

GAO

Testimony

Before the Subcommittee on Antitrust, Business Rights,
and Competition, Committee on the Judiciary, U.S. Senate

For Release
on Delivery
Expected at
2 p.m. EST
Thursday
March 19, 1998

AVIATION COMPETITION

International Aviation Alliances and the Influence of Airline Marketing Practices

Statement by John H. Anderson, Jr.
Director, Transportation Issues,
Resources, Community, and Economic
Development Division



Mr. Chairman and Members of the Subcommittee:

We appreciate the opportunity to testify on the United States' aviation relations with the United Kingdom (U.K.), our largest aviation trading partner overseas. Access to London's Heathrow Airport is important to any airline that desires to be a major participant in the transatlantic market. However, our current bilateral aviation agreement with the United Kingdom restricts the number of U.S. airlines that can serve Heathrow to two carriers—currently American Airlines (AA) and United Airlines. In June 1996, AA and the United Kingdom's largest airline, British Airways (BA), announced that they intended to form an alliance that would allow both carriers to market each other's flights as their own (referred to as "code-sharing") and that they would seek immunity for the alliance from U.S. antitrust laws. Such alliances must be approved by the Department of Transportation (DOT), and as a matter of U.S. policy, DOT only grants antitrust immunity to such alliances if there is an "open skies" agreement between the United States and the foreign airline's country.¹ DOT's negotiations with the British government were suspended in February 1997, and DOT is waiting to learn when the British would like to reopen negotiations.

Over the past several years, we have issued a number of products on international aviation issues, including our April 1995 report on the competitive impacts of code-sharing alliances and our June 1997 testimony on competition issues in the U.S.-U.K. markets.² As requested, for this testimony we drew on that body of work and interviewed U.S. and foreign government officials responsible for reviewing and/or approving the alliance, officials from airlines affected by the alliance, consumer groups, and other aviation experts to identify the major issues that they believe need to be considered in deciding whether to approve the alliance. My testimony today will address three questions: (1) What is the status of the various reviews of the proposed AA/BA alliance being undertaken by the European regulatory agencies and the U.S. Departments of Transportation and Justice? (2) What would be the competitive impact of the proposed alliance? and (3) To what extent should the sales and marketing practices

¹Generally, an open skies agreement removes all restrictions on air travel between two countries and allows airlines to fly between the countries when and where they want and to set fares in response to market forces.

²International Aviation: Airline Alliances Produce Benefits, but Effect on Competition Is Uncertain (GAO/RCED-95-99, Apr. 6, 1995) and International Aviation: Competition Issues in the U.S.-U.K. Market (GAO/T-RCED-97-103, June 4, 1997). Other related GAO products are listed at the end of this statement.

of American Airlines and British Airways be considered in reviewing the alliance?

In summary:

- European regulatory agencies have nearly completed their reviews of the proposed American Airlines/British Airways alliance. They are considering a range of issues that would have to be addressed as a condition of approving the alliance, including the number of slots and gates that other airlines would need at London's Heathrow Airport to compete, as well as American Airlines' and British Airways' sales and marketing practices. The European Commission³ anticipates its report proposing draft remedies for the American Airlines/British Airways alliance will be issued within the coming weeks. The United Kingdom, which is also reviewing the proposed American Airlines/British Airways alliance, is waiting for the European Commission to announce its draft remedies. In contrast, the U.S. Department of Transportation has not yet begun its formal review of the proposed alliance. Because neither American Airlines nor British Airways has filed all the documentation requested, the Department does not yet consider the application complete. As a result, Justice has not submitted formal comments on the alliance. Once American Airlines and British Airways file all of the requested documents, the Department of Transportation initially proposed holding an "oral hearing" to help complete its analysis of the issues in dispute. However, after receiving comments from the airlines, it is now reconsidering the type of hearing it may hold. In addition, the Department has reiterated that it will not approve the proposed American Airlines/British Airways alliance until the United States successfully negotiates an open skies agreement with the United Kingdom.
- The proposed alliance of American Airlines and British Airways—the two largest carriers in the U.S.-U.K. markets—raises significant competition issues. Currently, the two airlines account for nearly 58 percent of the available seats on scheduled U.S. and British airlines between the United States and London. In addition, they provide over 70 percent—and in some cases all—of the available seats on scheduled U.S. and British airlines between Heathrow and several key U.S. airports, including Chicago, Boston, and Miami. As a result of this level of market concentration, the

³The European Commission plays a central role in carrying out the activities of the European Union, a supranational organization that, as of March 1998, is composed of 15 European countries known as "member states." The European Commission—the European Union's executive institution—initiates proposals for legislation, ensures that provisions of the treaties that govern the European Union are properly implemented, and represents the European Union in international trade negotiations. The Commission's Directorate General for Competition is responsible for investigating airline alliances.

U.S. Department of Transportation's approval of the alliance would further reduce competition unless, as a condition of the approval, other U.S. airlines were able to obtain adequate access to Heathrow. Each major U.S. carrier we spoke with, as well as the other large British carrier that operates transatlantic service to the United States—Virgin Atlantic—emphasized that gaining a sufficient number of takeoff and landing slots, gates, and facilities at Heathrow was critically important to be able to compete effectively against the alliance, and several expressed doubt that the proposed alliance could be sufficiently restructured to prevent it from being inherently anticompetitive.

