consumer savings by the eight

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reviewable. Ordover & Willig Statement at 4. See also OSG Bulk Ships, Inc. v. United States, 132 F.3d 808 (D.C. Cir. 1998) (agency's statement of general enforcement policy relating to a statutory provision is subject to judicial review); see also Edison Elec. Inst. v. EPA, 996 F.2d 326, 333 (D.C. Cir. 1993) (EPA enforcement policy involving the substantive requirements of the law is reviewable); Nader v. Civil Aeronautics Board, 657 F.2d 453 (D.C. Cir. 1981) (CAB's fare suspension guidelines were judicially reviewable).

78 Regulatory Policies and Procedures Order, 44 Fed. Reg. 11,034, 11,043 ¶10(a) (1979).

79 Steven A. Morrison and Clifford Winston, The Evolution of the Airline Industry 13 (1995).

percent necessary to reach the $100 million threshold. When the economic effects on shippers, labor, affected communities and the carriers are considered as well, the threshold is clearly reached.

For the same reason, the Rules meet the second criterion: they would result in a major effect on the general economy in terms of costs and consumer prices. Passengers and shippers have become accustomed to reaping the benefits of aggressive airline price competition, which the Rules would discourage. DOT is required to provide a regulatory analysis before adopting the Rules.

C. Other Agency and Executive Orders Require DOT to Prepare a Regulatory Evaluation of the Proposed Rules.

Even if DOT's Rules did not trigger agency obligations to prepare a full-blown regulatory analysis under DOT's Regulatory Policies and Procedure Order, the Rules at a minimum require a regulatory evaluation.[80] This regulatory evaluation must contain "an analysis of the economic consequences of the proposed regulation, quantifying, to the extent practicable, its estimated cost to the private sector, consumers, Federal, State and local governments, as well as its anticipated benefits and impacts."[81] The docket does not contain even this minimal regulatory evaluation.

Second, Executive Order 12,866 requires all agencies, including DOT, proposing rules to:

- assess all costs and benefits of available regulatory alternatives, <u>including the alternative of not regulating</u>;[82]

- select approaches that maximize net benefits in choosing among alternative regulatory approaches;[83] and

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[80] DOT Order ¶ 10(f), 44 Fed. Reg. at 11043.

[81] <u>Id</u>. ¶ 10(e).

[82] Exec. Order No. 12,866 at § 1(a) (emphasis added).

[83] <u>Id</u>.

- propose or adopt a regulation only upon a reasoned determination that the benefits of the intended regulation justify its costs.[84]

The docket contains no such analysis. Indeed, the docket nowhere contains a DOT document that mentions the regulatory alternatives, much less one that either chooses among them in a way that maximizes net benefits or contains a reasoned determination that the supposed benefits of the Rules would justify their costs.

D. The Administrative Procedure Act Requires DOT to Disclose the Data Upon Which It Relies.

In addition to failing to conduct the required analyses, DOT has failed to provide sufficient information to constitute adequate notice and a meaningful opportunity for interested persons to comment on its Rules, as required by the Administrative Procedure Act in all rulemakings.[85] DOT should have placed this material in the record of its own accord, but failed to do so. Moreover, in an attempt to identify and obtain the precise data and analyses on which the Rules rely, ATA filed a May 1, 1998 request for additional information under the Freedom of Information Act, 5 U.S.C. § 552 (FOIA). DOT failed to respond to this or other FOIA requests regarding the Rules before the close of the comment period, further impairing the public's ability to comment on the Rules. As pointed out in ATA's May 8, 1998 Emergency Petition for Extension of Time, while DOT refers to "informal investigations" and other data supporting the Rules, DOT has failed to identify the information upon which it relies or make it available for public scrutiny or comment.

This regulatory action on the basis of undisclosed data violates the requirements of

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[84] Id. at § 1(b)(6).

[85] 5 U.S.C. § 553(c). Of course, some data may be confidential or otherwise protected from disclosure; however, DOT has provided nothing of substance regarding the data to which it refers.

Section 553(c). It is a fundamental precept of administrative law that "[i]t is not consonant with the purpose of a rule-making proceeding to promulgate rules on the basis of inadequate data, or on data that, [to a] critical degree, is known only to the agency." Portland Cement Ass'n v. Ruckleshaus, 486 F.2d 375, 393 (D.C. Cir. 1973); see also American Medical Ass'n v. Reno, 57 F.3d 1129, 1132-33 (D.C. Cir. 1995); National Black Media Coalition v. FCC, 791 F.2d 1016, 1023 (2d Cir. 1986). Later disclosure will not cure DOT's failure: "An agency commits serious procedural error when it fails to reveal portions of the technical basis for a proposed rule in time to allow for meaningful commentary." Connecticut Light & Power Co. v. NRC, 673 F.2d 525, 531-32 (D.C. Cir. 1982). Law and fundamental fairness prevent DOT from relying upon information that is not available to the public (and therefore unrebuttable) as the basis for its actions.

