THE AIRLINES INDUSTRY, CONCENTRATION, AND ALLEGATIONS OF COLLUSION

By Paula W. Render[1]

I. INTRODUCTION

In 1978, when Congress deregulated the airline industry, there were 10 airlines that provided scheduled national and international service, and those 10 accounted for 90 percent of the domestic marketplace.[2] Today, there are four major airlines and a few smaller ones providing comparable service, and the four major airlines provide 80 percent of U.S. domestic flights.[3] This consolidation occurred due to mergers, but also as the result of the industry's chronic lack of profitability. The airline industry lost about $60 billion in the three decades following deregulation.[4] There were over 160 airline bankruptcy filings in that period, leading the Government Accountability Office ("GAO") to conclude in 2005 that bankruptcy is "endemic"

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[2] Micheline Maynard, *Did Ending Regulation Help Fliers?*, N.Y. TIMES (Apr. 17, 2008), http://www.nytimes.com/2008/04/17/business/17air.html?_r=0.
[3] Drew Harwell, Ashley Halsey III & Thad Moore, *Justice Dept. Investigating Potential Airline Price Collusion*, THE WASHINGTON POST (Jul. 1, 2015), https://www.washingtonpost.com/business/economy/doj-investigating-potential-airline-collusion/2015/07/01/42d99102-201c-11e5-aeb9-a411a84c9d55_story.html.
[4] Caitlin Kenny, *Why Airlines Keep Going Bankrupt*, NPR (Dec. 16, 2011), http://www.npr.org/sections/money/2011/12/16/143765367/why-airlines-keep-going-bankrupt.

to the industry because of underlying structural issues.[5] As Virgin Airlines CEO Richard Branson stated, "If you want to be a millionaire, start with a billion dollars and launch a new airline."[6]

The airlines have turned this dismal performance around, at least temporarily, giving rise not just to accolades for good management but also to scrutiny from the Department of Justice ("DOJ") for potential collusion. For the first three quarters of 2015, the combined net income of U.S. airlines was $17.9 billion.[7] Compared to earlier years, when the industry's combined net income rarely topped $2 billion, 2015 was a dramatic departure from the past. The record earnings are attributed to lower fuel prices, higher fees and full planes.

It is the latter that are the focus of a pending DOJ investigation. The DOJ is apparently concerned that the airlines are colluding to restrict capacity to keep airfares high. At the same time, lawmakers and consumer advocates are demanding an investigation to determine whether concentration in the industry has facilitated collusion. As Senator Richard Blumenthal put it: "[c]onsumers are suffering rising fares and other added charges that seem to be the result of excessive market power concentrated in too few hands and potential misuse of that power."[8]

The industry's history suggests that the airlines have gotten tired of red ink and learned to manage for profitability. This paper summarizes the historical forces that have led to the current focus on capacity, which is most likely explained as the natural result of the lawful desire to run a profitable business.

II. FROM REGULATION TO DEREGULATION

The first commercial flight occurred in 1914. It flew from St. Petersburg, FL, to Tampa, at an altitude of 15 feet above Tampa Bay. The single passenger seat on the 23 minute flight was sold at auction for over $9,000 in today's dollars.[9]

The development of commercial aviation as well as its regulation began with the Air Mail Act of 1925.[10] The Act authorized the awarding of government mail contracts to private carriers, established the rates for transporting mail and setting the airmail rates. In 1926, the Air Commerce Act of 1926 established federal regulations regarding aircraft, personnel, navigational facilities and air traffic.[11] It also provided for the federal government to build

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[5] U.S. GOV'T ACCOUNTABILITY OFF., GAO-05-945, COMMERCIAL AVIATION: BANKRUPTCY AND PENSION PROBLEMS ARE SYMPTOMS OF UNDERLYING STRUCTURAL ISSUES 12 (2005) ("2005 GAO Report").

[6] Alex Mayyasi, *Can Airlines Make Money?*, PRICEONOMICS (Nov. 5, 2015), http://priceonomics.com/can-airlines-make-money/.

[7] Bart Jansen, *Airlines to Report 'Blowout' Record Profits Amid Low Gas Prices, Higher Fees*, USA TODAY (Jan. 12, 2016), http://www.usatoday.com/story/travel/flights/2016/01/12/airline-profits-2015/78647924/.

[8] THE WASHINGTON POST, *supra* note 2.