- Although slots, gates, and facilities are most important, most experts and some airline officials with whom we spoke also recognize that American Airlines' and British Airways' sales and marketing practices may make competitive entry more difficult for other airlines. Practices such as frequent flier programs⁴ and travel agent commission overrides⁵ encourage travelers to choose one airline over another on the basis of factors other than obtaining the best fare. Such practices may be most important if an airline is already dominant in a given market or markets. Ultimately, this may lead to higher fares than would exist in the absence of these marketing practices. Even so, the experts agreed that measuring the effect of these marketing practices is nearly impossible. In addition, mitigating their effect without banning them is difficult, and banning them involves a trade-off between their anticompetitive effect and the consumer benefits that some of them bring.

Background

In the international sector, the routes that airlines can fly, the frequency of their flights, and the fares they can charge are governed by 72 bilateral agreements between the United States and other countries. Many of these agreements, including the accord with the United Kingdom, are very restrictive. Since the late 1970s, U.S. policy has been to negotiate agreements that substantially reduce or eliminate bilateral restrictions. DOT's Office of the Assistant Secretary for Aviation and International Affairs, with assistance from the State Department, is responsible for negotiating these agreements and awarding U.S. airlines the right to offer the services provided for in those agreements.

⁴Under frequent flier programs, passengers qualify for awards by flying a certain number of miles with the sponsoring airline.

⁵A travel agent commission override is a special bonus commission paid by airlines to travel agents or agencies as a reward for booking a targeted proportion of passengers on their airline.

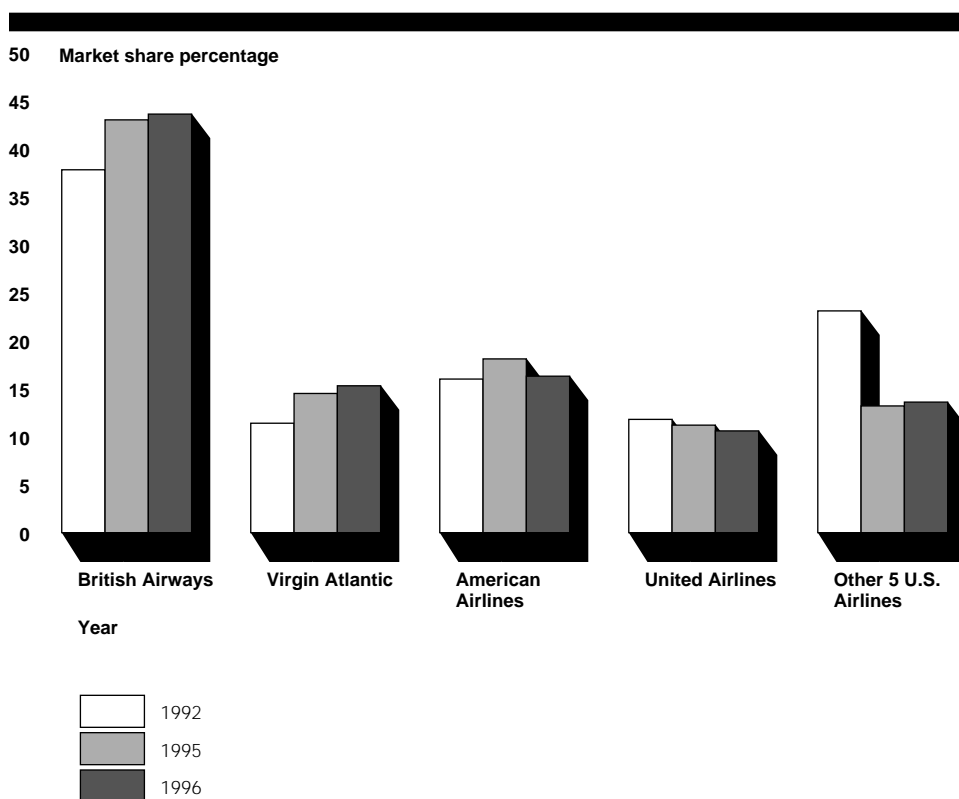
In January 1993, DOT granted antitrust immunity to the Northwest/KLM alliance in conjunction with the U.S.-Netherlands open skies accord. In April 1995, DOT issued the U.S. International Aviation Policy Statement in which it reiterated its desire for open skies agreements and endorsed the growing trend toward alliances between U.S. and foreign airlines. Since issuing that statement, DOT has negotiated a number of more liberal agreements, including open skies accords with Germany and numerous smaller European countries. In 1996, the agency granted antitrust immunity to the alliances between United and Lufthansa, which is Germany's largest airline, and between Delta and several smaller European carriers. In announcing their proposed alliance, American Airlines and British Airways emphasized that they are at a competitive disadvantage with these alliances because the airlines in those alliances can, among other things, better coordinate service and jointly set fares.

Despite success in negotiating open skies agreements throughout much of Europe, DOT has had very little success with the United Kingdom, our largest aviation trading partner overseas. The current U.S.-U.K. accord, commonly known as "Bermuda II," was signed in 1977 after the British renounced the prior agreement. Bermuda II restricts the number of U.S. airlines that can serve Heathrow to two carriers—currently American Airlines and United Airlines. DOT has expressed increasing dissatisfaction with Bermuda II and attempted to negotiate increased access for U.S. airlines to Heathrow. Negotiations with the British take on particular importance because of the size of the U.S.-U.K. markets. In 1996, 12 million passengers traveled on scheduled service between the United States and the United Kingdom, which is more than twice that for the U.S.-Germany markets and three times that for the U.S.-France markets.

