

Antitrust Review of Mergers and Alliances

Istanbul Technical University

Air Transportation Management, M.Sc. Program

Aviation Economics and Financial Analysis

Module 13

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Outline

A. Competitive Effects

B. Competition and Antitrust Laws
   - B.1 United States
   - B.2 Canada
   - B.3 Europe

C. Competition and Antitrust Analysis

D. Case Study: United/Continental

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AVIATION TRANSPORTATION TOURISM

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A. Competitive Effects

Economics of Mergers and Alliances

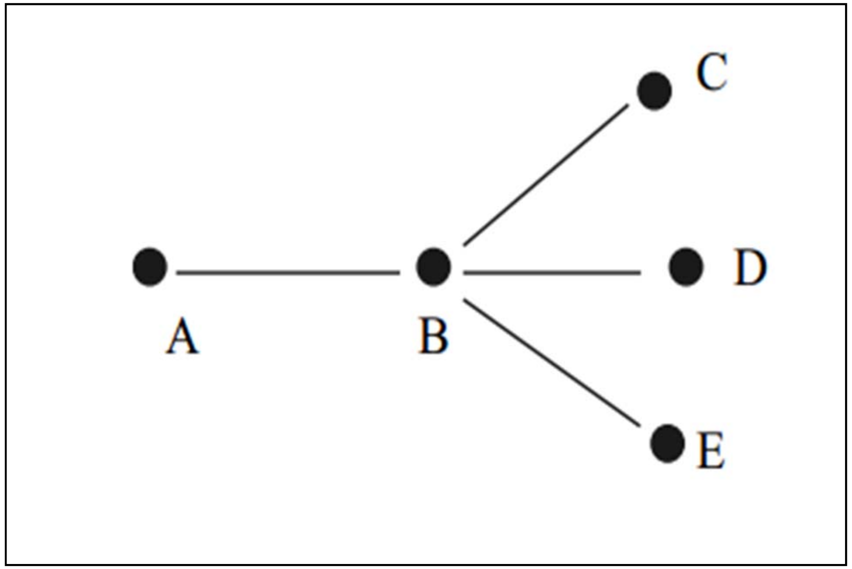
- **Key industry trends:**
  - **Increased penetration of mergers and alliances**
  - **Industry consolidation**
  - **“Hub and spoke” route systems post-deregulation**

- **On the one hand, increased industry consolidation and hub-and-spoke systems allow airlines to benefit from cost economies and passengers from better connections, higher frequency of service and a wider range of destinations.**

- **On the other hand, these trends can lead to enhanced ability by carriers to exercise market power, exclude competition and cause consumer harm.**

Competitive Landscape

- **Characteristics of the airline industry that favour anti-competitive practices:**
  - **Hub concentration**
  - **Airports slot constraints**
  - **Price transparency**
  - **Multi-market contact**



Competitive Landscape

- **Competition from other modes of transport is limited or ineffective**
  - **High speed trains may be a substitute on some route**
  - **Other ground transport is generally not an effective substitute**
  - **For most routes, airlines have no substitutes**

- **Business travellers account for a disproportionate share of airline profits**
  - **The 20/80 rule**
  - **Time-sensitive travellers are typically the focus of antitrust concerns**

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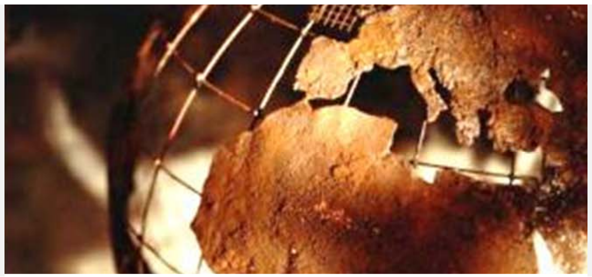
B. Competition and Antitrust Laws


The United States

- **Sherman Antitrust Act, 1890**
- **Clayton Act, 1914**
- **Robinson-Patman Act, 1936**
- **Federal Trade Commission Act, 1938**
- **Hart-Scott-Rodino Act, 1976**

- **Sherman Act, Section 1**
  - **Prohibits contracts, combinations and conspiracies in restraint of trade**
    - Airlines must request and obtain immunity from antitrust laws to operate alliances.

