Appendix A

Statement of Enforcement Policy Regarding Unfair Exclusionary Conduct

Department of Transportation
Office of the Secretary
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(Docket No. OST-98-3713, Notice 98-16)

Congress has put a premium on competition in the air transportation industry in the policy goals enumerated in 49 U.S.C. §40101. The Department of Transportation thus has a mandate to foster and encourage legitimate competition. We believe that legitimate competition encompasses a wide range of potential responses by major carriers to new entry into their hub markets[1]—responses involving price reductions or capacity increases, or both, or even neither. Some of the responses we

[1] We use the term "new entrant" to mean an independent airline that has started jet service within the last ten years and pursues a competitive strategy of charging low fares. We use the term "major carrier" to mean the major carrier that operates the hub at issue.

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have observed, however, appear to be straying beyond the confines of legitimate competition into the region of unfair competition, behavior which, by virtue of 49 U.S.C. §41712, we have not only a mandate but an obligation to prohibit.

Following Congress's deregulation of the air transportation industry in 1978, all of the major air carriers restructured their route systems into hub-and-spoke networks. Major carriers have long charged considerably higher fares in most of their spoke city-pairs, or the "local hub markets," than in other city-pairs of comparable distance and density. In recent years, when small, new-entrant carriers have instituted new low-fare service in major carriers' local hub markets, the 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. Once a new entrant has ceased its service, the major carrier will typically retrench its capacity in the market or raise its fares to at least their pre-entry levels, or both. The major carrier thus accepts lower profits in the short run in order to secure higher profits in the long run. This strategy can benefit the major carrier prospectively as well, in that it dissuades other carriers from attempting low-fare entry. It can hurt consumers in the long run by depriving them of the benefits of competition. In those instances where the major carrier's strategy amounts to unfair competition, we must take enforcement action in order to preserve the competitive process.

We hereby put all air carriers on notice, therefore, that as 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 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. Any strategy this costly to the major carrier in the short term is economically rational only if it eventually forces the new entrant to exit the market, after which the major carrier can readily recoup the revenues it has sacrificed to achieve this end. We will therefore be focusing our enforcement efforts

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on this strategy while continuing our scrutiny of any other strategies that may threaten competition.

Our policy represents a balance between the imperative of encouraging legitimate competition in all of its various forms and the imperative of prohibiting unfair methods of competition that ultimately deprive consumers of the range of prices and services that legitimate competition would otherwise afford them. This policy does not represent an attempt by the Department to reregulate the air transportation industry: we are neither prescribing nor proscribing any fares or capacity levels in any market. Rather, we are carrying out our statutory responsibility to ensure that if a new-entrant carrier's entry into a major carrier's hub markets fails, it fails on the merits, not due to unfair methods of competition.

BACKGROUND

The competitive benefits of deregulation have been exhaustively documented in numerous studies. Among other things, the major carriers' development of hub-and-spoke networks has brought most domestic air travelers more extensive service, more frequent service, and lower fares. Also widely documented are the competitive advantages in serving local markets that a major carrier enjoys at its hub. Flow traffic, or the passengers that the major carrier is transporting from their origins to their destinations by way of its hub, typically accounts for more than half of the traffic in local hub markets. Flow traffic thus allows the major carrier to operate higher frequencies in local markets than the local traffic alone would support. In turn, in local markets served by more than one carrier, the major carrier's higher frequency attracts a greater share of the local traffic than that carrier would otherwise carry.[2] Due to its more extensive route network, the major carrier is also able to offer a frequent-flier program and commission overrides—i.e., higher commissions to travel agents for a higher volume of sales—that are more effective. These factors, too, confer competitive advantages on the major carrier in local hub markets.

[2] This phenomenon, called the "S-curve" effect, reflects the value that time-sensitive travelers place on schedule frequency.

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These advantages have translated into the power to charge higher local fares. A major carrier usually provides all of the service in most of its local hub markets, the exceptions being mainly city-pairs whose other endpoints are hubs of other major carriers or city-pairs served by low-fare carriers. Many local hub markets that have enough traffic to support competitive nonstop service are nonetheless served only by the major carrier. In the absence of competition, the major carrier is able to charge fares that exceed its fares in nonhub markets of comparable distance and density by upwards of 40 percent, or at least $100 to $150 per round trip. Even in those local hub markets in which the major carrier competes with another major carrier, load factors may be relatively low, but fares are relatively high. We have observed, in fact, that low-fare service has provided the only effective price competition in major carriers' local hub markets.

