The State of Airline Competition and Prospective Mergers

Statement of

Steven A. Morrison
Professor and Chair, Department of Economics
Northeastern University
Boston, MA 02115
617-373-2873
s.morrison@neu.edu
http://www.economics.neu.edu/morrison/research

and

Clifford Winston
Senior Fellow, Economic Studies Program
The Brookings Institution
1775 Massachusetts Avenue, NW
Washington, DC 20036
202-797-6173
cwinston@brookings.edu
http://www.brookings.edu/scholars/cwinston.htm

"Competition in the Airline Industry"
Hearing before the
Judiciary Committee Antitrust Task Force
United States House of Representatives

April 24, 2008

Introduction

This fall the United States will celebrate the 30th anniversary of the Airline Deregulation Act of 1978—and the nation does have reason to celebrate because airline deregulation has benefited both travelers and carriers. Among the most important benefits: fares have fallen significantly, flight frequency has increased, and carriers have become more efficient. Moreover, these benefits have been realized while air travel safety continues to improve.

However, it would be misleading to conclude that the industry's adjustment to deregulation—and the extent of deregulation—is complete. Airline industry earnings have fluctuated greatly since deregulation and the industry has yet to earn a normal rate of return on invested capital on a consistent basis. Accordingly, carriers continue to seek ways to reduce costs and increase profitability, especially in light of recent opportunities to expand their international operations as part of the March 2008 Open Skies agreement with the European Union. Further deregulation of international markets could occur through Open Skies agreements with countries outside of the EU.

Mergers are one strategy that some airlines have pursued to improve the efficiency of their networks and to expand their domestic and international route coverage. Recently, Northwest Airlines and Delta Air Lines have filed an application to merge their operations and it is expected that other merger proposals will follow. This testimony provides some perspective on the motivation for and likely effects of airline mergers in the context of the current state of airline competition. We also note some policies that would spur additional competition in the industry.

The State of Airline Competition

The standard way to measure airline competition is the number of effective competitors (i.e., equivalent equal-sized carriers) on a route. Figure 1 shows that competition on all routes increased for several years after deregulation in 1978, and that it has fluctuated somewhat because of mergers in the late 1980s, the macroeconomic expansion in the late 1990s, and the 2001 terrorist attacks. Although the figure shows that the number of competitors varies by route distance, in general, airline competition today is nearly as great as it ever was. In fact, competition may be at an all-time high because of the growth of low-cost carriers. That is, the intensity of competition on a route is determined by the number of airline carriers and the *identity* of the carriers. Figure 2 shows that the percentage of passenger miles where low-cost carriers compete for traffic with legacy (i.e., pre-deregulation) carriers continues to increase.

The number and identity of airlines in city pair markets has been sufficient to cause real airline fares to continue their long term decline (figure 3). Of course, some travelers pay higher fares per mile than other travelers pay; but competitive pressures continue to keep real fares from rising. This fact is of particular importance for the current financial health of the industry because fuel prices have recently increased dramatically (figure 4). As recently as 1998 jet fuel accounted for less than 10 percent of airline costs. So far this year, it accounts for more than one-third of airline costs; thus, the industry is under additional pressure to reduce costs.

Competition unleashed by deregulation has caused airlines to become more efficient. In the decade before deregulation, load factors—or the percentage of seats filled with paying passengers—were around 55 percent (figure 5). Load factors have increased since deregulation, indicating that airlines are making more efficient use of their available seat capacity. In the wake of September 11, carriers have not increased their seat capacity as fast as passenger demand has risen, resulting in load factors that have climbed to record levels of nearly 80 percent.

Given such high load factors, it would be expected that the U.S. airline industry would be making handsome profits, but that is not the case. In 2006 and 2007, the industry rebounded to a modest extent from its substantial losses following the September 11, 2001 terrorist attacks, only to report a loss in the first quarter of 2008.

Prospective Mergers

Given the current state of the macroeconomy and the recent increase in fuel prices, airlines are under increasing pressure to reduce costs and increase revenues. How do mergers fit into the picture?

In a 2000 paper, we analyzed the determinants of all the actual and attempted airline mergers since 1978. We found that carriers are generally not motivated to merge for anticompetitive reasons, but rather by the acquiring carriers' desire to expand their international routes—which are more profitable than most domestic routes due to government agreements that limit entry—and by the acquired carriers' need to be rescued from financial distress.

What about evidence on the effects of previous mergers on travelers? In the aforementioned paper, we found that the USAir-Piedmont merger and the Northwest-Republic and TWA-Ozark mergers, which were opposed by the Justice Department but approved by the U.S. Department of Transportation (at the time DOT had jurisdiction in the matter), had benign effects on fares.