Competition is restricted in the U.S.-U.K. markets because Bermuda II, among other things, sets limits on the amount of service airlines can provide and prevents all U.S. airlines, except American and United, from flying to and from Heathrow. These restrictions on competition result in fewer service options for U.S. and British consumers. In addition, they also likely result in higher airfares. However, the extent to which airfares are higher is uncertain. DOT does not have data on the fares paid by passengers flown by BA or Virgin Atlantic if those passengers' itineraries did not involve a connection with a U.S. carrier, because it has generally not required foreign airlines to report data from a sample of their tickets, as it requires U.S. airlines to do.

Bermuda II's limits on competition also disproportionately affect U.S. airlines. In contrast to the continuing restrictions placed on U.S. airlines, the United Kingdom was successful in negotiating increased access for British carriers to the U.S. markets in the early 1990s. Partly as a result, between 1992 and 1996, the British carriers' share of the U.S.-U.K. markets rose from 49 percent to 59 percent. As figure 1 shows, this gain by British Airways and Virgin Atlantic has come primarily at the expense of the U.S. airlines that are not allowed to serve Heathrow.

Figure 1: Share of Scheduled Passenger Traffic Between the United States and the United Kingdom by Airline, 1992, 1995, and 1996



Source: GAO's analysis of DOT's international traffic data.

European Reviews Considering a Range of Competitive Issues; U.S. Reviews Pending

The proposed AA/BA alliance is subject to review by the European Commission, several agencies within the U.K. government, and DOT. The European Commission, the U.K. Department of Trade and Industry, and DOT have decision-making authority over the proposed alliance. The U.K. Office of Fair Trading and the U.S. Department of Justice's Antitrust Division (Justice) have advisory roles and provide analysis and comments to their respective decisionmakers. According to officials, the process for reviewing the AA/BA alliance is complicated by the fact that it is new and untested and some European laws have not previously been applied to airline alliances. The European regulatory agencies have nearly completed their reviews, and the formal U.S. review has yet to get under way.

Both the European and the U.S. reviewers have access to extensive information—including confidential proprietary data—to evaluate the competition issues arising from the AA/BA and other alliances. This information includes data on airline capacity, market shares on specific routes, and passenger travel statistics.

European Commission's Review Forthcoming

In July 1996, because of concerns about the anticompetitive effects of the alliances, the European Commission's Directorate General for Competition initiated a review of the proposed AA/BA alliance and three other ongoing alliances: United/Lufthansa/SAS; Delta/Swissair/Sabena/Austrian Airlines; and Northwest/KLM. This review is examining a broad range of competition issues on AA/BA, including access to slots and facilities at Heathrow Airport; the frequency of service offered by AA and BA, which would dominate the market at Heathrow; and AA/BA's sales and marketing practices, such as frequent flier programs, travel agent commission overrides, corporate incentive agreements,⁶ and computer reservation system practices.

The European Commission's Directorate General for Competition expects to issue its draft remedies for addressing the anticompetitive effects of AA/BA within the coming weeks. Officials added that their reports on other alliances should be done soon afterwards.⁷ Various parties then have the

⁶These agreements represent offers by airlines to corporate clients for fares that are discounted from the prices that are otherwise applicable. They may be stated as percentage discounts from specified published fares.

⁷European Commission officials told us that, although they initiated their reviews of all four alliances at the same time, they do not expect to have their proposed draft remedies for each completed at the same time, since the competitive problems are different in each case. European Commission officials expect to announce their draft remedies on the United/Lufthansa/SAS alliance, Delta/SwissAir/Sabena/Austrian alliance, and Northwest/KLM alliance soon after the report on AA/BA.

opportunity to provide comments and possibly participate in oral hearings on the draft remedies. After it obtains comments from the interested parties, the Directorate General for Competition prepares a document outlining its recommendations on whether to approve the alliance with conditions or to withhold approval, and submits the document to the European Commission's Member States Advisory Committee⁸ for review. After the Advisory Committee's review, the Directorate General for Competition incorporates appropriate comments and prepares its draft final ruling, which either lays out the conditions that must be met in order for the alliance to be approved or disapproves the alliance. It becomes the ruling of the Commission when it is adopted by the European Commission's College of Commissioners.⁹ Thus, the European Commission's final decisions are not expected for several more months.

United Kingdom Awaiting European Commission's Draft Remedies

The U.K. Department of Trade and Industry is conducting its own review of the proposed AA/BA alliance.¹⁰ It has asked the U.K. Office of Fair Trading to investigate and provide advice on the proposed alliance. The Office of Fair Trading investigation, which began in June 1996, examined a broad range of issues raised by the proposed alliance, including competitive impacts of the alliance on routes, hubs, and networks within the U.S.-European markets; the frequency of service in the U.S.-U.K. markets; the pooling of frequent flier programs; and access to slots at Heathrow. The Office of Fair Trading issued a draft report in December 1996 that called for AA/BA to, among other things, make available to other airlines up to 168 slots per week at Heathrow for use only on U.S.-U.K. transatlantic services and allow third-party access to their joint frequent flier program in those cases in which that party does not have access to an equivalent program. The report took into account the views of third parties on conditions that should be placed on the alliance to remedy competition concerns. Before they provide their final advice on the proposed AA/BA alliance, the U.K. Office of Fair Trading is awaiting the European Commission's publication of its draft remedies. The Secretary of State for Trade and Industry will decide on the case after receiving final advice from the Office of Fair Trading.