The United States

- **Clayton Act, Section 7**
    - **Prohibits anticompetitive mergers – mergers that substantially lessen competition or tend to create a monopoly**

- **Hart-Scott-Rodino Act**
    - **A merger or acquisition above a certain monetary amount must be reported to U.S. regulators**
        - Most airline mergers are reviewed under this act

Institutional Framework in the United States

- **Before 1985…**
  - **The Civil Aeronautics Board**
    - was responsible for review and approval of airlines mergers and acquisitions
    - could grand antitrust immunity
- **After 1985…**
  - **The US Department of Transportation**
    - has the mandate to review international alliances
    - has the power to grant antitrust immunity to international alliances
    - reviewed domestic airline mergers between 1985 and 1989
      - approved all 21 airline merger applications during that period
  - **The US Department of Justice**
    - has the mandate to review domestic airline mergers
    - under section 7 of the Clayton Act

The European Union

- The Treaty on the Functioning of the European Union, 2007
- The European Treaty, Article 101
  - Prohibits agreements and concerted practices between undertakings which may affect trade within the European Union and which have the objective or effect of preventing, restricting or distorting competition.
  - This article applies to price-fixing, output restrictions, market allocation or allocation of sources of supply and other transactions or agreements that place competitors at a competitive disadvantage.
- The European Commission
  - Has the mandate to review mergers and acquisitions
  - Has the power to block mergers and acquisitions that would impede competition in the European Economic Area

Canada

- The *Competition Act*, 1985

- The *Competition Act*, Sections 91 and 92
  - **Prohibits anticompetitive mergers which may substantially lessen competition in a market.**

- The Competition Act, Section 90.1
  - **Prohibits anticompetitive agreements between competitors**

- The Competition Bureau of Canada
  - **Has the mandate to review mergers and acquisitions**
  - **Has the ability to challenge anticompetitive mergers and acquisitions affecting Canada in court and seek remedies**

International Cooperation

- **Since 1991 the European Union and the United States have been coordinating regulatory reviews**
  - **transatlantic alliances**
  - **mergers and acquisitions affecting the transatlantic market**
  - **joint studies on the impact of alliances**

- **Different approaches in different jurisdictions may lead to inconsistent decisions or remedies**
  - **E.g. Transborder Joint Venture between Air Canada and United/Continental**
    - The US Department of Transport granted antitrust immunity (with carve-outs on 6 routes in total)
    - Canada's Competition Bureau challenged the JV in court with a subsequent settlement (additional carve-outs on 10 routes in total)

C. Competition and Antitrust Analysis



Antitrust Analysis
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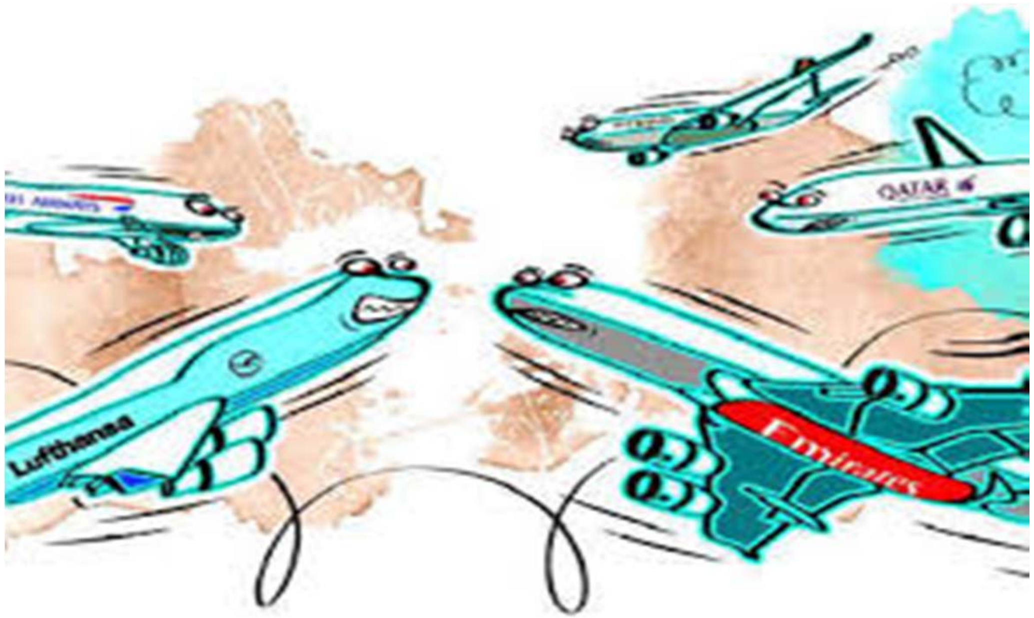
- **Competition authorities are likely to start with the view that a merger that may lessen competition is undesirable, especially if:**
  - **the merged airline has a dominant position**
  - **there is no effective competition**