E. DOT Must Explain Its Departure from Its Prior Authority on Predation.

Finally, DOT has, without acknowledging it (much less providing a reasoned explanation), contradicted its own standards for measuring predatory pricing. In the past, DOT (and its predecessor the CAB) wisely adopted the procompetitive standards required by the antitrust laws and in doing so adopted precisely the ATA's position:

> Congress clearly anticipated that elimination of fare regulation might lead to situations in which low cost carriers could drive their less efficient competitors from one or more markets. S. Rep. 95-631, 95th Cong., 2d sess. p. 107 (1978). Indeed, the displacement of inefficient firms by more efficient competitors is the hallmark of effective competition. The purpose of the antitrust laws, from which the section 408 standard is derived, is to protect competition, not particular competitors.
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> A party seeking a hearing on predation bears a heavy burden. Predatory pricing by definition involves pricing below cost. Such a strategy could lead to profits in the long run only if the firm adopting it expected to charge prices above competitive levels after it had driven its competitors from the market. The firm could expect such monopoly profits in the long run only if it were operating in a market that

> would be insulated from new entry once it started charging excessive prices. Such an outcome is highly unlikely in the domestic air transportation industry. With the elimination of route regulation, restraints on entry are very low. All a carrier need do to enter a market is to redeploy aircraft. In these circumstances, a carrier contemplating predatory pricing cannot expect to recoup its losses by charging excessive prices for a sustained period. Rather, it can expect that excessive prices will attract new competitors in the market.

Acquisition of Muse Air Corp. by Southwest Airlines, DOT Order 85-5-28, 1985 DOT Av. LEXIS 758, at *43-44 (1985) (footnotes omitted; emphasis added), made final DOT Order 85-6-79, 1985 DOT Av. LEXIS 548 (1985). While Southwest was a Section 408 case, its reasoning applies equally well to Section 411. Indeed, DOT looked to Section 411 cases to support that reasoning. Id. at *44 n.29.[86]

DOT's own prior analysis and conclusions thus used the procompetitive, proconsumer standards of the antitrust laws in evaluating predation, for precisely the reasons outlined in the preceding sections of these Comments. For DOT suddenly to abandon its precedent without explaining its reasons for doing so is arbitrary and capricious and thus unlawful.[87]

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86 See also Aviateca, S.A., DOT Order 92-7-36, 1992 DOT Av. LEXIS 544 at *5-6 (July 27, 1992) (examining cost and likelihood of recoupment through monopolization in § 411 predation analysis); Continental, Emergency Tariff Exemption, CAB Order 83-7-73, 102 C.A.B. 755, 1983 CAB LEXIS 170 at *9 (July 19, 1983) ("The essence of predation involves pricing below cost with the intent of obtaining monopoly power after the victim has been driven from the market."); Air Florida v. Eastern, CAB Order 80-3-194, 85 C.A.B. 2063, 1980 CAB LEXIS 480 (March 28, 1980) (analyzing predation under Section 411 using the standards of the antitrust laws). To the extent that Air Florida considered factors outside its primary focus of cost and recoupment in analyzing predation under Section 411, such consideration is no longer appropriate now that the disagreement over the proper legal standard of predation noted in Air Florida, id. at *3, has been definitively resolved by the Supreme Court in Brooke.

87 See, e.g., Motor Veh. Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 57 (1983) ("[A]n agency changing its course must supply a reasoned analysis. . . .") (citation and internal quotation omitted); Atchison, T. & S.F.R. Co. v. Wichita Bd. of Trade, 412 U.S. 800, 808 (1973) (agency has "duty to explain its departure from prior norms").

VI. THE PROPOSED RULES UNDERMINE U.S. AVIATION POLICY.

The nation's aviation policy has been to promote affordable, efficient, and convenient air transportation both domestically and internationally. Domestically, deregulation has brought lower fares, better service, and improved access to small and medium communities. The price of domestic air travel has declined by more than 35% in real terms since 1978.[88] Internationally, the United States' unquestioned commitment to free competition in the airline industry has brought similar benefits to international travelers and opened important new markets to American industry. The Rules threaten to undercut all these policies.

