EVERY PRO-CONSOLIDATION ARGUMENT IN THE CORDLE/MIFSUD/BONILLA PAPERS IS WRONG

Hubert Horan, 12 June 2010

As part of the PR campaign supporting the United/Continental merger, Vaughn Cordle, Paul Mifsud and Carlos Bonilla published a widely-distributed advocacy paper entitled "United + Continental is good news for all stakeholders: More mergers are needed; Is American and US Airways next?[1]" This paper explains why their ten pro-merger arguments are fundamentally wrong. Cordle (the principal author) uses deliberately misleading data to distort market share/market power claims, makes key economic claims that have been publicly refuted by United/Continental management, claims the merger will achieve multi-billion dollar synergies never realized by any previous airline merger, and makes other claims that are wholly unsubstantiated or easily contradicted by public evidence. I have provide direct quotes from Cordle's papers for each of his ten pro-consolidation claims.

This paper is only intended to refute Cordle's pro-consolidation arguments. It does not lay out the comprehensive argument as to why United/Continental and the ongoing industry consolidation movement violates longstanding antitrust laws and directly threatens consumers and long-term efficiency. Those arguments can be found in my June 16th testimony to the House Transportation and Infrastructure Committee, "The Anti-Competitive Impacts Of a United-Continental Merger and The Consolidation Of 80% Of The US Aviation Market Into Just Three Competitors"

1. CONSOLIDATION NOT A THREAT TO CONSUMERS BECAUSE LEGACY CARRIERS DON'T DOMINATE THE MARKET POSITION: *There is "destructive price competition" because "there are only five major U.S. network carriers and 28 LCC and regional airlines in the U.S...this domestic configuration does not risk giving any player unreasonable market power"... "Today, the network airlines produce 67% of the systemwide seats and only 57% of the domestic seats"*. **FALSE AND BASED ON DELIBERATELY MISLEADING DATA. Cordle includes Legacy regional carriers that operate as United Express, Continental Express and American Eagle among the "28 competitors." All of Cordle's market share tables isolate the "domestic mainline" portion of Legacy operations, but don't count the domestic regional or international portions, so the actual size of the Legacy carriers is grossly understated. As shown in attachment A, the Legacy sector (mainline plus regional) current operates 82% of total US aviation capacity vs. 18% for LCCs; in purely domestic markets the Legacy/LCC split is 77%/23%. Cordle deliberately misrepresents the data in order to obscure the obvious and serious market power concerns that consolidating the Legacy 80% of the market into just three carriers would create.**

2. LOW COST CARRIER GROWTH WILL SOLVE ANY COMPETITIVE PROBLEMS: "The U.S. network carriers' share of the domestic market (excluding regional ASMs) has been shrinking annually....Moreover, if the secular trend of faster relative growth in LCC capacity continues, and the three network airlines combine as we suggest, the remaining three networks would eventually provide only 35-40% of the total domestic

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[1] This paper, originally issued May 3rd, and two follow up pieces responding to criticism from Congressman James Oberstar and former American Airlines CEO Robert Crandall "Responding to Crandall and Oberstar"(May 27) and "Mergers – the best solution for network airlines" (June 1) are available online at the National Journal Transportation Expert Blogs, "Should United and Continental Be Allowed To Merge? at http://transportation.nationaljournal.com/2010/05/should-united-and-continental.php. This paper is an expanded version of my own comments published as part of that debate.

ASMs **FALSE AND BASED ON (THE SAME) DELIBERATELY MISLEADING DATA. The Legacy-to-LCC share shift shown in Cordle's data is largely the Legacy Mainline-to-Legacy Regional shift of recent years, as the Legacy carriers outsourced flying to their subsidiaries. The graphs in attachment A show only a 2% growth in LCC market share growth between 2003 and 2007 and none since 2007. Rapid LCC market share growth only occurred when most of the Legacy carriers were bankrupt, an event that no one expects to recur anytime soon. The claim that the three surviving Legacy carriers would shrink to only 35-40% of the domestic market is completely ludicrous. It would require all the LCC doubling in size and entering thousands of O&D markets they'd never served before. Legacy market share would never shrink to even 70-75% without another round of 9/11-type bankruptcies. The LCCs only provide meaningful price competition in about half of the domestic market—the very large volume O&D markets where the LCC business model works best. They provide little or no price competition in the thousands of low volume RJ markets, in most O&Ds at LGA, DCA and the Legacy Megahubs (DFW, MSP, EWR, MIA, etc) and of course in international markets.**

