U.S. House of Representatives
Committee on Transportation and Infrastructure
Washington, DC 20515

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September 15, 2008

SUMMARY OF SUBJECT MATTER

TO: Members of the Committee on Transportation and Infrastructure

FROM: Subcommittee on Aviation Staff

SUBJECT: Hearing on the "Effects of the Proposed Arrangement Between DHL and UPS on Competition, Customer Service, and Employment"

PURPOSE OF HEARING

The Full Committee will meet on Tuesday, September 16 at 2:00 p.m. in room 2167 Rayburn House Office Building to receive testimony regarding the Effects of the Proposed Arrangement Between DHL and UPS on Competition, Customer Service, and Employment.

BACKGROUND

DHL Express (DHL)[1] and the United Parcel Service (UPS) are competitors in providing air express service, in which packages are generally picked up by trucks, moved by air, and then delivered to the ultimate destination by truck. For the past few years, DHL has contracted with other air carriers to provide the airlift portion of its service. On May 28, 2008, DHL and UPS announced that they intend to enter into an agreement for UPS to provide airlift transportation services for DHL's domestic express and international package volume in the United States, and between the United States, Mexico, and Canada. DHL states that this agreement is the only way that it can continue to maintain its presence in the U.S. market due to the economic losses that is has experienced. The proposal has drawn attention because DHL is trying to remain a competitor with UPS, while also handing over its airlift operations, which are now carried out by ASTAR and ABX airlines, to UPS. Moreover, the City of Wilmington, Ohio, where DHL's hub is located,

[1] The initials of last names of the original founders Adrian Dalsey, Larry Hillblom, and Robert Lynn represent the D, H, and L.

stands to lose thousands of jobs and revenue if this deal is consummated. To date, no agreement has been reached between DHL and UPS.[2]

I. The Air Cargo (Express) Industry

According to the Air Cargo Management Group (ACMG), in 2007 the revenue of the U.S. domestic air cargo and express market[3] combined was $32.8 billion. Of that, Federal Express (FedEx) claimed 43 percent ($14.02 billion) of the market, UPS 32 percent ($10.60 billion), DHL 8.5 percent ($2.8 billion), and the U.S. Postal Service (USPS) 2.9 percent ($950 million).[4] In terms of domestic air express volume in 2007, FedEx claimed 33 percent, UPS 26 percent, USPS 23 percent and DHL 12 percent of the market.[5] The daily package volume in the U.S. domestic express market is now at 6.644 million shipments per day, which is down about 1.8 percent from last year, and about 5 percent below its peak in 2000.[6] Industry insiders attribute the decline in air express package demand to the downturn in the economy, the use of the internet to transmit documents, and the increase in jet fuel prices. In addition, as it has become more expensive to ship a package express or overnight, consumers have shifted their demand to ground package delivery (i.e., 2-3 day service).

According to ACMG, both UPS and FedEx experienced a 2 to 3 percent decline in their domestic express shipment counts in the first quarter of 2008.[7] Between 2003 and 2007, UPS and FedEx experienced over 10 percent gains in traffic, while DHL experienced a decline in traffic of almost 27 percent. In combined market share today, FedEx and UPS represent nearly 90 percent of the U.S. domestic express market in RTMs (revenue ton-miles).[8]

II. Relationship Between DHL, ABX and ASTAR

DHL's roots began in San Francisco in 1969, when it primarily shuttled documents between the U.S. mainland and Hawaii. Over time, DHL became a global express carrier. In 1998, Deutsche Post World Net (DPWN)[9] – the German Post Office – acquired a 25 percent stake in DHL International, and expanded its ownership to 100 percent by the end of 2002. Prior to DPWN's

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[2] Recent reports suggest that the timeframe has been pushed back to about November 2008, as opposed to August 2008 as originally slated. *Deutsche Post Faces Delays of U.S. Express Business Restructuring – Report,* German Business Digest (September 4, 2008).

[3] The air express package industry is defined as, "[T]he cargo carried by or for the integrated express operators that provide time-definite, door-to-door delivery service using closed-loop systems that include in-house (in the case of FedEx and UPS) controlled aircraft, dedicated sortation hubs and trucks/vans for pickup and delivery." Air Cargo Management Group (ACMG), *Development of the U.S. Air Express Market (2003-2007)* (Aug. 15, 2008), at 1. ACMG was engaged by APA Teamsters Local 1224 to research and describe the structure of and developments in the U.S. domestic express package industry between 2003 and 2007. ACMG was not engaged to issue its professional opinion of such developments or of their implications.