Deregulation has been a tremendous success. Consumers have received the benefits of greatly increased air travel at greatly reduced fares in comparison to the stifled regulated market. Deregulation has also given consumers a choice of "low-fare" carriers (as described by DOT).[89] For example, nearly 50% of passengers flying to or from hub cities of major airlines (when alternative airports are taken into account) have the choice of at least one low-fare carrier.[90] Overall, in the past 5 years, new entrants have increased their traffic from 2.2 million to 16.8 million passengers annually (increasing their market share more than sixfold), and low-fare service has expanded from 30.5 million to 66.9 million passengers annually.[91]

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[88] Kasper Statement at 1.

[89] Note that these figures are again based on DOT's arbitrary and narrow definition, which, for example, excludes low-fare subsidiaries of major airlines and substitutes regulatory classification for a factual evaluation of competition. The true numbers are thus even higher.

[90] Calculated from Department of Transportation, Origin-Destination Survey, Calendar Year 1997.

[91] Id.; Department of Transportation, Origin-Destination Survey, Calendar Year 1992.

Moreover, the airline industry is intensely competitive, with some of the slimmest profits of any major industry. In the 1990s, scheduled air carriers—including more profitable cargo carriers such as UPS—have achieved an average annual return of only .69%.[92] This bonanza of consumer benefit is a direct result of deregulation's unleashing of market forces and shows the wisdom of DOT's prior decision not to "[limit] the competitive strength of the network carriers, which would simply have resulted in a less efficient industry." The Low Cost Airline Service Revolution at 21.

The Rules threaten to create that less efficient industry and to undermine the genius of deregulation. Today, if major carriers reduce prices and increase capacity to compete with new entrants (or other carriers that have reduced their fares), the flying public can choose a carrier based on competitive factors such as fares, availability, type of equipment and service, quality of service, and safety record. The Rules would diminish those choices and, as Professors Willig and Ordover note, are unquestionably re-regulation.[93]

Even consumer advocate groups—a constituency one would hardly assume to blindly support major corporations—recognize that the Rules can only harm the public. As Linda Golodner, President of the National Consumers League, has stated:

> By seeking to limit the number of low-fare seats network airlines can offer, the Department's proposed guidelines clearly and unnecessarily put the affordability, convenience, and variety of air travel at jeopardy. Under the proposal, airlines would be fined for slashing fares — the very thing that benefits consumers most. In fact the guidelines would automatically shield new airlines from competition, leading to higher, not lower, fares. By mandating a capacity limit, the proposed

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92 Calculated as return on invested capital (ROIC) from data contained in Air Transport Association, Annual Report of the U.S. Scheduled Airline Industry, for the years 1991 through 1998.

93 Ordover & Willig Statement at 6-8; see also Kasper Statement at 17-18.

> guidelines will inevitably create a shortage of low-fare seats in the market and increase prices for low-fare seats.

Comments of Linda Golodner, President of the National Consumers League, OST-98-3713-117.[94] By embarking on impermissible fare regulation and industrial planning, the Rules will undermine the considerable benefits that consumers have reaped from deregulation.

The harm to the public will not be limited to increased fares and fewer seats. Small and medium-sized communities recognize that the restrictions in the Rules will jeopardize the very existence of service integral to the financial success of these communities.[95] Their fears are legitimate.

First, and most importantly, the Rules may divert more local traffic from the major carrier than would have been redirected under free and fair competition. The major carriers cannot afford to simply cede local traffic to the new entrant, as such traffic makes an important contribution to the overall profitability of the segment. The regulatory diversion of local traffic could result in reduced service from a major carrier or, indeed, in no service at all for a city-pair

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94 See also The Impact of Recent Alliances, International Agreements, DOT Actions, and Pending Legislation on Air Fares, Air Service, and Competition in the Airline Industry: Hearings Before the Subcomm. on Aviation of the House Comm. on Transportation & Infrastructure, 105th Cong., 2d Sess. (April 30, 1998) (testimony of Paul Hudson, Executive Director of the Aviation Consumer Action Project).