Antitrust Analysis
(new slide)

- **The merging airlines must show that the benefits of the merger will offset the costs**

  - **Cost efficiencies for airlines**
    - Benefits to airlines from reducing costs matter
  - **Increased revenues/prices for airlines**
    - Benefit to airlines from higher fares that result from reduced competition is not a benefit from an antitrust law point of view
  - **Benefits for passengers**
    - Better service (connectivity, scheduling, FFP integration, lounge access, etc.)
    - Better price that may result from cost savings

Antitrust Analysis
(new slide)

- **Competition authorities will compare potential benefits to the costs of an airline merger**

  - **Higher fares**
    - Complementary routes less problematic
    - Overlapping routes are particularly problematic

  - **Reduced capacity**
    - A cost if fewer passengers are served
    - A cost if less choices for passengers
    - A benefit if capacity reduction leads to costs savings

Complementary vs Overlapping Networks
(old slide 27)

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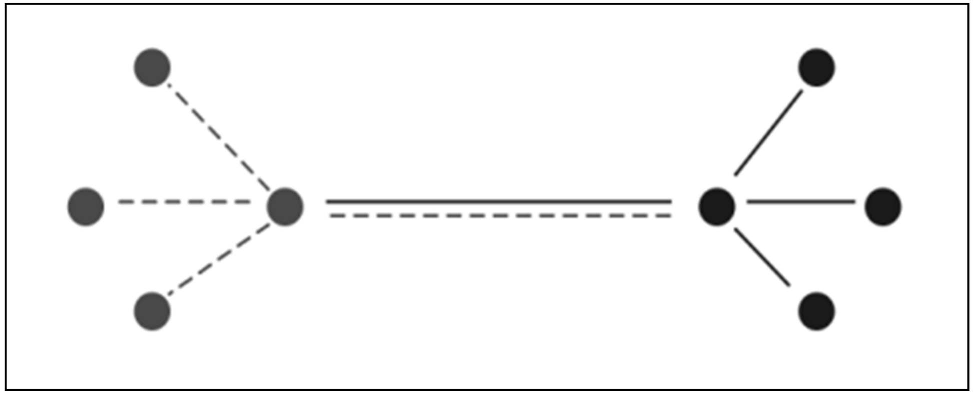
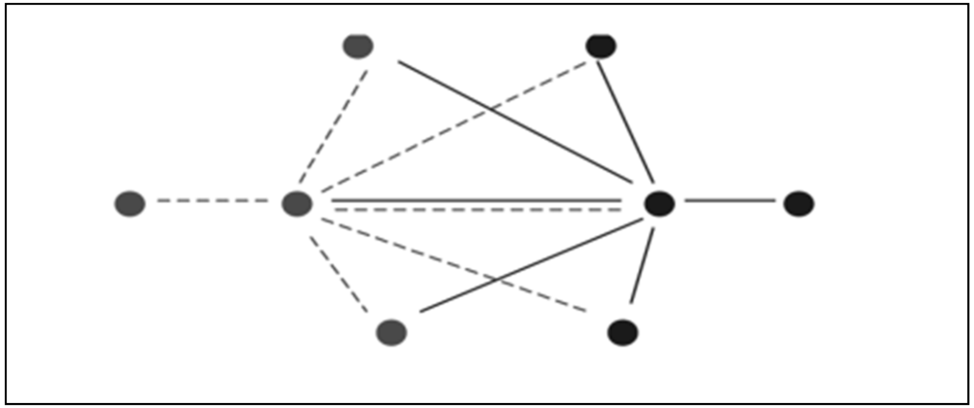
- **The anti-competitive effect of a merger/alliance between two airlines is**
  - **Smaller if the networks have limited or no overlap**

