Predatory Practices and Collusion in the Airline Industry

Module 25

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Outline

- Predation in the airline industry
- Legal criteria to establish predation
- Criminal or administrative enforcement
- Collusion in the airline industry
- The air cargo fuel surcharge case

Predation in the Airline Industry

What is predatory pricing?

- **Predatory pricing** is the practice of offering goods or services at exceptionally low prices, thereby foregoing profit in order to drive competitors out of the market.

What is predatory pricing?

- Traditionally, undercutting prices has been disciplined under competition law
  - because setting prices below production costs is one way of getting rid of competitors

- However, this is not necessarily true of all markets.
  - Consider the newspaper market, for example, where giving away papers for free can be a way of attracting readers and thus new advertisers to cover the losses due to production and distribution.
  - In this case, it is doubtful whether undercutting should be banned.

Airline predation

He had no idea what would happen when he took the restraints off, except that, at a time of raging inflation, he was pretty sure fare prices would fall. The great wave of mergers, predations and bankruptcies that followed shocked him; the reconcentration of the industry into giant hub-and-spoke operations scandalised him; the disappearance of the humble Allegheny Airlines flight that used to take him to work, transformed into USAir's transcontinental ambitions, annoyed him; but he could only be delighted that by 1986 90% of Americans were flying on discounts, and that the savings to consumers were reckoned at around $20 billion a year.

Related topics

Transportation

Air travel

Source: The Economist

Why bother?

" Investors concerned about airlines strategies of predation have often chosen to dedicate their resources to other business opportunities, leaving consumers with less choice and marketplace innovations, and unnecessary high airfares."