3. BIG CUTS OF EXCESS CAPACITY WILL DRIVE MERGER FINANCIAL BENEFITS: "we ultimately expect to see a 5-10% reduction in combined capacity post-merger, which will reduce their market share and improve efficiencies. we assume that UA/CO and a hypothetical AA/US combination are each 10% smaller than the sum of the paired airlines before the mergers **UNSUBSTANTIATED AND DIRECTLY CONTRADICTED BY THE CARRIERS AND THEIR UNIONS. United and Continental management have explicitly said that the merger will not lead to capacity cuts. So either Cordle is wrong or management is lying. Merger implementation depends on the support of both carriers' unions, who would undoubtedly object to any plan where their members bore the type of burden Cordle is predicting, while senior management was reaping tens of millions in special bonuses. Cutting 10% capacity out of United/Continental would require major, highly visible network downsizing, but Cordle doesn't offer any examples illustrating the downsizing opportunities. To the extent that carriers have hopelessly unprofitable capacity there are no obstacles to cutting this now—mergers actually make it harder to make these cuts. The Delta/Northwest merger did not lead to capacity cuts. In fact Cordle's own data says that 40% of the industry's excess capacity is attributable to DL/NW two years after they merged (UA/CO are responsible for another 25%). All of the data directly contradicts Cordle's "mergers will solve the industry's excess capacity problem" theory.**

4. EACH MERGER WILL CREATE $2 BILLION IN COST AND REVENUE SYNERGIES "The net effect of the mergers is approximately $6 billion in additional value created, or roughly $2 billion per combination." **FALSE, COMPLETELY UNSUBSTANTIATED AND CONTRADICTED BY THE RESULTS OF ALL PAST MERGERS. Cordle provides absolutely no evidence supporting this critical claim, and no examples of big-dollar efficiencies that couldn't be achieved without a merger. As shown in attachment B, the vast majority of US airline mergers since deregulation have been dismal financial failures no previous merger between large airlines (outside of bankruptcy) has ever produced a material reduction in unit operating costs and United's own press releases says the merger will only reduce operating costs by 0.6%. Mergers between airlines as large as United and Continental cannot exploit scale economies as these carriers already have extremely low overhead rates due their already huge scale and years of draconian cost cutting. Significant, sustainable revenue synergies are impossible major growth or hub development, which will not occur in any of these cases. United/Continental's revenue synergy claims were publicly question by Don Carty, who as CEO of American Airlines was responsible for the unsuccessful American-TWA merger in 2001. "Revenue is a zero sum game. You can't count on revenue synergies because implicitly you are taking revenues from someone and they will have a strategy to take them back." Most importantly, potential long-range synergies will be dwarfed by the up-front,**

multi-billion negative cash flow impacts of combining the two companies maintenance programs, IT systems, and other work processes. There is no evidence that the Delta/Northwest merger produced the multi-billion dollar efficiency benefits claimed at the time. There is no broad-based merger movement in aviation because these synergies do not exist. If a Continental/United merger could be justified by efficiencies it would have been pursued years ago when the cost and network synergies would have been even greater. Efficiency claims such as these ought to be the heart of any merger review, and the antitrust laws pose no obstacle to mergers that have legitimate evidence of sizeable synergies. But mergers like Delta/Northwest and United/Continental can only be rationally explained as seeking anti-competitive market power, especially in international markets. The United/Cordle arguments are just a PR smokescreen, claimed in the hope of discouraging anyone from actually scrutinizing any of these efficiency claims.

5. "THE U.S. AIRLINE INDUSTRY CAN ONLY SUPPORT THREE LARGE NETWORK AIRLINES" "the industry has too many airlines and this does not allow the profitability required" **FALSE, ILLOGICAL AND COMPLETELY UNSUBSTANTIATED Cordle's argues that the industry needs to shed hopelessly unprofitable ("excess") capacity, but has absolutely no basis for arguing that the industry needs to reduce the number of competitors. As noted above, there is no evidence that Delta/Northwest or any previous reductions in the numbers of competitors led to improvements in industry profitability, and carriers can eliminate hopelessly unprofitable capacity without first spending billions on a complex, risky merger. As noted earlier, United and Continental have already ruled out capacity cuts, and the "only need three carriers" claim is not justified by scale economies. The objective of consolidation is to give three companies control of the legacy 80% of the market served by six carriers in 2008. This consolidation is not justified by scale economies or large efficiencies or any other "market forces"—it is simply the result of the large airlines petitioning the government for reduced competition.**