Major carriers use sophisticated yield-management techniques to price-discriminate and thereby maximize their revenues. They can monitor sales and fine-tune fares, change fare offerings for individual flights as frequently as conditions may warrant, and segment each city-pair market so that those passengers needing the greatest flexibility pay the highest premiums while passengers needing progressively less flexibility pay progressively lower fares. The lowest fares, which typically carry heavy restrictions, provide revenue for seats that the carrier would otherwise fly empty. It is in the carrier's interest, of course, to sell each seat at the highest fare that it can. Generally, major carriers find it most profitable to focus on high-fare service, leaving much of the demand for low-fare service in many local hub markets unserved.

Both these unserved consumers and travelers paying fare premiums in local hub markets stand to reap substantial benefits from new competition. Southwest, a low-fare carrier certificated before deregulation, and various new-entrant carriers have shown that a nonhub carrier can compete successfully with a major carrier in the latter's hub markets.[3] By

[3] Southwest has scored the broadest and longest-lived success with this strategy, having established a strong presence in numerous local markets at a number of hubs. New-entrant carriers such as ValuJet (now AirTran Airlines), Morris Air (before being acquired by Southwest), and Frontier have entered local markets at Atlanta, Salt Lake City, and Denver, respectively. Vanguard, another new-entrant carrier, has pursued a strategy of providing direct service between Kansas City and several hubs.

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charging lower fares, the new entrant can profitably serve that portion of a local market's demand which the major carrier has mostly not been serving; the resultant competition can bring fares down for most travelers. Traffic stimulation and reductions in average fares can both be dramatic. According to a study by this Department, low-fare competition saved over 100 million travelers an estimated $6.3 billion in the year that ended September 30, 1995.[4] At Salt Lake City, for example, local markets served by Morris Air and Southwest saw their traffic triple and their average fares decrease by half, while local markets served only by the dominant carrier saw their fares increase. By late 1995, the average fares in local markets served by Morris Air and Southwest were only one-third as high as fares in other local Salt Lake City markets.

THE PROBLEM

The major carriers view competition by new entrants as a threat to their ability to maximize revenues through price discrimination. As noted, not only will the previously unserved consumers take advantage of a new entrant's low fares, but so, too, will at least some of the consumers that have been paying the major carrier's higher fares. Regardless of how the major carrier chooses to respond to the new entry, the more low-fare capacity available in the market, the less of its high-fare traffic the major carrier will retain. The stakes are high: a major carrier's fare premiums in its local hub markets can mean revenues of tens of millions of dollars annually over its revenues in markets where fares are disciplined by competition.

In some instances, a major carrier will choose to coexist with the low-fare competitor and tailor its response to the latter's entry accordingly. For example, at cities like Dallas and Houston, the major carriers tolerate Southwest's major presence in local markets by not competing aggressively for local passengers. Instead, they focus their efforts on carrying flow passengers to feed their networks. At the other extreme, the major carrier will choose to drive the new entrant from the market. It will adopt

[4] *The Low Cost Airline Service Revolution*, April 1996. A good portion of the savings occurred in local hub markets.

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a strategy involving drastic price cuts and flooding the market with new low-fare capacity (and perhaps offering bonus frequent-flier miles and higher commission overrides for travel agents as well) in order to keep the new entrant from achieving its break-even load factor and thus force its withdrawal. Before the new entrant does withdraw, the major carrier, with its higher cost structure, will carry more low-fare passengers than the new entrant, thereby incurring substantial self-diversion of revenues—i.e., it will provide unrestricted low-fare service to passengers who would otherwise be willing to pay higher fares for service without restrictions. Consumers, for their part, enjoy unprecedented benefits in the short term. After the new entrant's withdrawal, however, the major carrier drops the added capacity and raises its fares at least to their original level. By accepting substantial self-diversion in the short run, the major carrier prevents the new entrant from establishing itself as a competitor in a potentially large array of markets. Consumers thus lose the benefits of this competition indefinitely.[5]

We propose to consider this latter extreme to be unfair exclusionary conduct in violation of 49 U.S.C. §41712. We have been conducting informal investigations in response to informal allegations of predation, and we have observed behavior consistent with the behavior described above. The following hypothetical example involving a local hub market serves to illustrate the problem. Originally, the major carrier is able to charge one-third of its local passengers a fare of $350. These passengers generate revenue of $3 million per quarter, which constitutes half of the major carrier's total local revenue. After new entry, the major carrier initially continues to price-discriminate, continues to sell a large number of seats at $350, and sustains little revenue diversion. Then the major carrier changes its strategy and offers enough unrestricted seats at the new entrant's fare of $50 to absorb a large share of the low-fare traffic. It sells far more seats at low fares than the new entrant's total seat capacity. Consequently, virtually all of the passengers who once paid $350 now

[5] Economists have recognized that consumers are harmed if a dominant firm eliminates competition from firms of equal or greater efficiency by cutting its prices and increasing its capacity, even if its prices are not below its costs. See Ordover and Willig, An Economic Definition of Predation: Pricing and Product Innovation, *Yale Law Journal*, Vol. 91, No. 8, 1981.