Kevin Mitchell, Chairman of the Business Travel Coalition

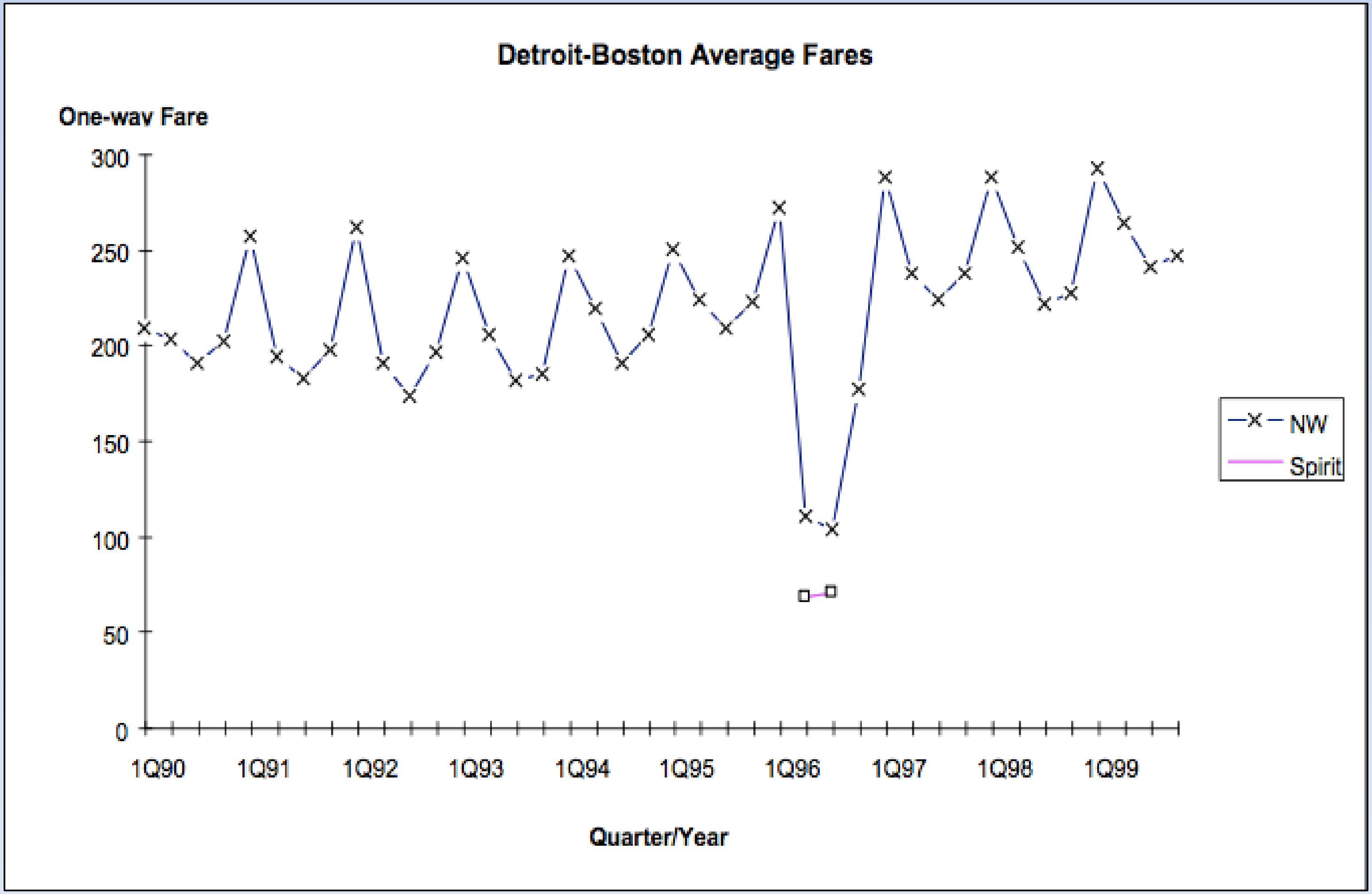
Other types of predatory conduct

- **Non-price predatory conduct**:
- capacity increase
- fighting brands
- foreclosure of essential services (CRS, gates)
- sham litigation
- abuse of governmental and regulatory processes
- predatory advertising

Spirit v. Northwest Airlines

- Before Spirit Airlines entered the Detroit-Philadelphia market, Northwest's lowest restricted fare was $355, and unrestricted fare was $125.
  - Spirit entered in December of 1995 with a $49 fare. Its load factors rose to 88.5% in June of 1996, when it added a second frequency.
  - Then Northwest dropped its fares in the market to $49. Spirit's load factors collapsed to 36% by August, when it withdrew its second nonstop, and to 31% in September, when it withdrew from the market altogether.
  - Northwest then raised its lowest fare to $271, and later to $461.
- Spirit met a similar response in the Detroit-Boston market, where Northwest flew 8.5 frequencies daily and charged $411 unrestricted and $189 restricted fares.
  - Spirit entered in April 1996 with lowest fares set at $69.
  - Northwest responded by matching the $69 fare, and increasing frequencies to 10.5 per day, including the addition of a wide-body DC-10.
  - Spirit's load factors never exceeded 31%, and it withdrew in September of that year.

Spirit v. Northwest Airlines



Spirit v. Northwest Airlines

- It is probable that Northwest sacrificed out-of-pocket losses not less than $10 million because of its fare decreases and capacity increases in the Detroit-Boston and Detroit- Philadelphia markets in the third quarter of 1996 alone. These actions clearly made no sense unless Northwest was confident that Spirit would be obliged to exit the market. . . . You will pardon us for believing that Northwest tried to put Spirit out of business in the third quarter of 1996."
  - Testimony of Mark Kahan before the Subcomm. on Aviation, of the U.S. House Comm. on Transportation and Infrastructure (Apr. 23, 1998).

How does predation occur?

Stage 1:

New carrier enters the route and offers cheap fares.

Stage 2:

Incumbent carrier reduces its fares.

A price war begins…

Stage 3:

Entrant exits.

Incumbent recoups.