In light of this evidence, the merger between Delta and Northwest appears to be motivated by the merged airline's desire to offer expanded international operations, to restructure its network to attract more business travelers in its traffic mix thus increasing revenues, and to achieve cost reductions by, for example, retiring older aircraft. It is highly unlikely that a merged Delta and Northwest would reduce competition on those routes that both carriers served (or could serve) because low-cost carriers tend to move very quickly to mitigate fare increases initiated by legacy carriers.

Generally, the effect on travelers of changes in airline market structure caused by mergers depends on the specific carriers that exit a market and the specific carriers that take their place.

Further Policy Considerations

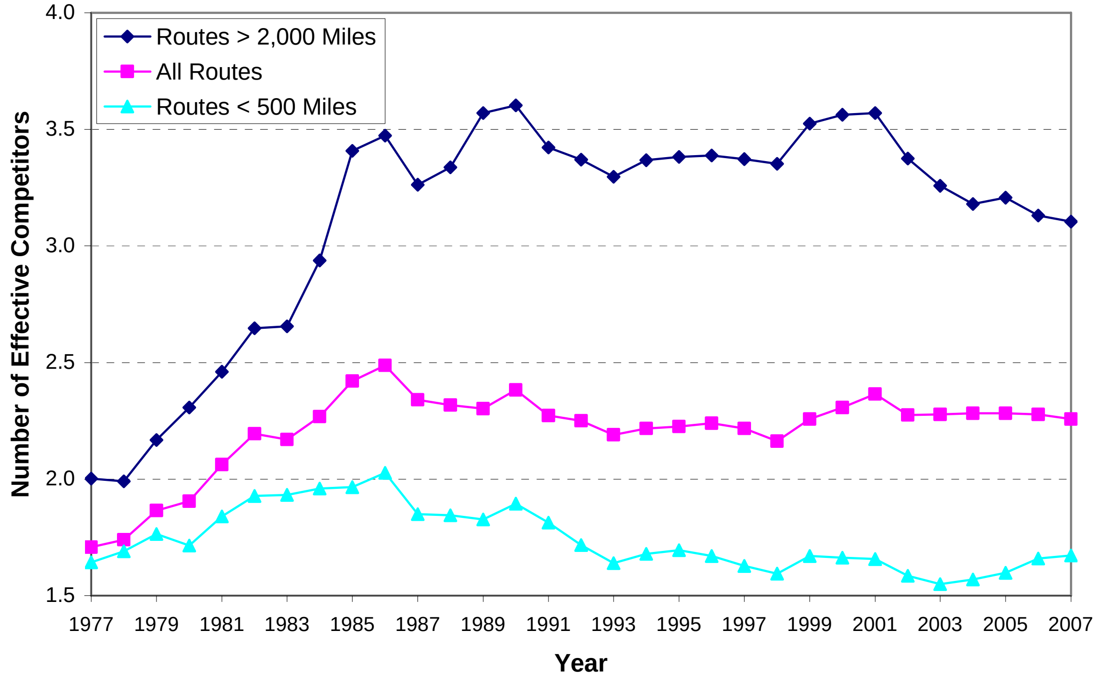
Thus far we have confined our statement to mergers, which are intended to help airlines without harming travelers. Taking a broader perspective, policies exist that could have a beneficial impact on the welfare of air travelers by increasing competition on international and domestic routes, but industry earnings could be reduced.

With one swift stroke, deregulation of international markets would spur competition on international routes and possibly eliminate a major motivation for some prospective mergers. The recent Open Skies agreement with the EU is a positive step that should be replicated by the United States with all regions of the world. Government-mandated limits on foreign ownership of U.S. carriers should be eliminated, which would make it easier for struggling U.S. carriers to attract foreign capital to help solve their financial problems and possibly eliminate another major reason that carriers seek a merger.

Allowing foreign carriers to serve U.S. domestic routes (cabotage) would provide another source of competition that would benefit air travelers. Think of how foreign transplants have transformed the automobile and steel industries to the benefit of consumers. Still another source of competition could be developed by allowing foreign investors to establish a new U.S. carrier without any limits on foreign ownership of the carrier.