[4] *Id.* at 2. Note that the FedEx component includes an undisclosed amount paid by USPS to FedEx for it to carry Priority Mail. In January 2001, the USPS entered into an agreement with FedEx for it to provide airport-to-airport movement of large containers of its mail, and to drop off packages at FedEx drop boxes nationwide.

[5] *Airfreight and Surface Transportation Report,* Bear Stearns (January 2008). Note that much of USPS's overnight service is provided by FedEx.

[6] ACMG, *supra* note 3, at 6.

[7] *Id.* at 7.

[8] *Id.* at 10, 11.

[9] At the end of 2007, DPWN was 70 percent owned by institutional and private investors and 30 percent owned by the German government.

acquisition of DHL, the company's air operations were conducted by DHL Airways (a U.S. company). After DPWN's purchase, DHL Airways was sold to U.S. investors and renamed ASTAR.[10] DHL's ground delivery operations are conducted by DHL Express, a wholly owned subsidiary of DHL.

In 2003, DPWN acquired Airborne Express for just over $1 billion. Prior to the DPWN acquisition, Airborne Express operated its airlift services through its in-house airline, ABX Air. After the acquisition, ABX Air became a separate, publicly traded company. DHL, as part of its acquisition of Airborne Express, took ownership of the Wilmington Air Park, a privately-owned regional cargo facility in Wilmington, Ohio. In 2005, DHL closed its new Cincinnati hub and moved those operations to the Wilmington facility.[11] According to DHL, the integration of the Cincinnati hub into Wilmington did not go well, resulting in customer service issues and lost contracts.

DHL currently has Aircraft, Crew, Maintenance, and Insurance Service Agreements (ACMI) contracts with both ABX and ASTAR for airlift in the United States. DHL states that having two such ACMI contracts puts it at a competitive disadvantage to FedEx and UPS because it has no operational control over the airlift service.

In 2007, DHL acquired a minority stake in ASTAR, in the hopes that ASTAR would purchase ABX to form a single carrier so as to reduce operating costs. ASTAR subsequently issued an "expression of interest" to buy ABX for $7.75 a share, which ABX rejected.[12]

According to DHL, it has invested over $5 billion in its U.S. operations since 2003, and is projecting operating losses of $1.3 billion in 2008.[13] On May 28, 2008, DHL announced a restructuring plan for DHL Express in the United States consisting of two elements: 1) reorganization and consolidation of its domestic ground network; and 2) negotiation of an agreement with UPS to have UPS provide airlift service for DHL's air parcel and cargo. DHL states that it wants to reduce its U.S. losses by switching to one airline carrier (UPS), while maintaining a strong U.S. presence and continuing to offer comprehensive service to its customers.[14] DHL expects to pay UPS about $1 billion per year under the proposed 10-year contract. DHL's current airlift contracts with ABX and ASTAR would be terminated, and its sorting operation would be shifted from Wilmington to UPS's hub in Louisville, Kentucky. The agreement would effectively eliminate between 30 and 50 percent of DHL's network capacity.[15]

In addition, DHL is reducing its ground line-haul network 18 percent, which includes expanding its agreement with USPS to provide ground delivery service in rural areas. DHL will

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[10] This occurred since U.S. law prohibits non-U.S. citizens from owning or controlling U.S. air carriers.

[11] *Joint Hearing of the Ohio Senate Finance and Ohio House State Government Committees*, Aug. 19, 2008 (statement of Joseph Hete, CEO of ABX Air).

[12] Letter from Joseph C. Hete, President and CEO, ABX Air, to John H. Dasburg, Chairman and CEO, ASTAR Air Cargo Holdings, LLC (July 24, 2007) (on file with Committee).

[13] Meeting with Wolfgang Pordzik, Executive Vice President of Corporate Public Policy for DHL, in Washington, D.C. (Sept. 4, 2008).

[14] Transcript, Deutsche Post AG, Deutsche Post AG to discuss the future of DHL U.S. Express business – Conference Call (May 28, 2008) (on file with Committee staff).

[15] *Deutsche Post Faces Delays of U.S. Express Business Restructuring – Report,* German Business Digest (September 4, 2008).

close 34 percent of its U.S. stations and pickup and delivery routes.[16] DPWN, DHL's parent company, estimates that the restructuring plan will cost $2 billion, including contract termination cost for ABX and ASTAR;[17] however, it predicts that its losses in North America would ultimately shrink to $300 million by 2011.