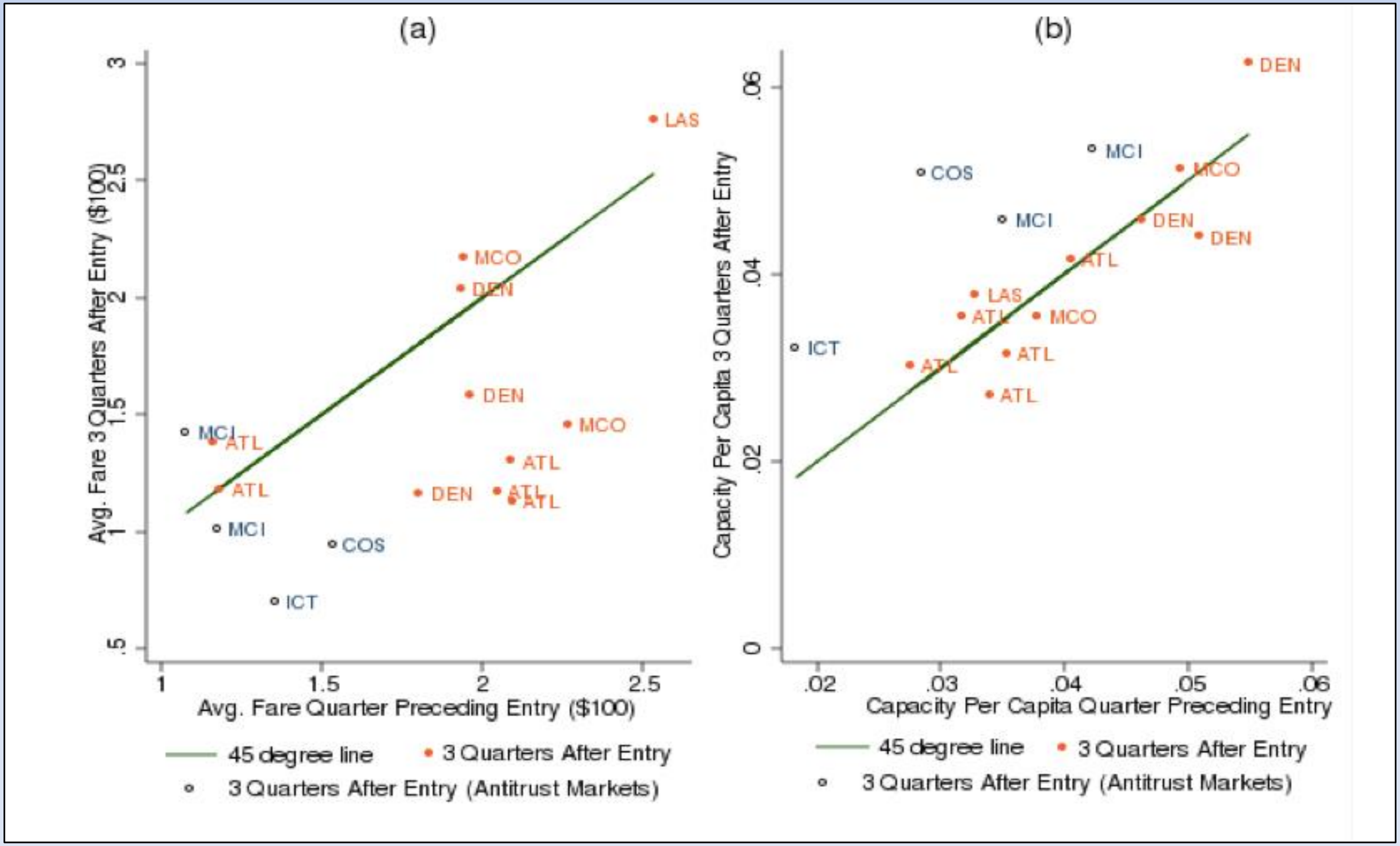
How does predation occur?

- Stage 1
  - Major airline establishes monopoly in a market, and raises prices to confiscatory levels.
  - New low-cost airline enters the market, offering low fares.
- Stage 2
  - Major airline responds by matching fares (even if below cost), sometimes adding aircraft capacity and frequency. Major airline rebates a portion of the ticket price in the form of frequent flyer travel.
- Stage 3
  - After suffering severe economic losses, new entrant airline withdraws from the market.
  - Major airline reduces service and raises prices to confiscatory levels, often higher than those prevailing before the new entrant emerged.