6. MERGERS WILL INCREASE SERVICE IN SMALLER MARKETS: "We make the case that, without mergers or industry consolidation, network airlines will have even less financial incentive to serve small markets. With mergers, the larger networks produce cost and revenue synergies that ...enhances the network airline's ability to support small-community service." **FALSE—MERGERS ARE A HUGE THREAT TO SERVICE IN SMALLER MARKETS. The anti-competitive threat from reduced competition will not come in large volume markets where LCCs directly compete; it will be in the markets where LCC have never and will never compete—international markets and the thousands of low volume RJ markets. Economic theory suggests that reducing competition to a cozy three airline oligopoly creates the ideal conditions for huge service cuts designed to drive fares as high as possible. As former American Airlines CEO Robert Crandall said "It is beyond me why a network carrier that does not need feed for an international network would operate service to smaller destinations that will not support fares high enough to make the feeder flights profitable in their own right. Across time, if consolidation continues, the network guys will simply withdraw from more small cities. Then where will we be? Consolidation will doubtless go on, but I am dead sure we will be sorry in the long run"**

7. DOJ ANTITRUST CRITERIA ARE OBSOLETE "DOJ policies related to their analysis of market concentration, product definition and potential market power in the air transport industry were first developed in the years just after deregulation in 1978 and have not been modified since. Simply stated, the policies are dated and stuck in the past...it is not government's job to second guess commercial thinking" **TOTALLY UNSUBSTANTIATED AND COMPLETE RUBBISH. Cordle presents no evidence of any economically**

justified merger application thwarted by flawed antitrust analysis, and doesn't identify any specific antitrust rule that has been rendered obsolete by recent changes. In fact the only airline merger seriously challenged by the DOJ in the last thirty years was the 2000 United/USAirways application. Had that merger gone through, the carriers would have undoubtedly liquidated given the lack of synergies, huge implementation costs and post 9/11 revenue declines. The two central antitrust criteria for evaluating this or any other airline consolidation case are whether the merger will create the artificial market power needed to sustain anti-competitive pricing, and whether the reduced competition is justified by legitimate, verifiable, merger-specific public benefits (major synergies, service expansion, price reductions). Since United/Continental and other recent/upcoming industry consolidation fails to meet either test, Cordle is improperly questioning the legitimacy of antitrust law. Cordle is saying that government shouldn't be allowed to challenge commercial decisions to merge EVEN when the merger creates anti-competitive market power risks, and when the merger can't demonstrate legitimate, verifiable evidence of public benefits.

8. CONSOLIDATION NEEDED BECAUSE STRUCTURAL BARRIERS PREVENT INDUSTRY PROFITABILITY "the industry's problem represents the classic "prisoner's dilemma" because firm value, airline economics and passenger preferences provide strong incentives to cheat (by over producing to gain disproportionate market share and lower relative costs). These incentives are so great that the ability of the individual airline to profitably maintain seat production levels that optimally balance supply/demand is severely limited. The result is, collectively, the entire industry is laden with excess capacity...These bad industry fundamentals will not change without consolidation" **AN ARGUMENT THAT FREE MARKETS DON'T WORK AND AIRLINES NEED TO BE REREGULATED Cordle is explicitly saying that Legacy airlines can't make money because of irresistible forces causing them to pursue unprofitable strategies. This is of course absurd—nothing is forcing Legacy airlines to fly hopelessly unprofitable routes in pursue of market share. The problem here is bad management who cling to outdated strategies and are slow to adapt to marketplace changes. The solution is to stop flying hopelessly unprofitable routes in the myopic pursuit of market share. Cordle is arguing that the solution to poor Legacy profitability is to give the managers responsible for creating 65% of the industry's hopelessly unprofitable capacity even more power. In free market competition, the winners are supposed to be the best managed, most efficient companies. Cordle and United are advocating an artificial result where the winners among the Legacy airlines are the worst run, less efficient companies. If structural barriers to profitable competition actually existed, the solution would be to re-regulate the industry. The entire justification for CAB regulation of airline competition between 1932 and 1978 was that airlines were incapable of efficient, profit-maximizing behavior if left to their own devices. What Cordle and United/Continental really want is a world where there is neither regulation or antitrust enforcement, so that carriers would be free to create anti-competitive market power, totally free of any constraints.**