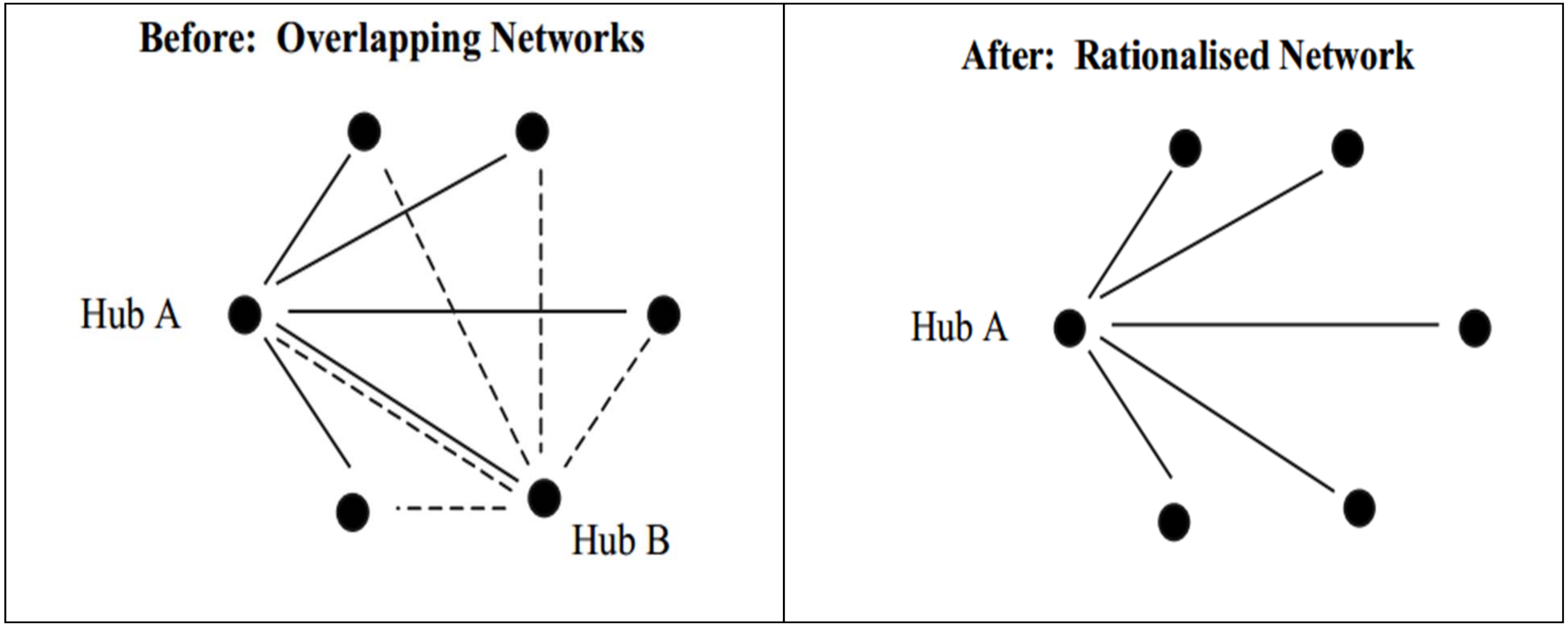


  - **Greater if the networks have substantial overlap**



Network Rationalization
(old slide 26)

- **The impact of mergers and alliances**
  - **Rationalization of networks and removal of competing hubs**
    - increased traffic density and reduced flight frequency
  - **Potential reduction in competition in markets previously served by the merger partners**



Antitrust Analysis
(new slide)

- **The presence of remaining competition in the market**

  - **A major focus of antitrust analysis**

  - **Based on the idea that effective outstanding competition disciplines exercise of market power**
    - Prevents the cost of higher fares
    - Prevents the cost of reduced passenger choices
    - Allows for the benefit of the merger

  - **Competition from carriers operating indirect service will be considered**
    - Generally not a good substitute for non-stop service

Airline Relevant Product Market
(old slide 17)

- **Product market**
  - **Business travellers / Leisure travellers**
  - **Economy / Business / First class**
  - **Connecting / Non-stop passengers**
    - Different time and price sensitivity
    - Different preferences for low frills versus full service airlines
      - Virgin estimated that time sensitive pax on London-New York value time at $240/hour

Airline Relevant Geographic Market
(old slide 18)

- **Geographic market**
  - **Airport pairs**
  - **City pairs**
    - Airline markets are usually defined as city pairs
  - **Entire networks**
  - **Hub airports**

Market Share
(old slide 19)

- **High market share may be an indication of market power**
  - **Determined in reference to the relevant market**
  - **Measured in traffic, revenue, frequency, etc.**
  - **Safe harbours**
    - A market share below 35% will not raise concerns
    - A market share above 60% will likely raise concerns

- **But high market share does not automatically equal market power**
  - **Barriers to entry need to be analyzed**
  - **Contestable market theory**

Entry Barriers
(old slides 20-24)

- **Airport slot constraints**
  - **Large airports operate nearly at capacity**
    - E.g. Heathrow is currently at 99% capacity
    - Other major airports in New York, London, Tokyo, etc. are also slot constrained
  - **Dominant airlines hold slots and limit new entry**