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pay just $50, and instead of $3 million, these passengers now account for revenue of less than $0.5 million per quarter. To make up the difference, the major carrier would have to carry six more passengers for each passenger diverted from the $350 fare to the $50 fare. The major carrier loses more revenues through self-diversion than it lost to the new entrant under its initial strategy.

DEPARTMENT'S MANDATE

Our mandate under 49 U.S.C. §41712 to prohibit unfair methods of competition authorizes us to stop air carriers from engaging in conduct that can be characterized as anticompetitive under antitrust principles even if it does not amount to a violation of the antitrust laws. The unfair exclusionary behavior we address here is analogous to (and may amount to) predation within the meaning of the federal antitrust laws.[6]

Although the Supreme Court has said that predation rarely occurs and is even more rarely successful, our informal investigations suggest that the nature of the air transportation industry can at a minimum allow unfair exclusionary practices to succeed. Compared to firms in other industries, a major air carrier can price-discriminate to a much greater extent, adjust prices much faster, and shift resources between markets much more readily. Through booking and other data generated by computer reservations systems and other sources, air carriers have access to comprehensive, real time information on their competitors' activities and can thus respond to competitive initiatives more precisely and swiftly than firms in other industries. In addition, a major carrier's ability to shift assets quickly between markets allows it to increase service frequency and capture a disproportionate share of traffic, thereby reaping the competitive advantage of the S-curve effect. These characteristics of the air transportation industry allow the major carrier to drive a new entrant from a local hub market. Having observed this behavior, other potential new entrants refrain from entering, leaving the major carrier free to reap greater profits indefinitely.

[6] We will continue to work closely with the Department of Justice in evaluating allegations of anticompetitive behavior, but we will take enforcement action under 49 U.S.C. §41712 against unfair exclusionary practices independently.

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ENFORCEMENT ACTION

We will determine whether major carriers have engaged in unfair exclusionary practices on a case-by-case basis according to the enforcement procedures set forth in Subpart B of 14 CFR Part 302. We will investigate conduct on our own initiative as well as in response to formal and informal complaints. Where appropriate, cases will be set for hearings before administrative law judges. We will apply our policy prospectively, and we expect to refine our approach based on experience. We anticipate that in the absence of strong reasons to believe that a major carrier's response to competition from a new entrant does not violate 49 U.S.C. §41712, we will institute enforcement proceedings to determine whether the carrier has engaged in unfair exclusionary practices when one or more of the following occurs:

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.

As the term "reasonable alternative response" suggests, we by no means intend to discourage major carriers from competing aggressively against new entrants in their hub markets. A major carrier can minimize or even avoid self-diversion of local revenues, for example, by matching the new entrant's low fares on a restricted basis (and without significantly increasing capacity) and relying on its own service advantages to retain high-fare traffic. We have seen that major carriers can operate profitably in the same markets as low-fare carriers. As noted, major carriers are competing

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with Southwest, the most successful low-fare carrier, on a broad scale and are nevertheless reporting record or near-record earnings.[7] We will consider whether a major carrier's response to new entry is consistent with its behavior in markets where it competes with other new-entrant carriers or with Southwest. Conceivably, a major carrier could both lower its fares and add capacity in response to competition from a new entrant without any inordinate sacrifice in local revenues. If the new entrant remained in the market, consumers would reap great benefits from the resulting competition, and we would not intercede. Conceivably, too, a new entrant's service might fail for legitimate competitive reasons: our enforcement policy will not guarantee new entrants success or even survival. Optimally, it will give them a level playing field.

The three scenarios set forth above reflect the more extreme and most obviously suspect responses to new entry that we have observed in our informal investigations. We do not intend them as an exhaustive list: we will analyze other types of conduct as well to determine whether to institute enforcement proceedings.[8] Besides examining service and pricing behavior, we will consider other possible indicia of unfair competition: for example, allegations that major carriers are attempting to block new entrants from local markets by hoarding airport gates, by using contractual arrangements with local airport authorities to bar access to an airport's infrastructure and services, or by using bonus frequent flyer awards or travel agent commission overrides in ways that appear to target new entrants unfairly.