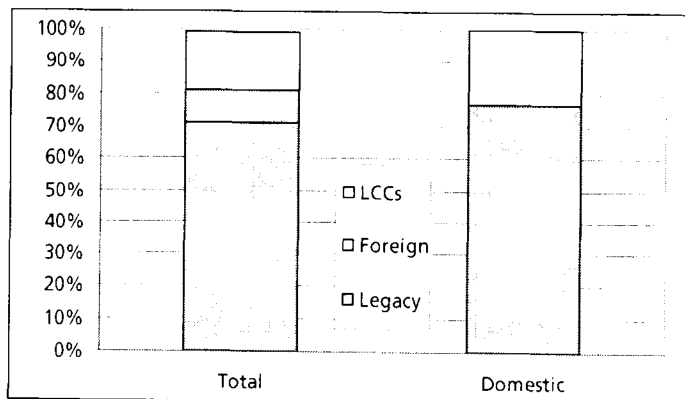
9. MERGERS ARE A "MARKET SOLUTION" TO INDUSTRY PROBLEMS: "Mergers provide a market-driven restructuring solution that effectively allows the network airlines to compete with the emerging low-cost carrier business model" COMPLETELY FALSE—**ALL RECENT AIRLINE CONSOLIDATION WAS DRIVEN BY GOVERNMENT INTERVENTIONS REDUCING COMPETITION. None of the post-2004 consolidation had anything to do with competitive "market forces" (highly efficient carriers displacing the capacity of carriers with higher costs and poorer service). All post 2004 consolidation was strictly the result of large incumbent carriers petitioning DOT and other government agencies for reduced competition, and the willingness of DOT and those government agencies to ignore longstanding antitrust rules in order to engineer changes to industry structure that free-market**

competition would have never created . Free markets with antitrust enforcement would not have produced the sudden post-2004 shift from robust trans-Atlantic competition with 47% concentration to a permanent Collusive Alliance Cartel with over 90% concentration, and would not have created the current process to eliminate trans-Pacific competition and to give three (or fewer) companies control of 80% of the entire US aviation market. Post-2004 North Atlantic consolidation reflects a totally artificial, governmentally driven process whereby DOT and the EU drove massive changes to industry structure designed to massively reduce competition on behalf of the interests of a small handful of politically powerful companies, just as it was in the days prior to deregulation.

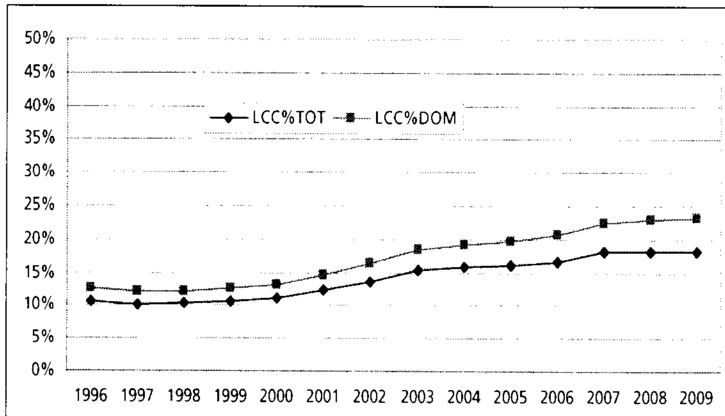
10. THE PROFITABLE NEXT MOVE IS AN AA/US MERGER: "A merger of AA and US provides one path that can create real value for the stakeholders of these two airlines and the industry"**. THAT'S ALSO WHAT THEY SAID ABOUT AN AMERICAN-TWA MERGER. That didn't work out for any of the stakeholders. Maybe the investment bankers and the consultants but not anyone else. As discussed earlier, Cordle's claim that an AA/US merger would produce $2 billion in synergies is false (AA-TW advocates had claimed similar synergy benefits); if these synergies existed AA and US management would have actively pursued a merger a long time ago, and you'd see many other large airline merger discussions. But these synergies don't exist, so you don't. You only see mergers in cases (Delta-Northwest, United-Continental) where there are opportunities to create anti-competitive market power.**

<u>Appendix A—Consolidation would give three companies control over 80% of the US aviation market; Low Cost Carriers are unlikely to ever serve more than 20% of the total market (or 30% of the purely domestic market) and they will never compete in Regional or Intercontinental markets</u>

- Legacy Network Airlines currently provide 82% of all capacity (ASMs) in the US aviation market and 77% of all capacity in purely domestic markets. Low Cost Airlines currently provide 18% of total capacity and 23% of domestic capacity. The LCC share of industry capacity increased modestly until 2007 but has been flat in the last three years.[2]
  - 77% of industry ASMs serve domestic markets; 23% serve international markets; 55% of the capacity in international markets is operated by US flag carriers, 45% by foreign carriers



[2] DOT Form 41 Schedule T-1 and T100 data. 2009 data is year ending November.