- **Access to airport facilities**
  - **Terminals, gates, check in counters, etc.**

- **Computer Reservation Systems (CRSs)**
  - **Display bias**
  - **Booking fees**

- **Travel agent incentives**

Entry Barriers
(old slides 20-24)

- **State ownership**
  - **Limits sources of finance for new entrants**
  - **Government “bailouts” or subsidies limit or impede new entry**

- **Loyalty programs**
  - **Act as a volume discount**
  - **Principle-agent problem (business travellers)**
  - **The effect is greater for loyalty programs where points can be accumulated faster or where an airline has a broader network**
  - **Incumbent airlines may be required to grant competitor access to their frequent flyer programs**

- **Discounts to large corporate customers**
  - **On the condition that all or nearly all travel is booked with a specific airline**

Entry Barriers

(old slides 20-24)

The U.S. Department of Justice:

"Frequent flyer preferences and corporate discount programs will <u>tend to reinforce business passengers' preference for the non-stop hub carrier</u> in any given city pair market. For example, for business passengers originating in Dallas, American's hub strength gives it by far the most attractive frequent flyer program."

Remedies

- **If a merger is undesirable from an antitrust point of view, measures can be adopted to reduce its harmful impact**
  - **Reduce entry barriers to other competing airlines**
    - slot divestiture at congested airports
  - **Carve out selected routes from a joint venture**
    - applied primarily where the merging airlines are the only operators
    - approach used by the United States in granting antitrust immunity to international alliances
      - the carriers can get approval without the carve outs but they must present evidence that benefits will offset costs
  - **Agreement that the merged carriers will not undercut prices post-merger**
    - or engage in other forms of anticompetitive conduct

Remedies

- **Structural remedies**
  - **Airport slot divestiture**
  - **Market share restrictions on key routes**
    - used by the European Commission

- **Behavioral remedies**
  - **Mandated access to essential facilities or services**
    - computer reservation systems, terminal gates, loyalty programs, etc.
  - **Obligation to interline**
    - or enter into other arrangements that facilitate competition
  - **Carve outs**
    - prohibition to coordinate on certain routes (carve outs)
    - used by the United States / Canada

D. Case Study: United-Continental

The Carriers
(old slide 32)

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- **United Airlines**
  - **Prior to the merger**
    - Based in Chicago
    - 3rd largest carrier in the United States by revenue
    - Operated service within the US and on international routes with hubs in Los Angeles, Denver, San Francisco, Chicago and Washington
    - Founding member of the Star Alliance
    - Member of the transatlantic joint venture (with Lufthansa, Air Canada and Continental)

The Carriers

- **Continental Airlines**
  - **Prior to the merger**
    - Based in Houston
    - 4th largest carrier in the United States by revenue
    - Operated service within the US and on international routes with hubs in New York, Cleveland and Houston
    - Member of the Star Alliance since 2009
    - Member of the transatlantic joint venture (with Lufthansa, Air Canada and United)