The U.K. agencies reviewing the proposed AA/BA alliance are in contact with the European Commission and have a duty to cooperate with it. If the

⁸This committee is composed of competition and transport officials from each of the member states.

⁹As of March 1998, the College of Commissioners was composed of 20 members proposed by the member states.

¹⁰The Monopolies and Mergers Commission has an advisory role for mergers but has had no detailed involvement to date concerning the alliance.

United Kingdom's decision on the proposed AA/BA alliance differs from the European Commission's, the differences will have to be reconciled. According to European Commission officials, this could require a judgement by the European Court of Justice in Luxembourg, which ultimately judges the sound application of the European Union's treaties by the institutions of the Union or the member states.¹¹

U.S. Reviews Not Proceeding Until AA and BA Complete the Application Process

In the United States, DOT has the authority not only for approving airline alliances, but also for granting those alliances immunity from the antitrust laws. In determining whether to grant approval and antitrust immunity for an airline alliance, DOT must find that the alliance is not adverse to the public interest. DOT cannot approve an agreement that substantially reduces or eliminates competition unless the agreement is necessary to meet a serious transportation need or to achieve important public benefits that cannot be met or that cannot be achieved by reasonably available alternatives that are materially less anticompetitive. Public benefits include considerations of foreign policy concerns. In general, DOT has found code-sharing arrangements to be procompetitive and therefore consistent with the public interest because they create new services, improve existing services, lower costs, and increase efficiency for the benefit of the traveling and shipping public. As with the other international code-sharing alliances that the United States has approved, DOT officials explained that they will not approve AA's and BA's proposed code-sharing alliance with antitrust immunity unless the United States has reached an open skies agreement with the United Kingdom.

According to U.S. law, DOT is to give the Attorney General and Secretary of State "an opportunity to submit written comments about" the application. In practice, DOT and Justice officials told us that they stay in contact throughout the application process regarding their respective analyses of airline alliances.

Justice's role is advisory and is performed pursuant to the Sherman Antitrust Act and the Clayton Act, which set forth antitrust prohibitions against restraints of trade. To determine if a proposed alliance is likely to create or enhance market power and allow firms to maintain prices above competitive levels for a significant period of time, Justice applies its Horizontal Merger Guidelines, which describe the analytic framework and the specific standards to be used in analyzing mergers and alliances. A key

¹¹Although the European Union has responsibility for applying its aviation laws, enforcement of those laws is left to the member states.

concern is whether entry into the market would deter or counteract a proposed merger's potential for harm.

DOT officials told us that in reviewing other code-sharing alliances, the Department did not apply any written set of guidelines in its analysis. Rather, DOT has discretion in deciding the factors it will analyze and in past applications for international code-sharing alliances has considered issues raised in petitions by interested parties. Those issues generally involved market power between particular hub airports, except in one instance. In response to United's application for antitrust immunity in its code sharing with Lufthansa, TWA contended that Lufthansa's control over travel agents, both through dominance of the computer reservation system and through commissions and override payments, was a serious impediment to new airlines' entry into the U.S.-Germany marketplace. In making its final decision, DOT addressed the concern about the computer reservation system, but wrote that other forums were more appropriate for addressing the other concerns.

DOT has considered, but not always completely agreed with, Justice's comments on the extent to which particular code-sharing alliances pose threats to competition in individual markets. In the case of United/Lufthansa, for example, Justice was concerned that competition could be reduced in two nonstop markets—Chicago-Frankfurt and Washington D.C. (Dulles)-Frankfurt. DOT agreed, and “carved out” (i.e., withheld antitrust immunity from) specific airline operations in those two markets. In considering Delta's proposed alliance, Justice identified seven nonstop markets that raised concerns of reduced competition. DOT agreed with Justice on three markets (Atlanta-Brussels, Atlanta-Zurich, and Cincinnati-Zurich) and withheld antitrust immunity for specific operations there; DOT generally disagreed with Justice and imposed different conditions on the other four city-pairs, each of which involved travel from New York.

In the case of the proposed AA/BA alliance, U.S. reviews are essentially on hold. DOT cannot move forward with its review of the alliance until AA and BA file the necessary documents to make their application complete. DOT officials do not believe that AA and BA will complete their application until after the European Commission issues its draft remedies on the alliance, and BA officials confirmed that to us. Once DOT determines that the application is complete, interested parties—including Justice—will have 30 business days to comment on the alliance. Interested parties and AA/BA will then have another opportunity for rebuttal comments.

According to its regulations, DOT may order a full evidentiary hearing at the end of the comment period. Requests for DOT to hold an oral evidentiary hearing must specify the material issues of fact that cannot be resolved without such a hearing.¹² However, DOT has the discretion by statute whether to hold a hearing, even if requested to do so by the Attorney General or Secretary of State.