In an enforcement proceeding, if the administrative law judge finds that a major carrier has engaged in unfair exclusionary practices in violation of 49 U.S.C. §41712, the Department will order the carrier to cease and desist from such practices. Under 49 U.S.C. §46301, violation of a Department order subjects a carrier to substantial civil penalties.

We have crafted our policy not to protect competitors but to protect competition. We hope that it will provide consumers with the benefits

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[7] One major carrier's internal documents that we reviewed as part of an informal investigation of alleged predation show strong profits on individual flight segments where it competes with Southwest.

[8] Moreover, our statutory responsibility to prohibit unfair methods of competition is not limited to the unfair exclusionary practices addressed here. We will continue to monitor the competitive behavior of all types of air carriers.

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of competition in increasing numbers of local hub markets over the long term.

INITIAL REGULATORY FLEXIBILITY ANALYSIS: The Regulatory Flexibility Act of 1980, 5 U.S.C. §601 *et seq.*, was enacted by Congress to ensure that small entities are not unnecessarily and disproportionately burdened by government regulations or actions. The Act requires agencies to review proposed regulations or actions that may have a significant economic impact on a substantial number of small entities. For purposes of this policy statement, small entities include smaller U.S. airlines. It is the Department's tentative determination that the proposed enforcement policy would, as explained above, give smaller airlines a better opportunity to compete against larger airlines by guarding against exclusionary practices on the part of the larger airlines. To the extent that the proposed policy results in increased competition and lower fares, small entities that purchase airline tickets will benefit. Our proposed policy contains no direct reporting, record-keeping, or other compliance requirements that would affect small entities.

Interested persons may address our tentative conclusions under the Regulatory Flexibility Act in their comments submitted in response to this request for comments.

PAPERWORK REDUCTION ACT: This policy statement contains no collection-of-information requirements subject to the Paperwork Reduction Act, P.L. No. 96-511, 44 U.S.C. Chapter 35.

FEDERALISM IMPLICATIONS: This policy statement would have no substantial direct effects on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government. Therefore, in accordance with Executive Order 12812, we have tentatively determined that this policy does not have sufficient federalism implications to warrant preparation of a Federalism Assessment.

(Authority Citation: 49 U.S.C. §41712.)

Issued in Washington, D.C., on April 6, 1998.

Rodney E. Slater, *Secretary of Transportation*

Appendix B

Recommendations from *Winds of Change* * Concerning Competition and Other Relevant Topics

ANTITRUST POLICY

The Committee recommends that the Department of Justice (DOJ) oppose mergers or acquisitions in which carriers offer substantial parallel service in city-pair markets or share a hub airport. However, DOJ should not necessarily oppose mergers or asset acquisitions of carriers with complementary or end-to-end routes. Such mergers or asset acquisitions often may not harm competition. Given the importance of having at least three effective competitors in city-pair markets involving a connection at a hub, the maintenance of this level of choice for con-

* TRB. 1991. *Special Report 230: Winds of Change: Domestic Air Transport Since Deregulation.* National Research Council, Washington, D.C., 399 pp.

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sumers should be used as a test for the adequacy of competition in "over hub" traffic when merger and acquisition proposals are considered, including acquisitions of individual assets, such as gates.

COMPUTER RESERVATION SYSTEMS (CRSs)

The committee recommends that travel agents be allowed to use their own equipment or desk equipment leased from the host carrier to access multiple CRSs. This would require a Department of Transportation (DOT) regulation to prohibit contract or lease terms that restrict the ability of travel agents to use equipment that is connected to a CRS to switch freely among CRSs, along with continuing the prohibition against display and function bias and extending it beyond CRS owners to any software used in the interface allowing multiple access.

CONSUMER INFORMATION

The committee recommends improving consumer information by requiring agents to disclose the incentive commissions (commission overrides) that they receive from carriers. This could be accomplished by a DOT regulation that has the effect of making consumers aware of the existence of override programs and the identity of the carriers favored by the agent.

CONGESTION PRICING

DOT should permit and encourage airports to experiment with congestion pricing and invite evaluation of the effectiveness of these efforts by independent researchers. In the development of these proposals, DOT should consider how to avoid the potential exercise of monopoly power by airports or airlines and their customers and how the revenues earned by congestion pricing will be used to provide needed additional capacity.