[9] Susan Carey, *First Airline Offered No Frills, Many Thrills*, THE WALL STREET JOURNAL (Jan. 1, 2014), http://www.wsj.com/articles/SB10001424052702304361604579290493407153708.

[10] 39 U.S.C. § 5401 *et seq*.

[11] 49 U.S.C. § 171 *et seq*.

airports and take steps to make flying safer. Other Acts followed, as Congress experimented with different forms of regulation. The Civil Aeronautics Act of 1938 created a new agency, eventually called the Civil Aeronautics Board ("CAB"), to regulate airline fares, routes, and safety and investigate aircraft accidents. Over the following decades, the federal government established passenger taxes to fund the creation of new airports and continued the regulation of prices and routes, air traffic, accident investigation and other aspects of airline operation. Airlines could not add or drop routes or change fares with permission from CAB.

CAB's regulation of the airline industry was criticized as preventing competition and entry. In 1976, Senator Ted Kennedy published a law review comment[12] summarizing the case for deregulation, based on a Senate investigation into that subject. He reported that although CAB had received 79 applications from would-be entrants since 1950, it had denied them all and had not permitted any new "trunk" airlines (the term used then for airlines that provided scheduled national and international air service) to compete with the original trunk airlines. Senator Kennedy reported that CAB had "secretly instituted a route moratorium" in which it denied "virtually all" proposals for route competition. According to his article, CAB had also "virtually outlaw[ed] price competition and now sets all coach and first class fares within the Continental United States according to a formula which seems to be based primarily on administrative convenience."[13] Kennedy offered the example of World Airways, a small airline that in 1967 offered to fly coast to coast for $75 while CAB's approved fare for that route was $145. CAB sat on the application for six years and then dismissed the application as "stale." The investigation led the Senate Subcommittee on Administrative Practice to recommend deregulation and an overhaul of CAB's oversight procedures.

The recommended reforms were implemented by the Airline Deregulation Act of 1978, which opened up competition in the airline industry by allowing carriers to enter and leave domestic markets and set prices and conditions of service without government authorization.[14] This Act completely transformed the airline industry. In the regulated world, the airlines' rate of return was guaranteed. Without the ability or need to compete on price, they had competed on amenities and service. They offered economy class lounges, at-your-seat meat carving and meals served by on-board chefs, a standard seat pitch of 34 inches (versus today's 31 inches), and other features that today's traveler will never see. On the other hand, few consumers could afford to fly. In 1974, an airline could not charge less than $1,442 (in inflation-adjusted dollars) for a flight between New York City and Los Angeles[15]; today, we can fly that route for far less.[16] In 1965, no more than 20 percent of Americans had ever flown in

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[12] Edward M. Kennedy, *Comment: The American Airlines Industry and the Necessity of Deregulation*, 9 AKRON L. REV. 631 (1976).

[13] *Id*. at 632.

[14] *Statement of John M. Nannes, Deputy Assistant Attorney General, Antitrust Division, Before the Committee on Transportation & Infrastructure, U.S. House of Representatives, Concerning Antitrust Analysis of Airline Mergers*, U.S. Department of Justice, June 13, 2000, available at https://www.justice.gov/archive/atr/public/testimony/4955.pdf, at 2-3.

[15] Derek Thompson, *How Airline Ticket Prices Fell 50% in 30 Years (and Why Nobody Noticed)*, THE ATLANTIC (Feb. 28, 2013), http://www.theatlantic.com/business/archive/2013/02/how-airline-ticket-prices-fell-50-in-30-years-and-why-nobody-noticed/273506/.

[16] According to American Airlines' website on April 29, 2016, the cheapest ticket available to fly the New York LaGuardia to LAX route on May 29, 2016, was $442. A first class ticket could be purchased for $1,151. The fares shown on the website reflected another interesting aspect of today's airline pricing: the available fares included $442

an airplane. By 2000, 50 percent of the country took at least one round-trip flight a year. The average was two round-trip tickets.[17]

Deregulation led to other changes that impact competition today. The legacy airlines transformed their routes into a hub-and-spoke design. In this design, all routes have an end-point at a few major airports, the hubs. The other endpoint of the routes, or spokes, reach other, non-hub airports. This allowed the airlines to improve the capacity utilization of their planes by concentrating passenger flow through the hubs. The hub design made it possible for airlines to provide service to a greater number of cities, and more frequent service, than the previous point-to-point design that existed in the regulated regime.[18] The hub design has also been the focus of scrutiny for allegedly raising barriers to new entry.[19]