- Legacy Network carriers will continue to control 75% or more of the US aviation market for the foreseeable future; further increases in LCC share are possible, but are likely to be modest
  - Legacy carriers will continue to completely dominate Intercontinental markets (where they have insurmountable competitive advantage) and have an overwhelmingly strong share of shorthaul international markets (Canada, Mexico, Caribbean)
  - Legacy carriers will continue to dominate domestic markets served by the highly efficient megahubs (Chicago, Atlanta, Dallas-Ft. Worth, Newark, etc), and will completely control low volume domestic O&D markets served via regional aircraft, where LCCs are uncompetitive
  - Larger share shifts from Legacy to LCC carriers are not impossible, but would require the types of major Legacy capacity cuts that occurred after multiple bankruptcies in the 2002-05 period

- Airline consolidation would give three competitors control over the vast majority of this huge market; meaningful price competition would be limited to high volume O&Ds where LCCs have already established a strong market presence. There is no possibility that LCC competition would discipline anti-competitive behavior in international markets, regional airline markets or most megahub markets.

Appendix B--No Large US Airline Merger Has Ever Been Economically Justified by Cost Efficiencies or Network Synergies and Almost All Mergers Since Deregulation Have Been Dismal Financial Failures

There were 18 mergers of major airlines in the years between deregulation and the 2008 Delta/Northwest merger. In almost every case, airline mergers failed to generate positive returns for shareholders, which is to say profit improvements (above and beyond what the carriers would have earned absent the merger) that fully justified the financial costs and implementation risks. Mergers that cannot earn positive returns for shareholders cannot possibly justify the risks (from reduced competition) imposed on consumers.

All ten of the "Synergy/Scope" mergers that had been justified on the basis of scale economies and revenue synergies from combining existing networks, were complete economic failures. In many cases the acquired network was quickly liquidated and/or the merged carrier went bankrupt.

Mergers such as Delta/Northwest and United/Continental have none of the characteristics of the four successful cases. The recent USAirways/America West merger justified its costs and risks because it occurred as part of a Chapter 11 bankruptcy restructuring, which allowed asset shifts that are impossible in non-bankruptcy cases. The 1994 Morris merger allowed Southwest to acquire a very small set of aircraft and

routes that were very easily integrated into Southwest's network and operation. And two mergers in the mid 80s, TWA-Ozark and Northwest-Republic, led to the integration of operations at large hubs (Detroit, Minneapolis and St. Louis) that had been artificially segregated by CAB route regulations.

Exhibit 9

Large Airline Mergers	Category	**Were merger acquisition and implementation costs fully justified by improved profitability?**
80: Pan Am/National	Post Deregulation	**FAILURE**—NA network largely liquidated
82: Texas Intl/Continental	Post Deregulation	**FAILURE**—carrier quickly went bankrupt
85: Southwest/Muse	Small Acquisition	**FAILURE** —MC assets quickly liquidated
85: People Exp/Frontier	Synergy/Scope	**FAILURE**— carrier quickly went bankrupt
86: TWA/Ozark	Post Deregulation	Profitable—Restructured STL into a competitive hub
86: Northwest/Republic	Post Deregulation	Profitable—Restructured DTW/MSP into competitive hubs
86: American/Aircal	Synergy/Scope	**FAILURE**—OC network totally liquidated
87: Continental/PE/NY/FL	Synergy/Scope	**FAILURE**—carrier soon bankrupt, FL/NY networks liquidated
87: Delta/Western	Synergy/Scope	**FAILURE**—WA network largely liquidated
87: Continental/Eastern	Synergy/Scope	**FAILURE**—CO soon bankrupt, EA network liquidated
88: USAir/PSA	Synergy/Scope	**FAILURE**—PS network largely liquidated
88: USAir/Piedmont	Synergy/Scope	**FAILURE**—US soon bankrupt, PI partially liquidated
94: Southwest/Morris	Small Acquisition	Profitable—easy fit with SWA network/operations
99: American/Reno	Synergy/Scope	**FAILURE**—QQ network largely liquidated
00: American/TWA	Synergy/Scope	**FAILURE**—TW network largely liquidated
00: United/USAir (plan)	Synergy/Scope	**FAILURE**—both carriers went quickly bankrupt
05: America West/USAir	Chapter 11 reorg	Profitable—helped avert liquidation, but profits still weak
07: Northwest/Midwest	Small Acquisition	**FAILURE**—YX soon bankrupt, NW had massively overpaid

Note: 2000 United/USAir merger reached regulatory review process but was never implemented
All Canadian airline mergers during this time frame were also failures