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BEFORE THE UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON THE JUDICIARY

"COMPETITION IN THE AIRLINE INDUSTRY"

JUNE 16, 2010

Good afternoon Chairman Conyers, Ranking Member Smith and members of the committee.

My name is William Swelbar. I am a Research Engineer with the Massachusetts Institute of Technology's International Center for Air Transportation. Our program is focused on the economic, financial, operational and competitive aspects of the global airline industry. I appreciate the opportunity to speak today in support of the merger of United and Continental Airlines. Whereas I have worked with each United and Continental in a consulting capacity in the past, I appear today as an independent expert on the U.S. and global airline industry.

Many see the global airline industry as somehow U.S.-centric. It is not. In aviation, the U.S. is but one piece of a big puzzle that is influenced by global economic interdependencies, just as the U.S. economic recovery could be affected by events in Greece, Portugal, Spain and Hungary.

United and Continental presented in their testimony before the Senate Committee on Commerce Science and Transportation an exhibit showing where U.S. airlines have fallen in their ranking among the globe's largest airlines. I am bothered by the fact that the U.S. carriers have been surpassed by Lufthansa/Swiss and Air France/KLM. This fact is but one reason that helps to explain why United and Continental are pursuing this merger.

For the network carriers like United and Continental, this round of consolidation is as much about preparing to compete with the world's other big carriers for international traffic as it is about competing with low cost carriers (LCCs) like Southwest, AirTran, jetBlue or Frontier in the domestic market. After all, it is the network carriers and not the low cost carriers that serve communities of all sizes. Despite the footprint established by the low fare carriers that is now national in scope, with their share of domestic traffic approaching 40 percent, it is the network carriers that connect the smallest U.S. markets to the globe's air transportation grid.

I would like to debunk some of the myths I have heard said about the merger of United and Continental.

1. **OVERLAPPING ROUTES/HIGHER PRICES:** There are just 15 nonstop, overlapping routes flown by each United and Continental. None of the 15 would be a monopoly United route after the proposed merger. Eleven of the 15 overlapping city pairs would have at least two competitors. Of the four routes that would have but one other nonstop competitor (Houston – Washington, Houston – Los Angeles, Houston – San Francisco and Cleveland – Denver), that other competitor is Southwest Airlines in three of the four and Frontier on the other. In each of the four routes, the LCC competitor has at least a 25 percent share of traffic.

   In addition to a nonstop competitor, two of the routes have four other carriers providing connecting service; one has three other carriers providing connecting service; and one has two other carriers providing connecting service. The airline industry is a network industry and connecting options for passengers must be taken into account when considering competitive impacts as they also work to discipline prices.

   The U.S. market should not fear the "end to end" network consolidation like Delta – Northwest and the proposed United – Continental merger. The low cost carrier segment of the US airline industry would regale in the fact that network carriers would price well above the market as was the case in the late 1990s and early 2000s as it would serve as the catalyst for growth at the expense of the network carriers again. The market has demonstrated time and again that where competition is vulnerable, a new entrant will exploit that vulnerability. Where there are market opportunities, there will be a carrier to leverage that opportunity. And where there is insufficient capacity, capacity will find the insufficiency.

2. **START OF ANOTHER BIG MERGER WAVE:** Some predicted that the Northwest-Delta merger in 2008 would be the catalyst to a big merger wave. Two years later, we have a second merger announcement. That hardly seems to be a wave. Nonetheless, each merger case should be considered on its own merits, not based upon what someone speculates might happen. Moreover, the concerns are most relevant in highly concentrated industries. The U.S. domestic airline industry will remain fragmented should the proposed merger be approved as seven airlines will have at least a 5 percent market share.

   When thinking about airlines in a global context, no one airline has a 5 percent share of the global market. The top 10 firms producing mobile handsets comprise 85 percent of their industry; the top 10 automotive manufacturers make up 76 percent of their industry; and the top 10 container shipping firms equal 63 percent of their industry. Yet the world's 10 largest airlines make up only 36 percent of the global airline industry. These define a fragmented industry prohibited from operating as other global industries, not a concentrated one.

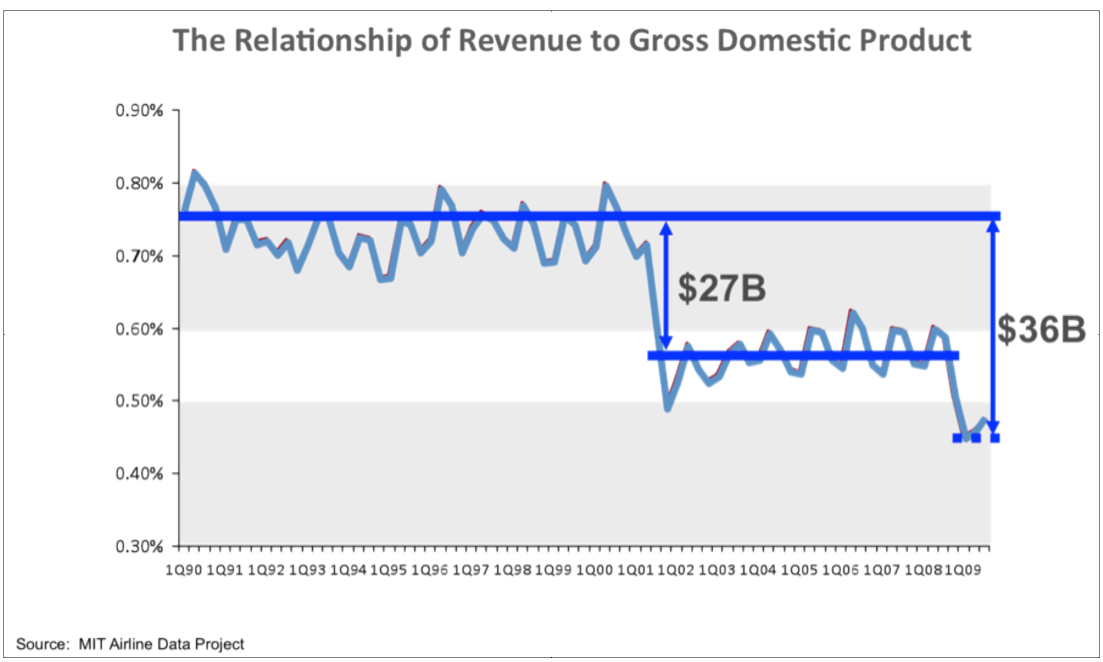
3. **HUB CLOSURES AND FLIGHT REDUCTIONS:** The fear mongers would have us believe unequivocally that there will be reductions in flying, the dislocation of small communities from the global airline map and even hub closures because of consolidation. Many use TWA and its St. Louis hub as an example. American Airlines did not merge with a failing TWA. Rather it acquired certain assets of a failed TWA. As a result it is a very poor example of what could happen to a hub.