Predatory response

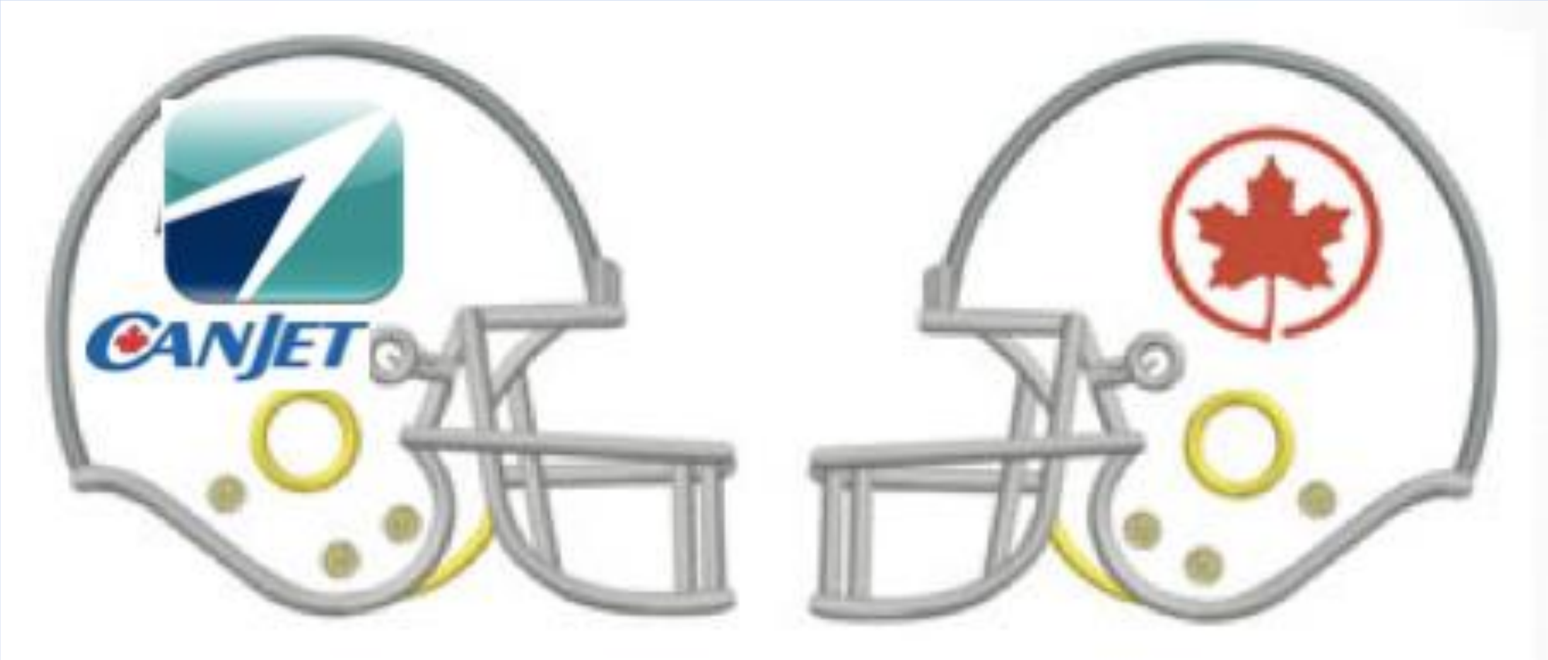
- "Differences in cost structures between large, hub incumbents and small, low cost entrants cause these predatory incentives to arise. Low cost carriers, with low marginal costs, set low prices and cut into the profitability of the hub carriers. These hub carriers however have lower avoidable fixed costs, due to prior sunk cost investments in their network, and are thus more committed to the market. Hub carriers are then able to prey on their low cost rivals by making costly commitments of capacity to a route."
  – Connan Snider, UCLA, 22 September 2009

American Airlines



Source: Connan Snider, UCLA

Air Canada…



- In 2003, a lawsuit was brought against Air Canada alleging that the carrier engaged in predatory pricing and capacity practices against two Canadian start-ups, WestJet and CanJet.

Legal Criteria to Establish Predation

Legal criteria

- Dominance
- Pricing below cost
- Competitive Injury
- Intent
- Recoupment
- Business justifications

Dominance

Dominance or **market power** in antitrust policy is the ability of a firm to behave in a substantially independent manner from other participants and to maintain fares above competitive levels for a prolonged period of time.

Price-cost test

- There is a general consensus that predatory pricing behaviour necessarily involves a practice of setting price below an appropriate measure of cost.

- Price-cost tests:
  - the average variable cost (AVC) test
  - the average avoidable cost (AAC) test
  - the average total cost (ATC) test
  - the marginal cost (MC) test

Competitive injury

- Many jurisdictions require the showing of competitive or consumer harm for predation to be illegal.

- This requirement is based on a simple principle that predation is a rational strategy for the incumbent only if the victim exits the market and consumer welfare is lowered as a result of diminished competition.

Intent

- Intent can be inferred **directly** from internal documents or **indirectly** based on competitive impact.
- Criticism: intent is inherently unreliable in determining liability because it is difficult to prove and often cannot be distinguished from the intent to compete.

Recoupment

Recoupment refers to **the ability of a carrier to recover the losses** sustained during the period of predation through profits earned after its rivals have been eliminated or disciplined.

Business justifications

- Promotional pricing
- Inventory and yield management
- Demand variations
- Network effects

Criminal or Administrative Enforcement?

Most countries apply civil law

- The 2008 ICN study looked at how 35 different jurisdictions treat predatory conduct:
  - 24 respondents – civil violation
  - 1 respondent – criminal offense
  - 10 respondents – civil violation or criminal offense

The perils of criminal liability

Criminal liability is undesirable because

- it may discourage pro-competitive behaviour
- it may prevent selling below cost as part of a valid business strategy
- the *per se* approach fails to take into account impact on competition or economic efficiency
- high standard of proof (proof beyond any reasonable doubt)

Few successful cases

- Selected major aviation market investigations:
  - American Airlines in the United States
  - Qantas in Australia
  - Air Canada in Canada
  - Lufthansa in Germany

- Only in the *Lufthansa* case, the German antitrust authority established a violation of predation laws and enforced a minimum price spread.