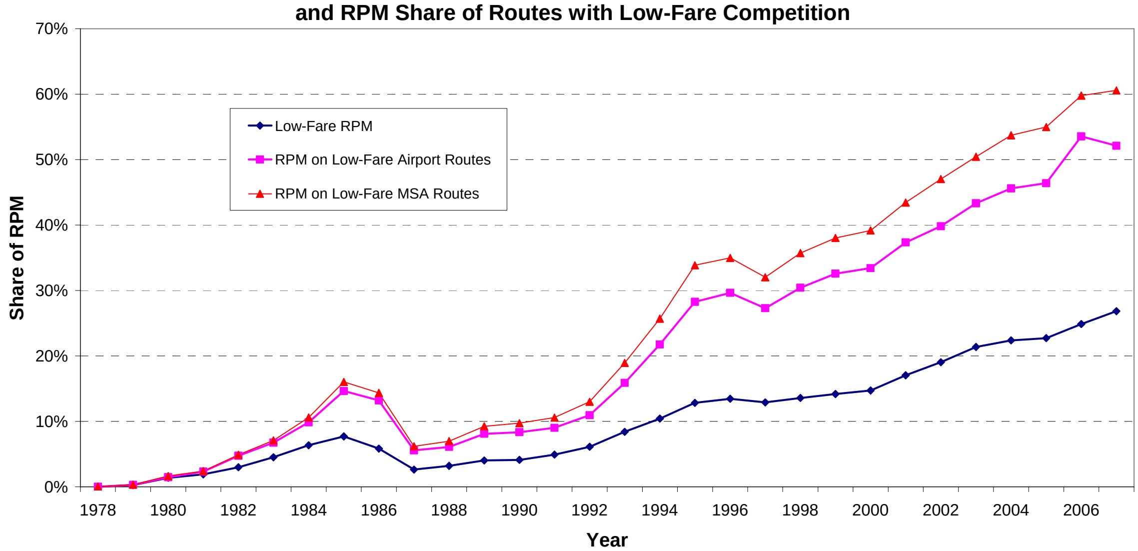
Finally, policy makers could potentially stimulate airline competition by experimenting with privatization of some U.S. airports, thereby allowing them to compete aggressively for air carrier service. Competitive entry at some airports is constrained by insufficient gates and terminal space. Given the contractual relationship governing publicly owned airports and the incumbent airlines that help pay their bonds, some airports have limited incentives to attract additional carriers.

Figure 1
Competition at the Route Level



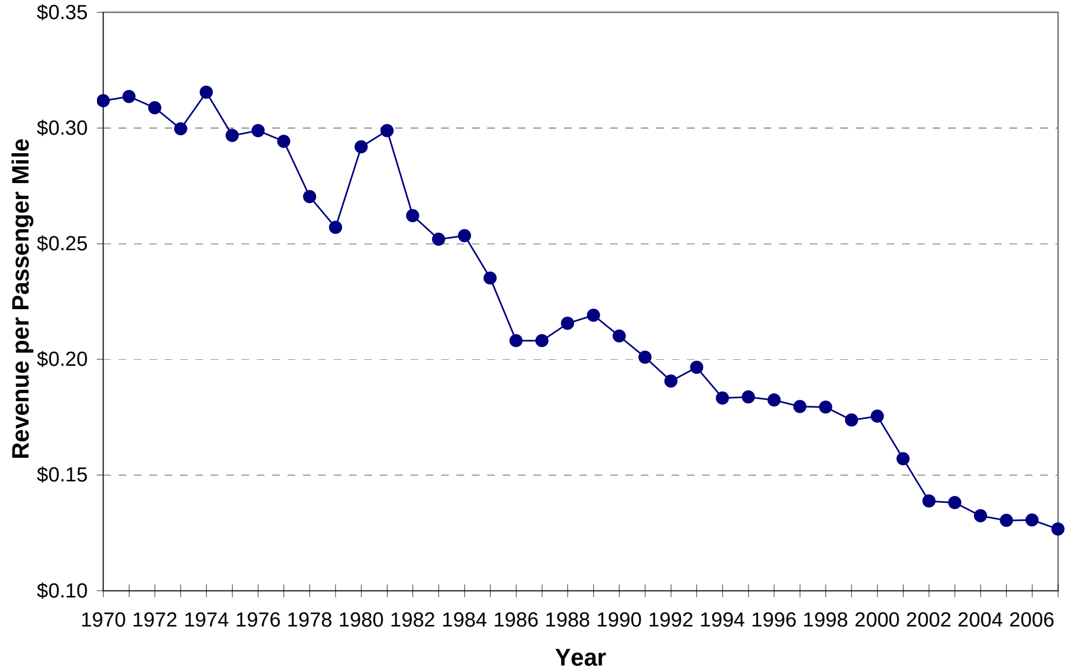
Source: Authors' calculations using data in U.S. Department of Transportation, Data Banks 1A and 1B

Figure 2
Revenue Passenger Mile Share of Low-Cost Carriers
and RPM Share of Routes with Low-Fare Competition



