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

James L. Oberstar
Chairman

John L. Mica
Ranking Republican Member

David Heymsfeld, Chief of Staff
Ward W. McCarragher, Chief Counsel

James W. Coon II, Republican Chief of Staff

June 15, 2010

SUMMARY OF SUBJECT MATTER

TO: Members of the Subcommittee on Aviation

FROM: Subcommittee on Aviation Majority Staff

SUBJECT: Hearing on "The Proposed United-Continental Merger: Potential Effects for Consumers and the Industry"

PURPOSE OF HEARING

The Subcommittee will meet on Wednesday, June 16, at 9:30 a.m., in room 2167 of the Rayburn House Office Building to receive testimony regarding the proposed merger of United Airlines and Continental Airlines and its potential effects for consumers and the industry.

BACKGROUND

United and Continental announced last month that they would merge to form the world's largest air carrier, further reordering the dynamic U.S. airline industry. Some analysts say the merger could increase the probability of more consolidation in the future, with American Airlines and US Airways regarded as potential participants, and with low-cost carriers having expressed interest in exploring potential transactions, as well.

The United-Continental merger is the second merger between so-called U.S. legacy carriers – mainline carriers that operate traditional hub-and-spoke route networks – to be announced after the industry-wide crisis that began on September 11, 2001. Legacy carriers have continuously struggled to regain profitability after a series of challenges that began with the 2001 terrorist attacks and culminated in skyrocketing oil prices and a global economic crisis. The challenging economic environment led to reorganizations in bankruptcy by Delta Air Lines, Northwest Airlines, United, and US Airways, and it led, as well, to the failures of smaller carriers such as ATA Airlines and Aloha Airlines. United operated in bankruptcy from 2002 until 2006; Continental did not seek bankruptcy protection during the post-2001 crisis.

The announcement of the merger at issue came slightly less than two years after Continental executives declined a prior United merger proposal, opting instead to cooperate on pricing and schedules with United and other Star Alliance carriers with Federally approved immunity from enforcement of antitrust law.

I. The Proposed Merger

United and Continental announced on May 3, 2010, that their boards of directors had reached agreement on a merger that would create the world's largest airline. The merger would be consummated by a stock-swap transaction the airlines value at approximately $8 billion. United shareholders would hold 55 percent of the equity in the combined entity; Continental shareholders would own 45 percent. Chicago-based United and Houston-based Continental operate largely complementary route networks, although their networks overlap on 15 routes among major U.S. cities. United president, chairman, and chief executive officer (CEO) Glenn Tilton would initially assume the chairmanship of the combined entity; Continental president, chairman, and CEO Jeff Smisek would become the new carrier's president and CEO.

The combined airline would retain the United name and Continental branding elements (including aircraft paint scheme) and would be headquartered in Chicago, although executives have publicly said they intend to maintain a management presence in Houston, Continental's base. Assuming no substantial network changes, the combined network would emanate from major U.S. hubs in Chicago, Cleveland, Denver, Houston, Los Angeles, Newark, San Francisco, and Washington, D.C., with smaller Pacific networks centered on Guam and Tokyo. According to projections, the merged carrier would surpass Delta Air Lines as the world's largest airline in terms of revenue and available seat miles (ASMs). United and Continental say Delta would continue to serve more destinations than any other U.S. carrier.

According to information published by the carriers, the proposed merger would result in new annual synergies totaling $1 billion to $1.2 billion, with net annual cost synergies expected to total between $200 million and $300 million and estimated revenue synergies to total between $800 and $900 million. The carriers say the combined company would generate annual revenue of approximately $29 billion. Combined, the two carriers employ approximately 89,000 people in the United States and abroad.

II. Federal Review

Under Federal law, the Department of Justice (DOJ) must thoroughly examine a proposal to combine two or more airlines to determine whether the proposal violates antitrust law. The Department of Transportation (DOT) must also approve the transfers of the combining carriers' operating authorities.