Deregulation also resulted in the development of low-cost carriers ("LCCs"). LCCs offer few amenities, charge for baggage and drinks, offer simplified rate structures, standardize their fleets to reduce cost and offer lower fares than "legacy carriers" (the airlines that existed during regulation). They focus on shorter routes where cost control can have more impact than on long-haul routes, and at least initially, LCCs provided point-to-point service rather than using the hub design. Today most have moved to a hybrid in which they use focus cities (or "mini-hubs") and point-to-point routing. PeopleExpress was an early LCC that perhaps exemplified the no-frills approach of the LCCs. It collected fares inflight, permitted one free bag and charged for each additional, and charged fifty cents for a can of soda. Its fares were equally no-frills. For example, its flight between Brussels and Newark in 1985 cost the equivalent of $334.00 in today's dollars. By 2003, the surviving LCCs competed in 45.5 percent of the routes served by legacy airlines, serving 84.6 percent of passengers in the top 5,000 markets.[20]

The industry expanded threefold between 1980 and 2005. The consumption of airline travel as measured by revenue passenger miles ("RPM") grew from 188 billion RPMs in 1978 to 584 billion RPMs in 2005, while airline capacity grew at a similar pace—from 306 billion available seat miles ("ASM") in 1978 to 758 billion ASMs in 2005. The number of unique city-pairs served by airlines rose from just over 6,000 in 1980 to more than 15,000 in 2012.[21] The average number of competitors increased from 2.2 per city-pair to 3.5 in that period.[22]

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for coach class; $16,694 for business class (to confirm, the business class fare was sixteen thousand six hundred and ninety-four dollars), and $1,151 for first class.

[17] Thompson, *supra* note 14.

[18] Nannes, *supra* note 13, at 3.

[19] For example, the Division's concern that Northwest and Continental "dominate their respective hubs" was a factor in its opposition to Northwest's attempt to buy a controlling interest in Continental in 1998. *The Importance of Entry Conditions in Analyzing Airline Antitrust Issues Address by John M. Nannes, Deputy Assistant Attorney General, Antitrust Division, U.S. Department of Justice, Before the International Aviation Club*, U.S. Department of Justice, July 20, 1999, available at https://www.justice.gov/atr/speech/importance-entry-conditions-analyzing-airline-antitrust-issues. *See also infra* note 19, at 16 (reporting on higher fares paid by passengers served by "fortress hubs.").

[20] U.S. GOV'T ACCOUNTABILITY OFF., GAO-06-630, AIRLINE DEREGULATION: REREGULATING THE AIRLINE INDUSTRY WOULD LIKELY REVERSE CONSUMER BENEFITS AND NOT SAVE AIRLINE PENSIONS 17 (2006) ("2006 GAO Report").

[21] IATA ECONOMICS BRIEFING NO. 10: PROFITABILITY AND THE AIR TRANSPORT VALUE CHAIN 19 (International Air Transport Association 2013).

[22] 2006 GAO Report, at 4.

Over the same period, passengers increased from 254 million to 670 million.[23] This explosion in demand did not lead to higher prices. The median airfare declined almost 40 percent in that period.[24]

III. FROM RED INK TO PROFITABILITY

In the years following deregulation, demand exploded, competition expanded and flights and service increased. It was all good news, except for the financial performance of the industry, which was among the worst in the U.S. economy.

LCCs struggled initially after deregulation to compete with better-capitalized legacy carriers, and a number failed. According to a report by the GAO, most of the new entrants into the airline industry during the 1980s and 1990s failed.[25] But the tide eventually turned against the legacy carriers. The GAO observed that the legacy airlines carried over cost structures that had developed during the period of regulation when airfares were set by a guaranteed rate of return, including a heavily unionized labor force. Demand for air travel declined significantly in the early 2000s due to an economic downturn, the September 11, 2001, terrorist attacks and the outbreak of SARS. At the same time, the legacy carriers were losing passengers to the new LCCs. The GAO noted that the legacy airlines had reduced costs in response to market costs, but mostly by reducing capacity and not nearly enough to be competitive with low cost airlines.[26]

The airline industry overall lost over $30 billion in the three decades following deregulation, according to data from Airlines for America, an airline trade association.[27] As Figure 1 shows, in the 25 years since deregulation, the industry had negative net income in 16 years and never managed to be profitable for more than 6 years in a row.