95 See, e.g., Comments of Amy Sullivan, Executive Director, Montana Tourism Coalition, Docket No. OST-98-3713-286; Comments of Cindi Whitbeck, Executive Ass't, Panama City-Bay County Int'l Airport, Docket No. OST-98-3713-271; Comments of James F. Leonard, Vice President, New Jersey Chamber of Commerce, Docket No. OST-98-3713-386; Comments of Lou Anne Dulaney, Executive Director, Tuscaloosa Convention and Visitors Bureau, Docket No. OST-98-3713-398; Comments of Robert Johnson, Airport Manager, Fort Smith Airport Commission, Docket No. OST-98-3713-113; Comments of Hugh Davis, President, Chattanooga Metropolitan Airport Authority Docket, No. OST-98-3713-104; Comments of Carol Bennett-Lindsay, Northwest Arkansas Regional Airport, Docket No. OST-98-3713-97; see also Comments of Harvey A. Schmitt,

route on which both carriers could survive in the absence of the Rules.[96] In such circumstances, small and medium-sized communities will suffer, given that new entrants are ill-suited to replace the extensive networks and services of major carriers. Free competition permits an efficient new entrant to compete on routes involving smaller markets without the protection of the Rules' capacity and fare regulation, thus providing low-fare local service and preserving the benefits that smaller communities derive from air service from major carriers.

President and CEO, Greater Raleigh Chamber of Commerce, Docket No. OST-98-3713-87 (Rules will result in higher prices for consumers).

96 For example, suppose Carrier A is selling 300 seats a day (on three 150-seat flights) with the segment fare at $100. The local traffic is 40% of the total, or 120 seats. New Entrant B enters the route with one 100-seat flight a day at $79. Assume a demand elasticity of 1, so that local traffic grows to 152 seats per day. Carrier A knows that it is not permitted to carry more passengers than New Entrant B and, because legal liability results if A is wrong in its estimate of traffic, A makes a fairly conservative estimate of a 55% load factor. A therefore could only match B's low fare on 55 seats. Carrier A may not match at all, instead capturing those passengers turned away from Entrant B <u>and</u> willing to fly for $100, thus leaving a portion of the market unserved. If Carrier A does match, its local traffic drops from 120 passengers per day to 55, and the remaining 97 local passengers either fly on the new entrant or are turned away (because many of them would not fly but for the lower fare). Either way, Carrier A's traffic will decline by over 20% and its local revenue will fall by more than 60% (assuming that a proportionate number of those turned away by B will be those who would not fly for $100). Even before accounting for the loss of higher-fare traffic, this change may well make the route unprofitable and induce Carrier A to withdraw flights (which will both reduce convenience and cut into beyond traffic by eliminating connections) or pull out completely.

In the absence of the Rules, Carrier A could compete vigorously for the local traffic. Assume that the Carrier A's advantages in service and customer loyalty permit it to capture 50% more of the local traffic than the Entrant B, or 91 passengers to Entrant B's 61, after matching on a restricted basis. Entrant B retains a 60% load factor, which is more than adequate to sustain an efficient carrier, and Carrier A suffers much more manageable losses of traffic (losses fall by half) and local revenue (losses fall by a third). Thus, the increased regulatory diversion of traffic to a new entrant under the Rules results in worse connecting service from the major carrier—or none at all—in a market in which both carriers and, more importantly, consumers could thrive under free competition.

Second, compliance with the Rules will require sophisticated economic and legal analysis under significant time pressure, and major carriers would be hard-pressed to devote such significant managerial resources to marginally important routes. Combined with the relatively high fixed costs per passenger in smaller markets, these additional costs will render smaller markets unattractive in light of their comparative insignificance relative to larger, more traveled routes.

In place of the procompetitive, efficiency-generating pricing standards of the antitrust laws, the Rules have adopted what amounts to an "infant industry" analysis: new entrants must be protected from the free market in order that they may develop into effective competitors sometime in the future.[97] Such an approach flies in the face of the deregulatory, pro-market policy not to "erect regulatory shields that were not there before to protect [a new entrant] in the hope it can survive" firmly established twenty years ago by the Civil Aeronautics Board. Chicago-Midway Low-Fare Proceeding, 78 CAB 479, 485, adopted as final order, 78 CAB 454 (1978).[98]

The threat the Rules pose to our nation's deregulatory aviation policy is concisely captured in a letter signed by Elizabeth Bailey (one of the principal architects of deregulation) and

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97 DOT should not forget that FAA has proposed a policy that would permit airports to subsidize indirectly new service. See Policy and Procedures Concerning the Use of Airport Revenues, Supplemental Notice of Proposed Policy, 61 Fed. Reg. 66,735, 66,738-39 (1996). That policy will combine with the Rules to further distort the market in favor of new entrants.

98 This rejection of regulatory protection for new entrants occurred at the height of the efforts of the vigorously pro-deregulation Board to introduce new competition into the airline industry, at a time when regulators were enormously interested in the prospects of new entrants. Indeed, the Board issued this opinion only three and one-half months prior to the enactment of the Airline Deregulation Act of 1978. No subsequent action of the

twenty-two other eminent experts:

> It is of great concern to us that twenty years after airline deregulation, the government is showing signs of abandoning this successful experiment and reasserting authority over pricing and capacity decisions.... DOT should focus on helping move air travel into the 21st century, rather than back to the 1970s.