A. Department Of Justice Antitrust Review

Federal law generally forbids large business entities from combining in ways that substantially restrain or eliminate competition. The Clayton Antitrust Act prohibits any transaction "where in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly."[1] The DOJ's Antitrust Division and the Federal Trade Commission enforce the Clayton Act and antitrust law, although the DOJ bears primary responsibility for reviewing proposed airline mergers.

To ensure DOJ officials have sufficient time in which to assess proposed transactions and to decide whether to challenge them, the Hart-Scott-Rodino Act (P.L. 94-435) requires the parties to certain high-value transactions – airline mergers included – to notify the DOJ of the pendency of those transactions and to observe a 30-day waiting period, which can be extended upon DOJ request, before proceeding with the transactions.[2] DOJ review typically consumes three to six months, at minimum; United and Continental legal counsel informed staff that the carriers hope DOJ review will conclude by the end of this year.

For purposes of application of antitrust law, airline mergers are horizontal mergers: combinations of competitors offering the same product in the same geographic markets. Horizontal mergers may result in, among other things: (1) an increase in the merged entity's market power, such that it would attain an undue level of control over pricing; and (2) informal collusion or predatory pricing practices among the few carriers remaining in a given market. In such a case, with relatively few companies in a given market, it becomes possible for firms to predict accurately how rivals will react to changes in price without any explicit agreements. Further, an increase in concentration may also enhance a company's ability to engage in predatory conduct toward competitors, producing new barriers to entry for new firms, leading ultimately to higher prices.

The DOJ applies its and the Federal Trade Commission's *Horizontal Merger Guidelines* to determine whether a merger will result in the creation or enhancement of any single carrier's market power in any relevant market.[3] Such a result obtains when a merger "significantly increases concentration and results in a concentrated market."[4] To ascertain whether the merged carrier's market power will blossom to improper levels, the DOJ conducts a five-part analysis prescribed under the Guidelines:

(1) The DOJ identifies markets affected by the merger, ascertains the merger's effect on the number of competitors in those markets, and assesses market concentration post-merger;

(2) The DOJ analyzes the likely competitive effects of any increase in concentration;

(3) The DOJ considers the likelihood of new entry that could mitigate potentially anticompetitive effects in affected markets;

(4) The DOJ assesses whether the merger may result in market efficiencies or any net increase in competition; and

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[1] 15 U.S.C. § 18 (2010).
[2] *Id.* at § 18a. Staff was informed the 30-day waiting period for this transaction has been extended.
[3] DOJ and U.S. Federal Trade Commission, *Horizontal Merger Guidelines* (April 8, 1997).
[4] *Id.* at § 1.0.

(5) The DOJ evaluates whether one or more of the parties to the merger are likely to fail, causing the loss of assets from the system, unless the merger proceeds.[5]

Folded into the analysis is an evaluation of the potential future consequences of the proposed merger, including its "downstream" effects, such as the likelihood that the merger might lead to other mergers[6] or will change competitive dynamics in the industry.[7] The DOJ applies the Guidelines "reasonably and flexibly to the particular facts and circumstances of each proposed merger," because "it is not possible to remove the exercise of judgment from the evaluation."[8]

The DOJ's market-by-market analysis typically requires the DOJ to identify city pairs in which a merger may affect the level of competition. A reduction in competition would most commonly occur on routes operated by both carriers, so the extent of network overlap is a major element in, if not a focal point of, the analysis. Generally, when determining competitive effects in relevant markets, the DOJ accounts for the significance of airline-specific practices such as loyalty programs and online reservation systems with instantaneous fare information.

The DOJ may consult with the DOT during its investigation when the DOT's expertise in aviation policy would assist the DOJ in making factual determinations. DOT staff said the DOT supplies data and policy advice to the DOJ as appropriate. In some past merger cases, the DOT has privately shared views with DOJ on the possible competitive consequences of proposed mergers.