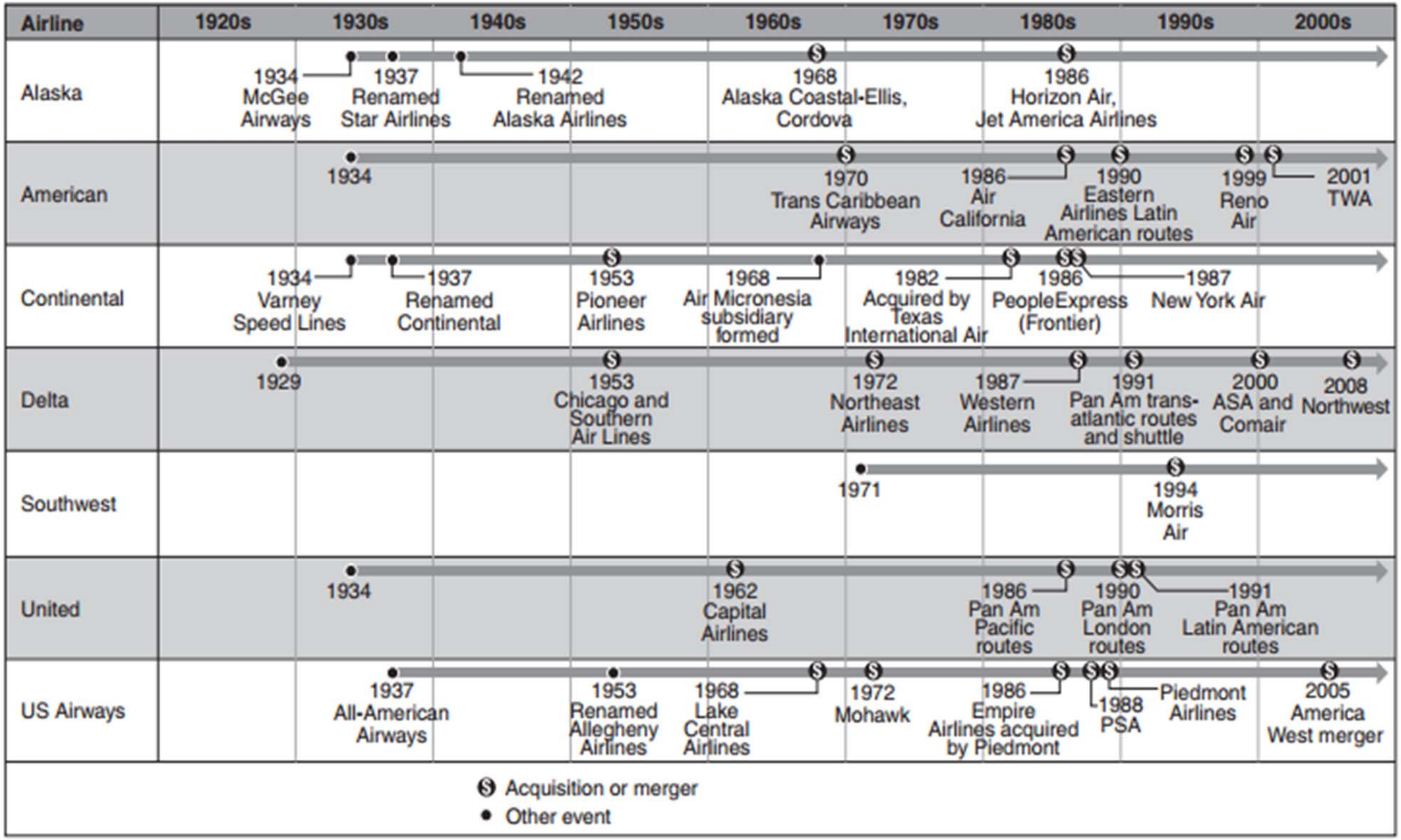
The Merger

- Merger announced on May 3, 2010
- Merger completed on October 1, 2010

- The new airline is now owned by United Continental Holdings, Inc.

- The new airline is
  - Headquartered in Chicago
  - Headed by Continental’s CEO
  - $8 billion in total equity value