Although the AA/BA application is not complete, DOT has already proposed holding an oral hearing before a departmental “decisionmaker” so that interested parties can express in person their particular opinions and views on the issues concerning the AA/BA alliance. AA and BA have characterized any type of hearing as merely a delaying tactic. Six airlines opposing the proposed AA/BA alliance, on the other hand, have argued that the kind of hearing DOT has proposed is not sufficient; they contend that questions of fact could only be adequately explored and resolved with an oral evidentiary hearing before an administrative law judge. For example, AA and BA have contended that slots are easily obtainable at Heathrow and that Gatwick is an available and competitive alternative. Other airlines have testified that it is impossible to obtain slots at Heathrow that are timely and competitive, that Gatwick is full, and, in any event, that Gatwick is not a reasonable alternative to Heathrow, especially for business travelers. DOT has told us that it may reconsider its proposed schedule for reviewing the AA/BA alliance, along with the type of hearing it would hold.

We are not in a position to assess whether material issues of fact remain to be resolved in the proposed AA/BA alliance, but we believe it is critical that DOT avail itself of all empirical data in making its determination. Although DOT considers code-sharing agreements to be procompetitive, it has not collected sufficient data to fully analyze the long-term effects of such alliances. In our 1995 report on alliances, we found that DOT’s ability to monitor the impact of alliances was limited because foreign airlines are not required to report data from a sample of their tickets involving travel to or from the United States.¹³ In addition, U.S. carriers were not required to report traffic flying on a code-share flight. Since that report, DOT has required foreign airlines in alliances that have been granted antitrust immunity to report data on traffic to and from the United States. Even so,

¹²In the application of Delta and its European alliance partners for antitrust immunity, TWA argued that DOT should hold an oral evidentiary hearing. DOT rejected the request, responding that it was “unnecessary to resolve the relevant issues of fact.”

¹³International Aviation: Airline Alliances Produce Benefits, but Effect on Competition Is Uncertain (GAO/RCED-95-99, Apr. 6, 1995).

alliances have not been sufficiently studied to determine their long-term consequences or to allay fears that such alliances may hinder competition in the long term.

AA/BA Alliance Would Dominate, and Competition Would Decline Unless Substantial New Entry Occurred

The proposed AA/BA alliance has network benefits and could increase competition in markets between the United States and the European continent, the Middle East, and Africa because the number of alliances competing in these markets would increase from three to four. However, it raises serious competition issues in U.S.-U.K. markets. Competition issues arise because, under the alliance, rather than competing with each other, the two largest airlines in U.S.-U.K. markets would in essence be operating as if they were one airline. For the month of March 1998, an analysis of Official Airline Guide data indicates that AA and BA account for nearly 58 percent of the seats available on scheduled passenger flights between the United States and London. Moreover, as of March 1998, the two airlines account for 37 of the 55 total daily roundtrips (67 percent) between the United States and Heathrow offered by scheduled U.S. and British airlines.¹⁴

AA and BA currently compete with one another from six U.S. airports to Heathrow¹⁵ and from Dallas to London's Gatwick airport. New York's importance—Kennedy and Newark—is underscored by the fact that the market between these airports and Heathrow accounts for nearly one-fifth of all U.S.-London service and is more than three times the size of the Los Angeles-Heathrow market. At five of the seven airports where AA and BA compete—Kennedy, Chicago, Boston, Miami, and Dallas—these two airlines account for over 70 percent of the service, and at Los Angeles, they account for almost 50 percent. In addition, in Boston, AA and BA currently are the only carriers that serve Heathrow, and in the Dallas market, they are the only nonstop competitors. Figure 2 shows the location of seven cities where AA and BA currently compete with each other.

¹⁴In several markets, other foreign carriers provide service between U.S. cities and London. For example, Air New Zealand provides service through Los Angeles to Heathrow.

¹⁵These airports are Boston, Chicago O'Hare, Los Angeles, Miami, New York Kennedy, and Newark.

Figure 2: Seven Cities Where AA and BA Directly Compete With Nonstop Service to London



Note: "H" denotes service to Heathrow; "G" denotes Gatwick.

Our review of current competitive conditions in the New York-Heathrow (Kennedy and Newark) market indicates that substantial new entry would need to occur to provide competition because of the (1) size of the market, (2) large share of that market currently held by AA and BA, (3) frequency of service in that market—15 flights a day—provided by the two airlines (compared with 3 daily flights by United and 3 daily flights by Virgin Atlantic), and (4) substantial portion of the market accounted for by time-sensitive business travelers. New entry could come from Delta and TWA, which have hubs at Kennedy, and from Continental from its hub at nearby Newark. In the Boston and Chicago markets, new nonstop service

may offset the effect on competition caused by joining the two largest competitors in those markets.

In the event of the alliance, time-sensitive business travelers in the Dallas-London and Miami-London markets will have fewer nonstop options and thus will likely pay higher fares for nonstop service. In the Dallas-London market, AA and BA are currently the only competitors providing nonstop service. In the Miami-London market, the number of nonstop competitors would fall from three to two. Several carriers told us that it is unlikely that a new U.S. competitor would attempt nonstop London service from either Miami or Dallas, since no carrier besides American maintains a large enough network from either of those airports to provide critical “feed” traffic. As a result, DOT will need to carefully examine the unique circumstances associated with these markets.

At another eight U.S. cities, either BA or AA has a monopoly on nonstop service to either Heathrow (two cities) or Gatwick (six cities). In our October 1996 report on domestic competition, we found that competition was most limited and airfares highest in markets dominated by one airline.¹⁶ Figure 3 shows the location of eight cities where either AA or BA has a monopoly.