   But was it consolidation of the industry that ultimately caused American to downsize St. Louis or was it the events of 9/11 and the changed economics of the industry that followed that ultimately rendered St. Louis uneconomic? Might the local economy in St. Louis have contributed to the city no longer being an attractive hub city that produces significant local traffic to support the hub carrier? St. Louis is but one example of hub closures since September 2001 as US Airways/America West has in effect closed it Las Vegas hub and its Pittsburgh hub. Neither of the closures can be laid at the feet at the carrier's merger with US Airways. In fact if America West had not agreed to merge with US Airways it is highly likely that the old US Airways would have been liquidated.

   In the case of this merger, there has been much speculation about the future of Continental's Cleveland hub. There is nothing that I can see from this merger that would make Cleveland redundant. Without knowing what the internal data might say but being knowledgeable about airline planning models, I would guess that the modeling would suggest that Cleveland would be made stronger as a result of the merger and not weaker. The answer to Cleveland remaining a critical point on the combined carrier map will have everything to do with the condition of the local Cleveland economy as well as the price of oil and little to nothing to do with the decision to merge.

4. **EMPLOYEE/EMPLOYMENT DISRUPTIONS:** Since 2001, the industry has shed nearly 140,000 airline jobs. But 400,000+ good jobs where wages and benefits average over $81,000 per year per full time equivalent remain. In fact, the average wage for airline employment reached its high point for the decade during the third quarter of 2009. This average employee cost comes after the significant concessions granted at each of the five remaining network carriers between 2002 and 2007. Headcount reductions were significant during the period as well as companies were forced to reduce their size in response to a changed revenue environment and increasing fuel prices. The reductions continued into 2008 as oil climbed to $147 per barrel and jet fuel to the equivalent of $172 per barrel. 2009 marked the second largest decrease in industry capacity since 1942.

   Susan Carey of *The Wall Street Journal* wrote an article titled: "Airline Industry Sees Pain Extending Beyond the Recession." In this critically insightful piece Carey examines the relationship of airline industry revenue to U.S. Gross Domestic Product. "For decades U.S. airlines could rely on a remarkably stable relationship between their revenue and gross domestic product. Year after year, domestic revenue came in at 0.73% of GDP on average, and total passenger revenue was equal to 0.95% of GDP. For the year ended March 31, domestic revenue was 0.54% of GDP, while total passenger revenue was 0.76% of GDP". What this means is that based on the historic norm of the revenue to GDP relationship, there is $27 billion less in revenue today to be shared among the industry's competitors than there was just 10 years ago.



Consolidation is not the culprit of lost airline jobs or declining airline wages. Airlines were left with little choice but to restructure given the changed revenue environment precipitated by the growth of the low cost carriers and the transparency in fares facilitated by the internet as a distribution vehicle.

What is clear to me is that no individual airline except possibly Southwest and Delta would have the financial wherewithal to withstand another geopolitical event similar to what occurred on September 11, 2001. Unlike other rounds of consolidation that focused primarily on network scope, scale, revenue and cost synergies, this round is different. Now the industry is looking at the balance sheet. Consolidated carriers promise more stability to employees and communities that benefit from the combined strength of the respective balance sheets.

5. **REREGULATION:** Some suggest that re-regulation of the industry will improve the economic well being of certain stakeholders. Isn't a goal of policy makers to maximize the number of good paying jobs? The airline business sells what is best characterized as a highly price elastic product. Only a segment of the buyers of airline services is less sensitive to price. Over the past 30 years, the industry has competed away the savings/benefits of nearly every innovation (ex. reduced commission expense) in the name of low and lower fares for consumers. Some think that reverting back to the days of a regulated industry will benefit certain segments of the industry. I firmly believe it would harm the industry by causing it to contract further as prices rise as inefficient costs are passed through to the consumer. A smaller industry would employ fewer workers.

Many government officials and certain industry watchers have instilled fear into the marketplace regarding the impact of current and prospective industry consolidation. Fears of higher prices, reduced service, more monopoly routes, and labor strife are not well founded. Their analysis of the industry today parallels an analysis appropriate in a regulated period.

Simply put, the network carrier model of the 1980's and 1990's does not work in today's environment. Consolidation is a logical step to position airlines in a highly fragmented domestic and global industry to better weather the financial challenges that have caused years of economic pain for many stakeholders and a rising tide of red ink.