Enforcement

- Antitrust agencies and courts generally take a cautious approach to enforcing laws against predation to avoid discouraging competition.
  - Civil or administrative laws (as opposed to criminal laws) are generally applied to review predatory conduct.

- However, civil enforcement of anti-predation rules has been weak as courts and competition authorities often choose to err on the side of under-deterrence.

Collusion and Conspiracies between Airlines

Cooperation and collusion

- Some forms of cooperation between airlines are benign and do not violate antitrust law
  - Coordination of loyalty programs enables passengers to accumulate points across multiple airlines
- Other forms are inherently harmful and bring no benefit to consumers
  - Collusion or cartels to fix price or restrict output
  - Collusion between airlines on fares, schedules, capacity, market or customer allocation is prohibited under cartel laws

Airline cartels

- Airline cartels are arrangements or agreements to fix price or restrict capacity in order to improve profitability of member airlines
  - Higher profits are enabled by coordination of activities between cartel members

- Cartels are more likely in markets with **fewer players, high barriers to entry, homogenous products, price transparency and stable demand**.

Theory of cartels

UNITED \ American Airlines	64,000 pax	48,000 pax
64,000 pax	UA 4.1m AA 4.1m	UA 5.1m AA 3.8m
48,000 pax	UA 3.8m AA 5.1m	UA 4.6m AA 4.6m

Source: J. Perloff, Microeconomics at 427 (2004)

Facilitating factors

- The airline industry has unique features that make it conducive to cartelization
  - Multi-market contact between airlines
  - IATA Tariff Conferences
  - Pricing and marketing platforms (ATPco, OAG, Innovata)

Why do cartels break up?

- Firms have an incentive to “cheat” on a cartel because they can steal market share
- Enforcement agencies have used leniency or immunity programs to expose a cartel:
  - Canada: Immunity Program (2000); Leniency Program (2007)
  - US: Amnesty Program; Corporate Leniency Program (1993)
  - Europe: European Commission leniency policy (2002)

The Air Cargo
Fuel Surcharge Case

The fuel surcharge case


Lufthansa
blows whistle
NO FINE


Singapore
Fine: €74.8m


Martinair
Fine: €29.5m
50% reduction


SAS
Fine: €70.1m
15% reduction


Korean


AF-KLM
Fine: €182.3m
20% reduction


BA
Fine: €104m
10% reduction


Cargolux
Fine: €79.9m
15% reduction

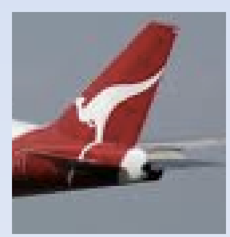
FUEL SURCHARGE
SECURITY SURCHARGE
CARTEL
1999-2006

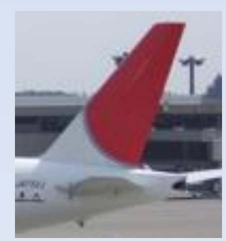

Cathay
Pacific
Fine: €57.1m
20% reduction


El Al


Air Canada
Fine: €21m
15% reduction


LAN Chile
Fine: €8.2m
20% reduction


Qantas
Fine: €8.8m
20% reduction


Japan
Airlines
Fine: €35.7m
25% discount

Investigations in multiple jurisdictions

- It is unlawful in many countries around the world for competitors to agree to fix prices or divide territory.
  - In the U.S., such conduct can result in criminal prosecution by the U.S. Justice Department.
  - In the European Union, companies may face a fine of as much as 10% of annual turnover.
  - Investigations were opened in multiple jurisdiction including the US, the EU, Canada, Australia, New Zealand and South Africa

Penalties in different jurisdictions

- Regulatory penalties (as of Sept 2012)
  - **US: $1.8 billion + fines and prison terms for executives**
  - Canada: $21.6 million CAN
  - **Europe: 800 million EURO (+ individual country fines)**
  - New Zealand: $21 million NZD
  - Australia: $58 million AUS
  - South Africa: $5.8 million

- Civil proceedings by victims seeking damages
  - Class actions in the US
  - Special Purpose Vehicles in Europe

Source: Competition Law Insight (Sep 2012)