¹⁶Airline Deregulation: Barriers to Entry Continue to Limit Competition in Several Key Domestic Markets (GAO/RCED-97-4, Oct. 18, 1996).

Figure 3: Eight Cities in Which AA or BA Is the Only Carrier Providing Nonstop Service to London



Notes: "H" denotes service to Heathrow; "G" denotes Gatwick. According to AA and BA representatives, with an open skies policy, the alliance would likely switch much of the current Gatwick service to Heathrow.

US Airways plans to begin Philadelphia to Gatwick service in April and hopes to begin Charlotte to Gatwick service in May.

If slots at Heathrow were made available, several U.S. carriers might serve London from their primary or secondary hubs.¹⁷ These slots would provide new competition to AA and BA on several routes that they currently monopolize. In particular, U.S. carriers could provide new nonstop service in the Philadelphia, Charlotte, and Pittsburgh markets. They could also provide new nonstop service from cities that are currently unserved with nonstop flights, such as Cleveland.

In addition to increased nonstop competition, carriers could provide consumers with new one-stop options to compete with the alliance's nonstop services in markets that include their primary or secondary hubs. For example, if Northwest Airlines, which is one of the largest carriers in Seattle, could serve Heathrow from its hub in Minneapolis, consumers in Seattle would have more and better connecting opportunities to Heathrow, and hence competition would be greater than it is today with BA's being the only nonstop carrier. However, for time-sensitive travelers, these one-stop options may not be very competitive. Consumers in cities such as Des Moines or Fargo with no nonstop service to London, would experience an increase in the number of one-stop options offered by competing airlines to Heathrow.

Air Carriers Vary on the Effort Needed to Overcome Combined AA/BA Strength

When we testified last June on the proposed alliance, representatives from six major U.S. airlines told us that they would need a total of 38 daily roundtrip slots (or 532 weekly slots) at Heathrow, along with gates and facilities, to compete with the AA/BA alliance. For this testimony, we discussed the issue of access to Heathrow with officials from each major U.S. carrier, as well as with Virgin Atlantic. This time, some were not as clear on the number of slots they would need to be competitive. The officials emphasized that gaining a sufficient number of commercially viable slots, gates, and facilities at Heathrow was critically important for them to be able to compete effectively against the alliance, and several expressed doubt that the proposed alliance could be sufficiently restructured to prevent it from being inherently anticompetitive.

¹⁷The other six major U.S. airlines' primary hubs for transatlantic service are Chicago (United), Detroit (Northwest), Newark (Continental), New York (Delta and TWA), and Philadelphia (US Airways). In general, these airlines' secondary transatlantic hubs are Atlanta (Delta), Houston (Continental), Minneapolis (Northwest), Charlotte (US Airways), St. Louis (TWA), and Washington Dulles (United). However, carriers may also choose other locations as key cities in their networks for international service. For example, Delta currently serves Gatwick from both Atlanta and its other international hub, Cincinnati. Also, until February, Continental was authorized to serve London Gatwick from its Cleveland hub.

The carriers' representatives expressed a range of views on the actions needed to compete effectively against the proposed alliance. For example, officials from Continental discussed the importance of flight frequency, which they argued is vital for business travelers, who represent the most valued passenger because of the revenue generated by business travel. For Continental to be able to compete in the New York-London market, where, they said, AA/BA would operate what amounts to a virtual shuttle, they argued that an additional three flights between Newark and London on top of their current schedule would not be sufficient. They believed they would need an additional six flights per day.

Officials from United Airlines, which already participates in a global alliance, suggested that their alliance would compete effectively with AA/BA for many points beyond Heathrow. However, because of the importance of Heathrow, they would like to create a greater presence for their entire alliance. Thus, United officials did not indicate a desired number of slots and gates needed at Heathrow but spoke about the importance of having its STAR alliance partners (Air Canada, Thai, Varig, SAS, and Lufthansa) operate out of a single terminal at Heathrow.

On the other hand, officials from Delta, which also participates in a global alliance, found the proposed AA/BA alliance to be highly anticompetitive and argued that the best way to protect the traveling and shipping public would be to disapprove the proposed alliance. Failing that, Delta officials have testified that the respective governments should guarantee that competing carriers will have unrestrained opportunities to provide service between the United States and London and receive a significant number of commercially viable slots and airport infrastructure to support those services. They suggested a minimum of 800 weekly peak-period slots would be required to provide sufficient competition at Heathrow.

Virgin Atlantic officials concluded that determining the number of slots needed for a carrier to compete successfully in the U.S.-U.K. markets is difficult, but that BA would need to divest itself of a "very large" number of slots to make successful competition by another airline (besides American) a realistic possibility.

As we testified last year, as a practical matter, because of a limited number of slots available at Heathrow, AA and BA would likely need to have slots transferred from them and made available to competing airlines. If the proposed alliance is approved and the regulatory agencies decide how many slots and gates should be made available, it is uncertain how long it

would take the British Airports Authority, which owns and operates seven U.K. airports, including London's Heathrow and Gatwick airports, to actually make them available to new airlines. For example, according to the British Airports Authority, it probably will not have the facilities to allow the STAR alliance to locate all of its members within the same terminal until Heathrow opens the new Terminal 5, which is not scheduled to open before the fall of 2004.