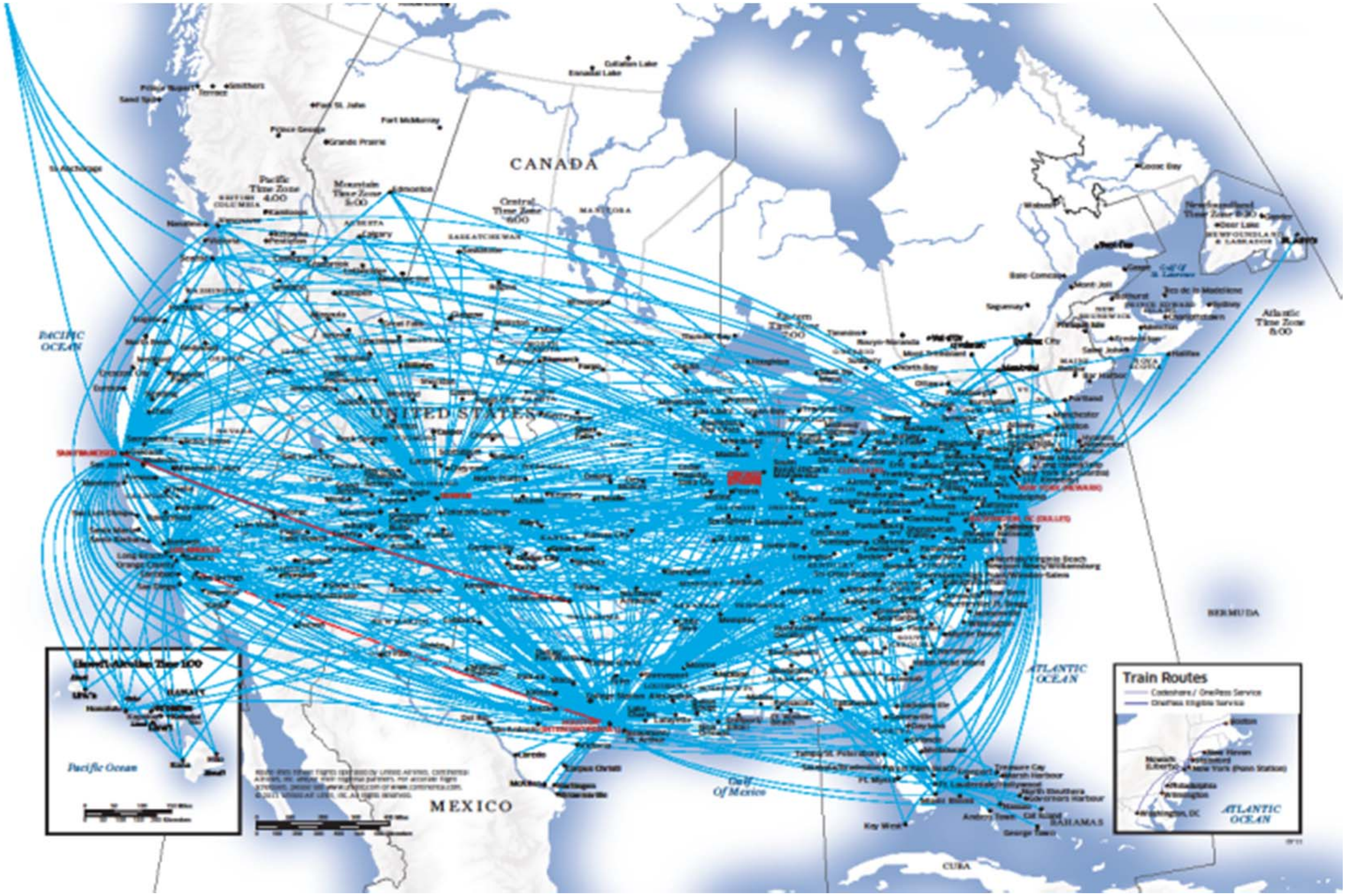
Competitive Landscape



Source: US Government Accountability Office (2010)

Domestic Route Network

United Airlines' Domestic Route Map



Source: United Continental Holdings Fact Sheet, April 2013.

International Route Network

United Airlines' International Route Map

Source: United Continental Holdings Fact Sheet, April 2013.

Why Merge?

- **Broader route network**
  - **United and Continental networks were highly complementary**
  - **Online connections and expanded range of destinations**

- **Strengthen competitive position in domestic markets**
  - **LCCs have increased presence and competition in domestic markets**
    - Southwest is the largest carrier by the number of passengers domestically

- **Strengthen competitive position in international markets**
  - **Consolidation between carriers on international routes via alliances and mergers**
    - Air France/KLM, Lufthansa/Swiss/Austrian, British Airways/Iberia
  - **Penetration of international markets by Emirates, Jet Airways, Virgin Australia and other non-allied carriers**

Why Merge?

- **Cost savings**
  - **Increase competitive cost structure**
    - Eliminate duplicative IT services, reservation systems, baggage handling systems and maintenance operations
    - Achieve fuel costs savings due to optimized routing and higher load factors
    - Achieve fuel costs savings due to aircraft up-gauging on certain routes
    - Improve fleet utilization
  - **Estimated savings of $200-300 million per year**

Competition Assessment

Table 2: Total Assets, Operating Revenue, and Capacity of Top U.S. Airlines (4 Quarters Ending October 2012)

Airline	Capacity as measured by available seat miles (thousands)	Total operating revenue (thousands)[a]	Total assets (thousands)
Combined American-US Airways	226,545,216	$38,847,509	$130,928,916
United	218,563,833	37,470,318	154,554,977
Delta	200,931,079	36,615,819	144,019,527
Southwest[b]	128,365,001	17,023,282	75,640,126
Alaska	27,655,088	4,561,605	19,770,760

Source: Bureau of Transportation Statistics Form 41

Source: US Government Accountability Office (2010)

Competition Assessment

- **Relevant market**
  - **Geographic market**
    - City pairs
      - competition from adjacent airports disciplines pricing
    - The entire U.S. network
      - past jurisprudence rejects this approach
      - a flight from San Francisco to Newark does not compete with a flight from Seattle to Miami
  - **Product market**
    - Business travellers vs. leisure travellers
    - Network carriers vs. LCC carriers
      - LCCs should be included as well as they increasingly compete for business travel