Comments of Elizabeth Bailey et al., Docket No. OST-98-3713-378.

The Rules would also do grave damage to the nation's procompetitive international aviation policy.[99] Foreign governments have habitually sought protection for their flag carriers, who frequently allege "predation" by U.S. carriers.[100] In post-deregulation bilateral agreements, foreign governments' ability to intervene against the low fares of U.S. airlines was generally limited to predatory conduct and subsidized prices. In the most recent "Open Skies" agreements, even the "predatory" ground for intervention was deleted because of potential misuse by foreign governments to reduce the competitiveness of efficient U.S. carriers.

If adopted, the Rules would be a road map for foreign governments seeking to protect their less efficient carriers from the aggressive competitive behavior of highly efficient U.S. carriers. Until now, the United States has vigorously defended complaints instigated by foreign airlines that U.S. carriers are dumping capacity, insisting on definitive proof that capacity has outstripped demand. The United States has been able to mount principled defenses against these protectionist attacks because it has adhered consistently to the well-honed principles of

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Board or DOT has even hinted at departing from the procompetitive principle enunciated in the Chicago-Midway Low-Fare Proceeding—until these Rules were proposed.

99 See generally Kasper Statement at 23-26.

100 Kasper Statement at 24; see also Complaints of TACA Int'l Airlines and Aviateca, DOT Order 90-11-52, 1990 DOT Av. LEXIS 985 (1990) and DOT Order 92-7-36, 1992 DOT Av. LEXIS 544 (1992); Continental, Emergency Tariff Exemption, CAB Order 83-7-73, 1983 CAB LEXIS 170 (1983); Lufthansa v. Pan Am, Fares Complaint, CAB Order 82-1-81, 1982 CAB LEXIS 429 (1982).

competition and vigorously sought the removal of all pricing and capacity controls.[101] These principles are an integral part of U.S. bilateral air services agreements, which typically guarantee carriers a fair and equal opportunity to compete and prohibit unilateral regulation of capacity.

The Rules would forever diminish the power of U.S. negotiators to achieve U.S. international air transportation policy objectives. In response to dumping charges, U.S. negotiators would no longer be able to insist on a principled review of the demand-capacity relationship. U.S. negotiators faced with unfair pricing charges would not be able to argue that those prices must be evaluated under the standards of predation in U.S. antitrust law.

In the future, foreign governments likely would insist that the U.S. government apply the Rules' principles to international markets. They would first insist on an examination of whether the U.S. carrier's capacity offering, coupled with its low fares, is likely to result in "lower local revenue than would a reasonable alternative response." Rules at 17,922. They would then contend that a violation of this extremely subjective test constitutes an "unfair exclusionary practice," thereby denying the foreign competitor the fair and equal opportunity to compete guaranteed by the bilateral agreement.

In short, the Rules would legitimize the protectionist tactics of foreign governments and thus deprive U.S. negotiators of the clear, procompetitive tests for anticompetitive behavior articulated in the antitrust laws and make it impossible for the United States to promote its international aviation policy goal of fostering "affordable, convenient and efficient air service for consumers."[102]

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101 DOT, U.S. International Air Transportation Policy Statement, 60 Fed. Reg. 21,841, 21,843-44 (1995).

102 International Air Transportation Policy Statement, 60 Fed. Reg. at 21,841.

CONCLUSION

The Rules substitute assumption, speculation, and protectionism for sound economic analysis. Rather than limiting its enforcement activity to truly anticompetitive behavior evaluated on a case-by-case basis, DOT proposes to adopt Rules that tar competitive practices with a broad brush for fear that too much competition might result in too few competitors. That bias is flatly inconsistent with the competitive policy of the nation, as expressed in both the antitrust laws and the deregulatory, free-market approach Congress has taken to the airline industry. As experience has shown in the airline industry, consumers benefit greatly from vigorous competition on price and service. The Rules will have the direct effect of dampening that competition, and consumers will have to pay that price in the pursuit of an ill-conceived industrial policy favoring one category of "low-fare" airlines.

For the reasons stated above, the ATA respectfully suggests that the Rules be withdrawn and that any allegedly predatory conduct in the airline industry be addressed through case-by-case adjudication under the well-settled predatory pricing standards of the antitrust laws.

Respectfully submitted,

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