If approved, the AA/BA alliance would bring a history of competitive service to London. Many other airlines that do not have a history of service to London, on the other hand, would have no such advantage. DOT will have to address this issue because it will be critical for new carriers to obtain access to commercially viable slots, as well as needed gates and facilities, at the same time as the proposed alliance begins joint operations. Some have suggested that AA and BA "phase in" their alliance over time, in part to give other carriers the time needed to establish themselves. If this happened, new airlines' operations should be phased in to coincide with the alliance.

Airline Sales and Marketing Practices May Further Enhance Market Dominance Over Smaller, Nonaligned, and New Entrant Carriers

According to airline officials, aviation experts, and consumer groups we interviewed, restrictions on access to slots and gates at Heathrow Airport are the most significant barriers to competition in U.S.-U.K. markets, but sales and marketing practices—which include frequent flier programs, travel agent commission overrides, multiple listings on computer reservation systems, and corporate incentive programs—may also reduce competition. They do so by reinforcing market dominance at hubs and impeding successful entry by new carriers and existing carriers into new markets, which can lead to higher fares. However, measuring the impact of these practices on fares is difficult, and limiting them would involve a trade-off between their anticompetitive effect and the consumer benefits that some of them bring.

In October 1996,¹⁸ we reported that sales and marketing strategies, when used by incumbent airlines in U.S. domestic markets, make it difficult for nonincumbents to enter markets dominated by an established airline. The strength of these programs depends largely on an airline's route networks, alliance memberships, and hubs. If an airline is already dominant in a given airport, these programs will serve to reinforce this dominance. In particular:

¹⁸Airline Deregulation: Barriers to Entry Continue to Limit Competition in Several Key Domestic Markets (GAO/RCED-97-4, Oct. 18, 1996).

-
- Travel agent commission overrides encourage travel agencies to book travelers on one airline over another on the basis of factors other than price.
 - Frequent flier programs encourage travelers to choose one airline over another on the basis of factors other than price.
 - Corporate fare agreements make it more difficult for point-to-point carriers to compete for corporate business.
 - Bias in the computer reservation systems, in which multiple listings of a single flight offered by an alliance partner crowd the first few screens in U.S. systems, makes the booking of an alliance flight more likely.

In our October report, we noted that travel agent commission overrides and frequent flier programs are targeted at business fliers and encourage them to use the dominant carrier in each market. Because business travelers represent the most profitable segment of the industry, airlines in many cases have chosen not to enter, or quickly exit, domestic markets where they did not believe they could overcome the combined effect of these strategies and attract a sufficient amount of business traffic.

AA, which is credited with having first created frequent flier programs in 1981, is reputed to have the largest frequent flier program in the world, with more than 30 million members. Continental has more than 15 million members. European airlines, on the other hand, tend to have much smaller frequent flier memberships. BA's program, for example, has approximately 1 million members. The difference in memberships compared with U.S. carriers is due to their relative newness among European carriers and U.S. programs' tending to allow members to accumulate miles for activities other than flying (e.g., through car rentals or stays at hotels), while European carriers' programs are more restrictive in scope.

Some airline officials we interviewed expressed concern that the scope of AA's and BA's combined route network and flight frequency, in combination with sales and marketing practices, would effectively preclude competition by other carriers in the U.S.-U.K. markets, especially at BA-dominated Heathrow. These carriers argued that the alliance would be able to exercise such market power, especially in relation to travel agents and corporate fare products, that other carriers would not be able to attract key business traffic. Officials from Continental Airlines told us that the problem with the sales and marketing practices of the combined AA/BA alliance would be their effect on enhancing AA/BA's dominance of market share. They said that rather than restrict AA/BA in combining their frequent flier programs, travel agent commission overrides, corporate incentive

agreements, and computer reservation system practices, DOT should not grant antitrust immunity to AA/BA. TWA officials also said that these sales and marketing practices are anticompetitive and their use by the proposed alliance should be restricted. Officials from Virgin Atlantic, noting the strength and market dominance of AA and BA, questioned whether any mitigating conditions would be sufficient to limit the competitive advantage the two airlines would have if joined in a code-sharing partnership.

However, United, Delta, and Northwest—each of which participates in its own global code-sharing alliance—generally disagreed that any of these sales and marketing practices represented significant barriers to their ability to compete. United told us that its alliance would compete with any other both in terms of their networks and their various sales and marketing practices. US Airways also indicated that it was not concerned with sales and marketing practices, as long as it had access to sufficient Heathrow slots and gates.

Outside experts on airline competition had varying opinions on the degree to which sales and marketing practices stifle competition. While none had done research specifically on how these practices affect international air transport markets, some said frequent flier programs do not raise entry barriers for large worldwide carriers because they all have relatively strong frequent flier programs and extensive route networks. However, point-to-point carriers may be at an additional disadvantage when competing against carriers with both large route networks and strong frequent flier programs. For example, while AA and BA are perceived to have considerable advantages in their frequent flier programs compared with other nonallied or point-to-point airlines, the differences are relatively minor when compared with other U.S.-European alliances. Even so, these experts said it is almost impossible to measure the degree to which sales and marketing practices impede competition.

We were unable to obtain any data on these sales and marketing practices. The airlines are not required by law to report this information to DOT, and GAO has no right of access to commercially owned data. However, we know of at least two lawsuits alleging that BA has engaged in certain sales and marketing practices that are anticompetitive in nature. However, because these actions have not yet entered the trial phase, we have been unable to obtain detailed information on the alleged economic damage stemming from BA's practices, or BA's evidence to the contrary.