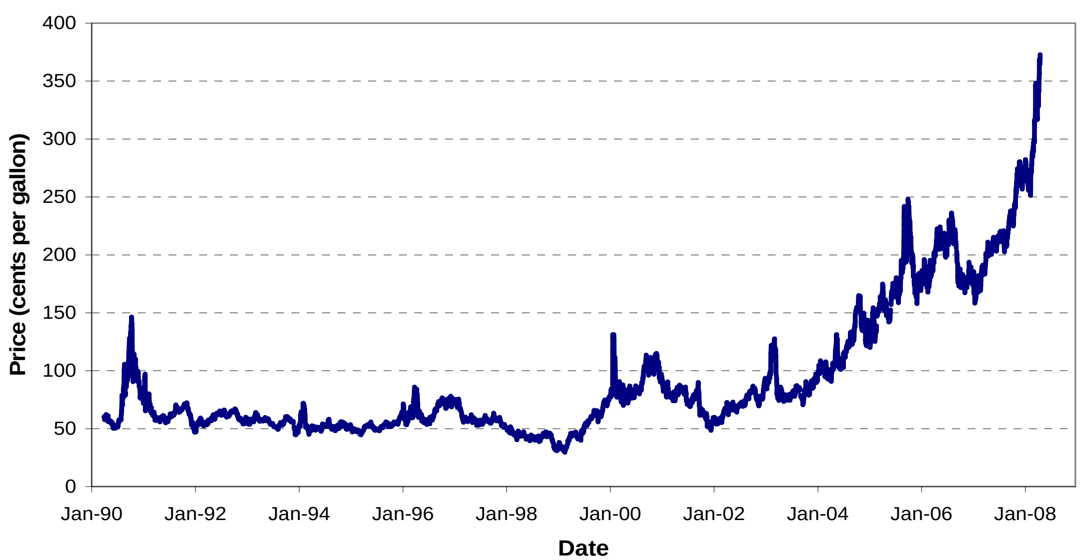
Source: Authors' calculations using data in U.S. Department of Transportation, Data Banks 1A and 1B

Figure 3
Domestic Airline Yield Adjusted for Inflation (2007 dollars)



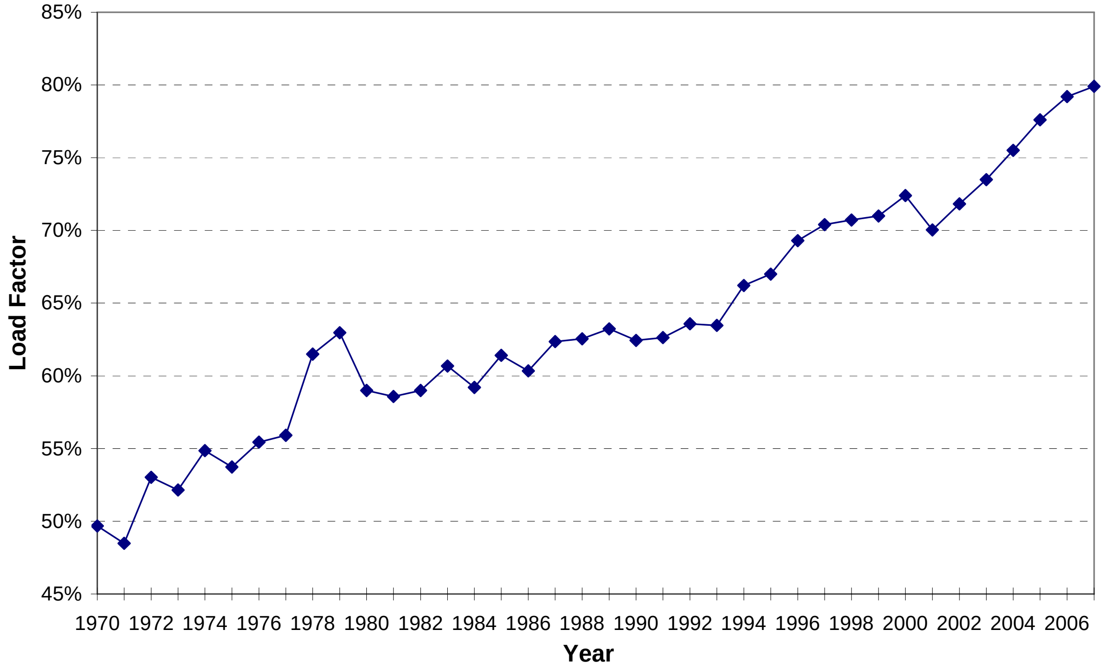
Source: Authors' calculations using data from the Air Transport Association

Figure 4
Daily Spot Price of Kerosene-Type Jet Fuel
(FOB New York Harbor)



Source: U.S. Energy Information Administration

Figure 5
Percentage of Seats Filled with Revenue Passengers



Source: Air Transport Association