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[23] *Id*. at 10.
[24] *Id*. at 18.
[25] *Id*. at 16.
[26] 2005 GAO Report, at 5.
[27] Caitlin Kenny, *Why Airlines Keep Going Bankrupt*, NPR (Dec. 16, 2011), http://www.npr.org/sections/money/2011/12/16/143765367/why-airlines-keep-going-bankrupt.

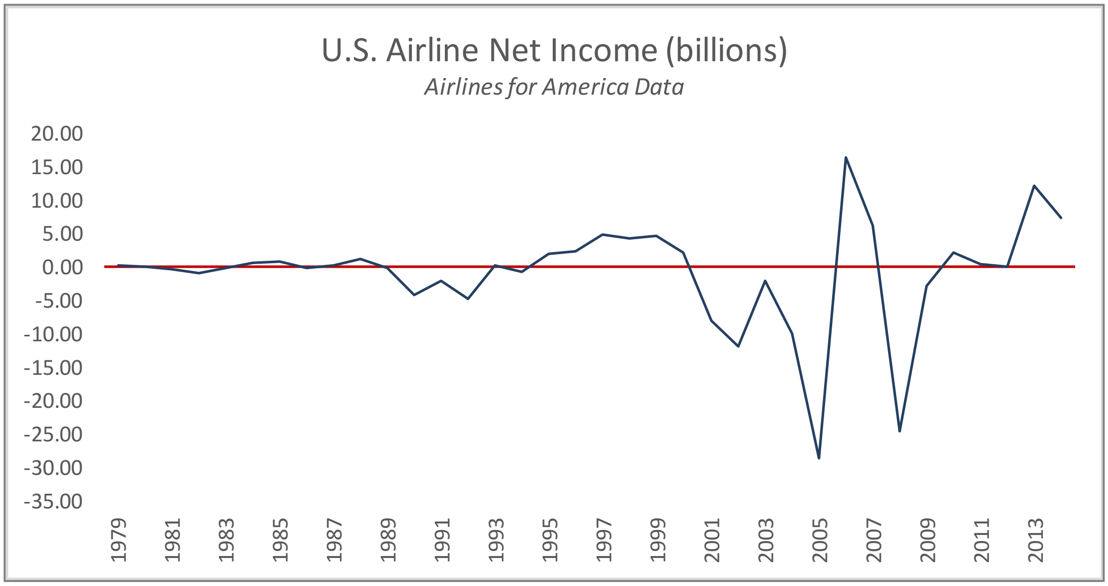

Figure 1.[28]

According to a McKinsey study, between 1965 and 2007, the airline industry generated one of the lowest returns on capital of all industries.[29]

One cause of this dismal performance was excess capacity. Capacity in the airlines industry is measured in ASMs, and capacity utilization is measured by the "load factor." An airline's break-even load factor varies depending on fuel and other costs. The Department of Transportation reported that break-even load factors increased sharply from 2000 to 2003, increasing for United Airlines and US Airways, for example, from 77.7 percent in the first quarter of 2000 to 114 percent in the first quarter of 2003. In other words, those airlines could not have been profitable at then-prevailing prices even if they sold every seat. Other carriers had break-even load factors approaching 100 percent. Far from reaching these break-even points, however, from the late 1990s until 2008, airlines frequently added flights, increased plane size and added new routes, not based on demand but in a battle for market share.[30] This attempt to buy market share had the predictable results, especially given the one-passenger per plane difference between black and red ink.

In 2008 and 2009, the worldwide financial crisis slashed demand for air travel, oil prices shot up and airline income plunged again.[31] To stem their losses, the airlines began cutting routes and the frequency of flights on the routes they continued to serve.[32] But as demand increased in the years following the financial crisis, the airlines did not add significant

[28] *Profitability Trends of U.S. Passenger Airlines in the Deregulated Era*, AIRLINES FOR AMERICA (last visited May 2, 2016), http://airlines.org/data/profitability-trends-of-u-s-passenger-airlines-in-the-deregulated-era/.
[29] IATA ECONOMICS BRIEFING NO. 10, *supra* note 20, at 12.
[30] Ben Mutzabaugh, *Airline 'Capacity Discipline' in Spotlight After Justice Probe,* USA TODAY (July 1, 2015), http://www.usatoday.com/story/todayinthesky/2015/07/01/airlines-capacity-discipline-in-spotlight-after-justice-probe/29580687/.
[31] IATA ECONOMICS BRIEFING NO. 10, *supra* note 28.
[32] *See* Geoff Colvin, *Jeff Smisek: United Continental's king of the skies*, FORTUNE (Apr. 21, 2011), http://archive.fortune.com/2011/04/19/news/companies/jeff_smisek_united_continental.fortune/index.htm.