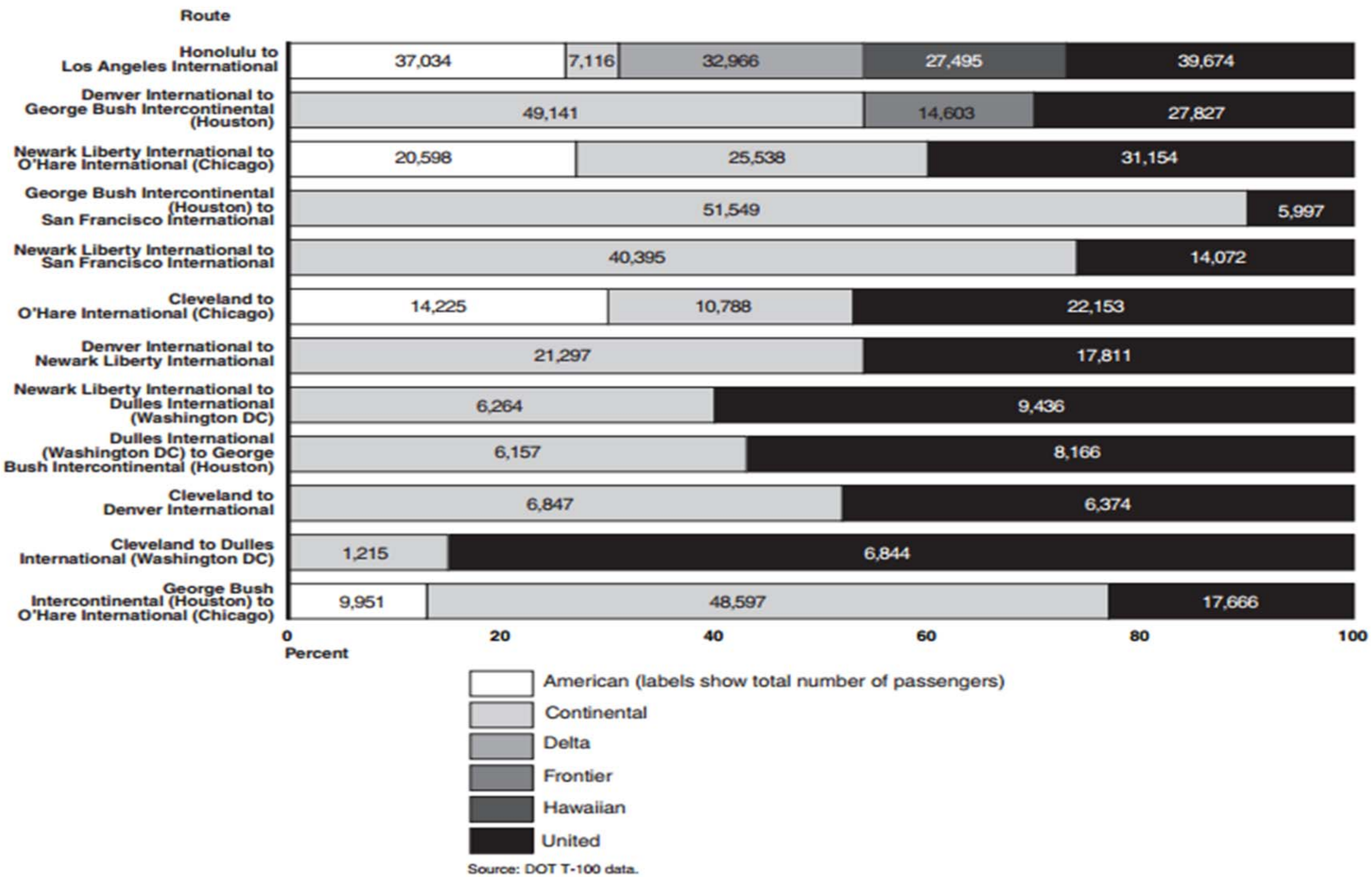
Competition Assessment

- **United / Continental networks are largely complimentary**
  - **no overlap on international routes (city pairs)**
  - **overlap on a limited number of domestic routes (city pairs)**
  - **where United / Continental competed directly**
    - Continental's hub in Newark and United's hubs

- **Outstanding competition**
  - **at least one outstanding competitor on most overlapping airport-pair markets**

Network Overlap
(revised slide)

Figure 4: Total Passengers on Overlapping Nonstop Airport Pairs (January 2010)



Source: US Government Accountability Office (2010)

Remedies

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- **Transfer of take off and landing slots**
  - **United / Continental agreed to transfer take off and landing slots at Newark (New York)**
  - **The slots were transferred to LCC Southwest**

Thank You!

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