II. Impact of Proposed Agreement on ASTAR and ABX

Both ASTAR and ABX report that if the DHL-UPS agreement goes forward they will have to reevaluate their respective company structures and employment needs. ASTAR will likely be forced out of business since the majority of its business is from DHL.[18] ABX states that over 7,000 employees would lose their jobs. To survive in the industry, ABX states that it has three options: 1) operate a maintenance repair organization at the Wilmington Air Park; 2) modify its fleet of Boeing 767 freighters and operate as a standalone ACMI carrier; or 3) cease operating an airline and secure revenue by leasing B767s to other operators. In the last scenario, ABX Air would effectively cease to exist since less than 100 employees would be required to support that operation.[19]

Reports suggest that negative effects of the proposed agreement are occurring now including lost revenue and service for DHL, ASTAR and ABX. ABX disclosed that revenues are down 40 percent[20] and ASTAR estimates that DHL's volume has decreased 40 percent in the past 60-75 days.[21]

III. Impact on the State of Ohio

The anticipated affects of the agreement would potentially devastate the city of Wilmington and much of Ohio. The Wilmington Air Park is the largest employer in southwest Ohio. Approximately 9,000 jobs are expected to be lost in Ohio alone (1,200 DHL employees, 725 employees of ASTAR, and 7,000 ABX employees); one out of three households in Wilmington has an ABX employee.[22] ABX announced that 235 employees would be let go by October 24, 2008 since DHL is retiring 23 of its planes as part of the restructuring plan.[23] In February 2008, DHL cut 3 percent of its workforce in the United States, or 600 jobs, including 35 in its headquarters in Plantation, Florida.[24]

Ohio also predicts that its unemployment trust fund will be insolvent by the end of 2008 or early 2009. Small businesses in the area estimate they will see a 30 percent drop in revenue as well. The Ohio state government is working quickly with all stakeholders to assist employees involved

[16] ACMG, *supra* note 3, at 20, 21.
[17] Deutsche Post AG, *supra* note 14.
[18] Meeting with Gary Hammes, COO of ASTAR, Washington, D.C. (Sept. 8, 2008). Approximately 90 percent of ASTAR's revenues are drawn from its DHL airlift operations and the remainder (10 percent) is from military contracts.
[19] *Joint Hearing of the Ohio Senate Finance and Ohio House State Government Committees*, Aug. 19, 2008 (statement of Joseph Hete, CEO of ABX Air).
[20] Meeting with John Herron, Legislative Liaison, Airline Professionals Association, Teamsters Local 1224, Representing the ABX Air Flight Crewmembers, Washington, D.C. (September 2, 2008).
[21] Gary Hammes, *supra* note 18.
[22] See *supra* note 19 (statement of Lt. Governor Lee Fisher, Director, Ohio Department of Development).
[23] *First Wave of ABX Job Cuts to End Oct. 24*, Business First of Columbus (Aug. 28, 2008).
[24] *DHL to Slash 3 Percent of Workforce*, Miami Herald (February 13, 2008).

through job training and career resources, emergency grants, unemployment insurance and other assistance programs.

DHL states that it has committed to provide over $260 million in severance, retention and health benefits for the Wilmington Air Park employees.

IV. Competition Concerns

While the terms of the proposed UPS/DHL airlift agreement are unknown at this time, numerous concerns have been raised about competition in the express delivery market if the deal is consummated. Opponents of the proposed agreement have alleged that it potentially could violate antitrust statutes under both section 1 of the Sherman Act, which prohibits agreements that restrain competition, and section 5 of the Federal Trade Commission Act, which prohibits unfair competition.[25] Because this is not a merger or acquisition, it is not subject to the Hart-Scott-Rodino Act, and thus the parties are not required to file the agreement for pre-implementation review under the antitrust statutes. However, this does not prevent the Department of Justice (DOJ) from reviewing the agreement to determine if there are any anticompetitive effects. In April 2000, the Federal Trade Commission and the DOJ issued guidelines to explain how the agencies analyze certain antitrust issues raised by collaborations by competitors.[26] Some of the factors that DOJ/FTC review include: whether the agreement limits independent decision-making or combines/controls financial interests; competitive effects in relevant product and geographic markets; market concentration; likelihood of anticompetitive information sharing; duration of collaboration; ease of entry for new competitors; as well as procompetitive benefits.[27] These antitrust issues involve complex legal analysis and the Committee has invited an expert to testify on these items.