capacity, even as demand increased.[33] The average domestic load factor for all airlines in the United States by year increased from 72.68 percent in 2003 to a high of 84.98 percent in 2015.[34]

IV. THE CURRENT INVESTIGATION

In June 2015, the DOJ launched an investigation into "possible unlawful coordination by some airlines."[35] Delta Air Lines, Southwest Airlines, American Airlines, and United Airlines confirmed that they are among the airlines being investigated. The investigation initially focuses on public statements by airline executives about "capacity discipline," meaning a resistance by the airlines to add more planes and flights even though their profits have soared. News articles report that Division officials are also concerned that common ownership of airlines by large investors may facilitate capacity coordination and result in higher prices.[36] The officials have asked the airlines for information on meeting at which industry capacity was discussed with investors whose stake in the airlines exceeds two percent.[37]

The airlines are focused on what they refer to as "capacity discipline."[38] As then-United Airlines CEO Jeff Smisek explained in 2011, "[w]e've been very disciplined at United and across the industry in making sure we've got the right level of capacity and not supplying overcapacity, driving down pricing."[39] Capacity increases in early 2015 unnerved investors; in June 2015, airline executives addressed those fears at a meeting of the International Air Transport Association. Delta's president, Ed Bastian, told the press that his airline was "continuing with the discipline that the marketplace is expecting." American Airlines' chief, Doug Parker, said the airlines had learned their lessons from past price wars. "I think everybody in the industry understands that," he told Reuters.[40]

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[33] *Airline Industry Will Have to Maintain Capacity Discipline to Remain Profitable*, FORBES (Jun. 20, 2014), http://www.forbes.com/sites/greatspeculations/2014/06/20/airline-industry-will-have-to-maintain-capacity-discipline-to-remain-profitable/#6c320a475eb0.

[34] Load Factor (passenger-miles as a proportion of available seat-miles in percent (%)) All Carriers - All Airports, UNITED STATES DEPARTMENT OF TRANSPORTATION, OFFICE OF THE ASSISTANT SECRETARY FOR RESEARCH AND TECHNOLOGY, BUREAU OF TRANSPORTATION STATISTICS (last visited May 2, 2016), http://www.transtats.bts.gov/Data_Elements.aspx?Data=5.

[35] THE WASHINGTON POST, *supra* note 2.

[36] David McLaughlin and Mary Schlangenstein, *U.S. Looks at Airline Investors for Evidence of Fare Collusion*, BLOOMBERG (Sept. 22, 2015), http://www.bloomberg.com/news/articles/2015-09-22/do-airfares-rise-when-carriers-have-same-investors-u-s-asks.

[37] *Id.*

[38] It is worth noting that capacity discipline does not mean capacity reduction. Business Travel News reported in July 2015 that total U.S. airline capacity increased 3.8 percent in June 2015 compared to June 2014, and that "[o]verall demand rose in the same proportion, and thus load factors remained steady at 86.5 percent." *Total U.S. airline capacity increased 3.8 percent in June compared with the same month last year*, BUSINESS TRAVEL NEWS (Jul. 15, 2015), http://www.businesstravelnews.com/Strategic-Sourcing/Total-U-S-airline-capacity-increased-3-8-percent-in-June-compared-with-the-same-month-last-year-.

[39] Colvin, *supra* note 31.

[40] James B. Stewart, *'Discipline' for Airlines, Pain for Fliers*, N.Y. TIMES (June 11, 2015), http://www.nytimes.com/2015/06/12/business/airline-discipline-could-be-costly-for-passengers.html.

The only question is whether the airline managers are focused on capacity discipline because of an unlawful agreement, or because the history of the industry has led them to conclude that flooding the marketplace with empty seats is a bad strategy. With more than $30 billion lost by this industry in the last three decades, a federal investigation hardly seems necessary.

V. CONCLUSION

If the DOJ discovers that the airlines have reached an unlawful agreement to constrain capacity, then it can take steps to punish the wrongdoers and protect consumers. But given the history of the industry, it is not at all difficult to believe that the airlines have simply decided to stop cutting their own throats.