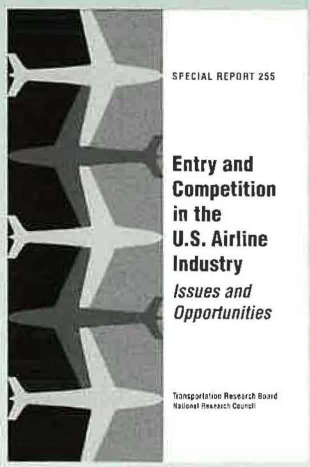
Policies to Promote Airline Competition

New TRB Special Report

THOMAS R. MENZIES, JR.



The federal government should make more consistent and concerted efforts to promote competition in the U.S. airline industry, urges an expert committee in a new Transportation Research Board report, Special Report 255: *Entry and Competition in the U.S. Airline Industry: Issues and Opportunities*. To that end, suggests the committee, Congress and the U.S. Department of Transportation should rescind federal rules that inhibit airline operations and entry at some of the nation's most important airports, provide federal air traffic control services more rationally, and give airport operators more leeway to raise and spend funds for the supply of gates and other facilities needed by competitors. In addition, the U.S. Department of Justice should closely review proposed codeshare alliances, reciprocal frequent-flier programs, and other affiliations among major airlines that may be precursors to unhealthy consolidation in the industry. Although committee members differed on whether U.S. DOT should augment the Justice Department's efforts to police anticompetitive behavior in the industry, they all agreed that national aviation policy should be oriented toward creating and expanding opportunities for airline competition throughout the system.

"On the whole, we believe the Department of Transportation should concentrate on building an overall environment in which it is difficult to engage in anticompetitive conduct because rivals can more easily enter markets," said committee chair John R. Meyer, Professor Emeritus of Economics and James W. Harpel Professor of Capital Formation and Economic Growth, John F. Kennedy School of Government, Harvard University. "Even with the many benefits brought about by deregulation, we noted some alarming trends against healthy rivalry. Specific action needs to be taken to counter them."

Preserving Competitive Benefits of Deregulation

The new report, requested by Congress and funded by U.S. DOT, updates an earlier TRB report, Special Report 230: *Winds of Change: Domestic Air Transport Since Deregulation* (1991). The latter report documents many benefits derived from deregulation of the industry in the late 1970s. According to the new report, those benefits continue. Adjusted for inflation, average fares fell about 25 percent during the 1990s, reflecting a drop in both fuel prices and other costs during the decade, as well as the expansion of low-fare carriers, such as Southwest Airlines. Because of the hub-and-spoke systems operated by major airlines, travelers in a number of markets continue to enjoy multiple flight and service options; competition in many longer-haul markets—served by competing hub-and-spoke systems—is especially strong.

Certain characteristics of the industry, however, continue to generate concern. Although travelers in cities with major hub airports have available frequent, nonstop service to scores of cities, they also typically pay higher fares, on average, than travelers in other, nonhub (or spoke) markets. This is particularly true on short-haul routes, where hubbing carriers tend to dominate local traffic. Time-sensitive business travelers, who are most appreciative of the frequent flights permitted by hub-and-spoke networks, typically pay the highest fares. These travelers often fly during peak travel times and purchase unrestricted tickets that allow for itinerary changes and refundable cancellations, a costly service for airlines to provide. A concern, however, is that airlines have become so skilled at identifying price-inelastic business travelers—through restrictions such as weekend stayover requirements—that they are using their market power, especially in hub markets, to raise unrestricted fares beyond what it costs them to maintain the service.

In recent years, many low-fare airlines have attempted to enter markets dominated by hubbing carriers. They have met with mixed success. About 20 percent of airline passengers today fly on low-fare airlines, but mostly on Southwest. Several smaller and newer low-fare airlines have encountered aggressive responses by incumbent airlines, particularly in hub markets such as Atlanta, Dallas-Fort Worth, and Chicago. The new competitors have protested to U.S. DOT and Congress, accusing major airlines of setting fares below cost in an effort to divert traffic from the new entrants—effectively excluding them from the marketplace—and subsequently raising fares to recover the cost of this "predation."