In past alliances, DOT has not restricted partner airlines in their use of frequent flier programs, travel agent commission overrides, or corporate fare packages. It has, in some of the alliances, withheld antitrust immunity from the airlines' coordination of the management of their financial interests in computer reservation system companies. While restrictions on other sales and marketing practices would be unprecedented, the European Commission, as noted earlier, is considering whether to address sales and marketing practices with all alliances. DOT and some U.S. carriers are concerned that the European Commission would so broadly regulate the industry's practices.

The outside experts we interviewed concurred that restrictions on sales and marketing practices in alliances should not be imposed. They believed that any restrictions on the pooling of frequent flier programs, for example, would reduce the benefits that accrue to travelers while doing nothing to address the underlying issue of market dominance. Moreover, they said it would be difficult to limit alliance members' use of these marketing practices without eliminating them altogether; banning them involves a trade-off between their anticompetitive effect and the consumer benefits that some of them bring.

In summary, Mr. Chairman, as a result of the challenges in addressing the barriers to entry at Heathrow, significant intergovernmental agreement will be needed well beyond the scope of prior open skies agreements. If the U.S. government is successful in obtaining an open skies agreement with the United Kingdom, and that agreement provides for sufficient access to Heathrow, significant new entry in the U.S.-U.K. markets would likely provide substantial benefits for consumers in both countries in terms of lower fares and better service. However, because these markets have been heavily regulated for 2 decades, the incumbent airlines enjoy a competitive advantage over new carriers in the U.S.-London markets. Because of AA's and BA's dominance at certain airports and extensive networks, that advantage may be further strengthened by sales and marketing practices. Thus, it will be important that new competitors are able to initiate their service no later than the time at which the AA/BA alliance becomes operational.

How much access would be needed for other airlines to effectively compete, and what other conditions should be imposed on the alliance can only be determined after careful analysis of the facts to ensure that over the long run, consumers benefit. While we recognize that ultimately,

decisions on all conditions must inevitably reflect numerous policy judgments, public policy should be based on significant quantitative analysis of the factors at issue, rather than anecdotal evidence. At least four governmental bodies—DOT, Justice, the European Commission, and the U.K. Department of Trade and Industry—have the ability to get the data needed for such analyses. Only then can the public be assured that such important international policy is grounded on a sound basis and that consumers benefit, both in the short and long term.

Mr. Chairman, this concludes my prepared statement. Our work was conducted in accordance with generally accepted government auditing standards. We would be pleased to respond to any questions that you or any Member of the Subcommittee may have.

Related GAO Products

International Aviation: Competition Issues in the U.S.-U.K. Market
(GAO/T-RCED-97-103, June 4, 1997).

International Aviation: DOT's Efforts to Promote U.S. Air Cargo Interests
(GAO/RCED-97-13, Oct. 18, 1996).

Airline Deregulation: Barriers to Entry Continue to Limit Competition in Several Key Domestic Markets (GAO/RCED-97-4, Oct. 18, 1996).

International Aviation: DOT's Efforts to Increase U.S. Airlines' Access to International Markets (GAO/T-RCED-96-32, Mar. 14, 1996).

International Aviation: Better Data on Code-Sharing Needed by DOT for Monitoring and Decisionmaking (GAO/T-RCED-95-170, May 24, 1995).

International Aviation: Airline Alliances Produce Benefits, but Effect on Competition Is Uncertain (GAO/RCED-95-99, Apr. 6, 1995).

International Aviation: DOT Needs More Information to Address U.S. Airlines' Problems in Doing Business Abroad (GAO/RCED-95-24, Nov. 29, 1994).

International Aviation: New Competitive Conditions Require Changes in DOT Strategy (GAO/T-RCED-94-194, May 5, 1994).

International Aviation: Measures by European Community Could Limit U.S. Airlines' Ability to Compete Abroad (GAO/RCED-93-64, Apr. 26, 1993).

Airline Competition: Impact of Changing Foreign Investment and Control Limits on U.S. Airlines (GAO/RCED-93-7, Dec. 9, 1992).

Airline Competition: Effects of Airline Market Concentration and Barriers to Entry on Airfares (GAO/RCED-91-101, Apr. 26, 1991).

Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are \$2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. VISA and MasterCard credit cards are accepted, also. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:

**U.S. General Accounting Office
P.O. Box 37050
Washington, DC 20013**

or visit:

**Room 1100
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC**

**Orders may also be placed by calling (202) 512-6000
or by using fax number (202) 512-6061, or TDD (202) 512-2537.**

Each day, GAO issues a list of newly available reports and testimony. To receive facsimile copies of the daily list or any list from the past 30 days, please call (202) 512-6000 using a touchtone phone. A recorded menu will provide information on how to obtain these lists.

For information on how to access GAO reports on the INTERNET, send an e-mail message with "info" in the body to:

info@www.gao.gov

or visit GAO's World Wide Web Home Page at:

<http://www.gao.gov>

**United States
General Accounting Office
Washington, D.C. 20548-0001**

**Bulk Rate
Postage & Fees Paid
GAO
Permit No. G100**

**Official Business
Penalty for Private Use \$300**

Address Correction Requested