Opponents of the deal state that allowing DHL to outsource its airlift to UPS, one of its main competitors, would essentially leave DHL "captive" to UPS in terms of capacity, price, and customer service. Airlift services comprise about 60 percent of the cost of shipping a package overnight.[28] Therefore, because a significant percentage of DHL's costs will be tied to UPS, DHL could lose the ability to competitively price its services to compete with both UPS and FedEx (this is called "price squeezing") in the market. In other words, when a direct competitive rival (here, UPS) supplies a major input (air transport) to DHL, the rival is free to increase its rates to the point where DHL can no longer make a profit because it is paying so much for the necessary air transport that its prices must be higher than its competitor's. This means that DHL sales could be detrimentally affected, or, alternatively, if DHL's retail price to its customers is lower than UPS's, it could lose money on each sale that it makes. Either way, DHL could go out of business, leaving the market a duopoly. Moreover, because UPS will also control the capacity on its planes, if DHL is not guaranteed space, its ability to ensure on-time arrivals could be hampered, thus affecting customer service. These pricing and capacity issues raise the question of whether DHL can remain a viable competitor in the U.S. express industry.

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[25] *See, e.g.,* Ohio Congressional Delegation Letter to Thomas O. Barnett, Assistant Attorney General, Antitrust Division, Department of Justice, and William E. Kovacic, Chairman, Federal Trade Commission (July 15, 2008).
[26] *See Antitrust Guidelines for Collaborations Among Competitors,* U.S. DOJ & FTC, April 2000, *available at* http://www.ftc.gov/os/2000/04/ftcdojguidelines.pdf.
[27] *Id.*
[28] Wolfgang Pordzik, *supra* note 13.

In addition, opponents are concerned that if the express industry is reduced to two major carriers, competition could be substantially reduced and prices could increase. When established carriers control markets, the tendency is for the carriers to follow each other's price changes so that prices are identical, and customer choice is limited. If DHL is effectively "neutered" in the marketplace, there would be incentives for UPS and FedEx to refrain from competing with each other, thereby increasing the price overall for express delivery packages.

Opponents have also expressed concern that UPS will have access to DHL's proprietary customer data because the packages that would be sorted at UPS's facility would contain either barcodes or labels that include information such as package contents, volume, name and address, and price. UPS would then have information necessary to not only undercut DHL on price, but also to persuade DHL customers to switch express delivery providers.

Last, opponents argue if DHL decided that it no longer wanted UPS to provide its airlift service, it would not have many other options, especially if ABX and ASTAR go out of business. FedEx may not be a viable option because it would present similar competitive issues that the proposed UPS deal raises. This could also limit DHL's ability to compete in the market.

DHL states that its restructuring plan will improve its financial condition and sustain it as a competitor in the U.S. market. The company continues to see the U.S. market as a crucial piece in maintaining its international network, with manageable losses. DHL notes that it expects to lose \$1.3 billion in 2008 (in addition to restructuring costs); that is, approximately \$5 million per day. Though the implementation cost of the proposed agreement will be about \$2 billion, DHL's expected cost savings from the proposed deal would be approximately \$1 billion annually. DHL also states that it will retain complete control over its ground delivery business, pricing strategies, and proprietary information, so as to retain its status as an independent competitor in the U.S. express delivery market. According to DHL, the proposed arrangement with UPS is merely a substitution of one vendor for its current two vendors, and "would not involve any merger, acquisition, or transfer of assets between DHL and UPS."[29] Moreover, DHL notes that similar vendor relationships are common in the transportation industry, stating that FedEx currently provides airlift services for USPS, and UPS claims that similar arrangements exist in trucking, rail and ocean carriage, as well as in the telecommunications industry.[30] DHL also argues that the UPS arrangement would bring substantial operating efficiencies, thus making it a viable competitor in the long term. Moreover, both DHL and UPS state that many of the anticompetitive concerns expressed regarding this agreement can be worked out through contract negotiations.

[29] *Competition in the Package Delivery Industry: Hearing before the U.S. House Committee on the Judiciary*, 110th Cong. (2008) (statement of John Mullen, CEO, DHL Express), at 8.
[30] *Id.* at 9. See also, *Effects of the Proposed Arrangement Between DHL and UPS on Competition, Customer Service and Employment: Hearing before the U.S. House Committee on Transportation and Infrastructure*, 110th Cong. (2008) (statement of Burt Wallace, President of Corporate Transportation, UPS), at 3.

WITNESSES

MEMBERS PANEL

The Honorable Sherrod Brown
United States Senate - Ohio

The Honorable Michael R. Turner
U.S. House of Representatives
3rd District, Ohio

PANEL I

The Honorable Lee Fisher
Lt. Governor of the State of Ohio and
Director of the Ohio Department of Development

The Honorable David L. Raizk
Mayor
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PANEL II

Mr. John P. Mullen
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Mr. Burt Wallace
President of Corporate Transportation
United Parcel Service of America

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