In April 1998 U.S. DOT put forth a proposal to address these complaints. This proposal included several criteria for judging whether a major carrier's price-cutting response is rational given other response options. Committee members expressed concern that these criteria for identifying suspected predation could lead to arbitrary enforcement decisions, based largely on hypothetical and speculative reasoning. The committee acknowledged the difficulty of developing an empirical test for identifying potential predatory behavior, and commended the Justice Department for becoming more active in policing exclusionary practices in the airline industry. Committee members also commended U.S. DOT for raising the level of attention to the problem, but many expressed concern that the agency's administrative enforcement efforts could become increasingly regulatory and inhibit legitimate competitive responses. Others, however, judged the problem sufficient to warrant this risk, and favored the idea of U.S. DOT taking an active enforcement role.

Removing Longstanding Obstacles to Competition

The report's central message is that aviation policy should be aimed at increasing opportunities for airline competition and entry, which are natural protections against monopolistic and anticompetitive behaviors. Some impediments to competition—most notably slot controls and perimeter rules—stem from long-standing policies that were originally enacted to ease airport congestion.

Four of the country's largest airports—O'Hare in Chicago, LaGuardia and John F. Kennedy in New York City, and Reagan National in Washington, D.C.—operate under a 30-year-old slot-control system that sets hourly quotas on the numbers of takeoffs and landings. Perimeter rules, also approved about three decades ago, limit nonstop flights that exceed a certain distance traveling to and from LaGuardia, Reagan National, and Love Field in Dallas. These rules were intended to shift long-haul traffic toward other, nearby airports that could accommodate larger jet aircraft, which were introduced in the 1960s. Together, however, the regulations inadvertently make it difficult for new carriers to enter these airports, which are important destinations for business travelers. Established carriers hold most of the slots that allow airlines to operate from these airports. They also tend to have main hubs within the perimeter distances. Carriers that hold few slots or whose main hubs are beyond the perimeter limits are at a disadvantage in attracting business travelers to their networks.

Both slot controls and perimeter rules should be replaced with pricing strategies, such as higher airport landing charges or fees for using air traffic control services during peak periods, the report recommends. Pricing could be used to reduce delays caused by heavy demand on air traffic control and by overcrowding of airport runways and facilities; some traffic would be shifted to nonpeak times or to underused secondary airports. Chronic air traffic delays are particularly harmful to low-cost carriers, which depend on intensive labor and equipment usage to achieve a competitive advantage. The fees could also provide extra funds for construction of runways, gates, and other airport facilities where

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Committee for a Study of Competition in the U.S. Airline Industry

John R. Meyer *(Chair)*
Emeritus Professor of Economics and James W. Harpel Professor of Capital Formation and Economic Growth
John F. Kennedy School of Government
Harvard University
Cambridge, Massachusetts

Elizabeth E. Bailey
John C. Hower Professor and Chair
Public Policy and Management Department
University of Pennsylvania
Philadelphia, Pennsylvania

Jonathan B. Baker
Associate Professor of Law
Washington College of Law
The American University
Washington, D.C.

Roden A. Brandt
Air Transportation Consultant
Palm Harbor, Florida

Darius W. Gaskins, Jr.
Partner, Norbridge Inc., and High Street Associates Inc.
Ipswich, Massachusetts

José A. Gómez-Ibáñez
Derek C. Bok Professor of Public Policy and Urban Planning
Graduate School of Design and John F. Kennedy School of Government
Harvard University
Cambridge, Massachusetts

Cornish F. Hitchcock
Attorney
Washington, D.C.

Alfred E. Kahn
Robert Julius Thorne Professor of Political Economy, Emeritus
Cornell University
Ithaca, New York

Randall Malin
Air Transportation Consultant
Los Gatos, California

Steven A. Morrison
Professor
Department of Economics
Northeastern University
Boston, Massachusetts

Sherwin Rosen
Edwin A. and Betty L. Bergman Distinguished Service Professor of Economics
University of Chicago
Chicago, Illinois