The DOJ's analysis may end with a conclusion that a merger does not jeopardize the level of competition in any relevant markets. In that case, the parties would be free to proceed with the transaction. On the other hand, the DOJ may conclude that the merger would create one or more anticompetitive concentrations of market share. In such a case, the DOJ may file suit in Federal court to block the merger, and the parties could agree to enter into a consent decree to dispose of the lawsuit, voluntarily agreeing to remedy competitive problems by divesting assets, or the case could proceed to final disposition by a judge, who could issue an injunction that either permits the merger to proceed with limitations or blocks the transaction altogether.

A DOJ decision to file a lawsuit to challenge a proposed airline merger would not be unprecedented. In 2001, the DOJ announced it would sue to block a proposed merger between United and US Airways; the carriers ultimately decided not to pursue that transaction.

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[5] *Id.* at §§ 1.0, 2.0, 3.0, 4, and 5.0.

[6] Asked about the role of the potential for future mergers in the DOJ's antitrust analysis, Assistant Attorney General James H. O'Connell, Jr., testified at the Aviation Subcommittee's 2008 hearing on the Delta-Northwest merger that "industry-wide implications can play a part in" the DOJ's market-power analysis. *Impact of Consolidation on the Aviation Industry, With a Focus on the Proposed Merger Between Delta Air Lines and Northwest Airlines,* U.S. House of Representatives, Committee on Transportation and Infrastructure, Subcommittee on Aviation, Transcript of Hearing (May 14, 2008), at 31.

[7] Mr. O'Connell further testified that the DOJ "look[s] at all aspects of competition . . . to determine what the current state of play is and, most importantly, to determine to what extent, if any, the transaction will alter that state of play, will change the competitive dynamic." *Id.* at 33.

[8] *Horizontal Merger Guidelines, supra* note 3, at § 0.

B. The Department Of Transportation's Limited Review

Each U.S. air carrier must possess a DOT certificate of public convenience and necessity in order to provide air transportation.[9] The DOT's role in government review of a proposed airline merger focuses on approval of the transfer of the predecessor carriers' statutorily required certificates to the merged entity. The DOT approves the transfer of such certificates – which include international route authorities – only if it concludes that doing so would be "consistent with the public interest."[10]

A certificate of public convenience requires a DOT finding that the applicant carrier is economically fit.[11] From an economic fitness perspective, both air carriers must provide DOT updated fitness information on the merged entity, and DOT would also have the authority to review any code-sharing arrangements or alliances involving the two carriers that would be affected by a merger.

III. <u>Possible Effects on Domestic and International Competition</u>

Any airline merger invariably affects consumers and communities, as a merger inherently reduces the number of competitors in the marketplace. According to data provided to staff from a variety of sources, including the carriers themselves, the proposed merger between United and Continental will affect competition in certain domestic and international city-pair markets. Reduction in competition inevitably leads to higher air fares. The recent public remarks of airline executives and industry analysts, furthermore, bespeak a strong industry expectation that further consolidation activity will follow.

A. Possible Effects on Domestic Competition

Concerns have been raised that a merger of United and Continental could result in substantial increases in air fares. The carriers could exert their market power to monopolistic effects at their hubs in some of the nation's important cities: Chicago, Cleveland, Denver, Houston, Los Angeles, New York, San Francisco, and Washington, D.C. The carriers state that they do not intend to close any of those hubs as a result of the merger. Accordingly, the combined carrier will be a generally bigger competitor at its hubs and will exert its power to discourage competitors from entering the market.

In 1993, the Government Accountability Office found that fares at concentrated hubs are higher than fares elsewhere.[12] Moreover, the Transportation Research Board noted in a 1999 report on competition in the airline industry that: "[h]igher average fares in concentrated hub markets compared with unconcentrated hub and nonhub markets have been observed in several studies" and that "the consistency with which hub markets appear among the highest fare markets is noteworthy and raises the possibility that hub carriers are exploiting market power in ways that would not be sustained if they were subject to more effective competition."[13] Proponents of the merger generally

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[9] *See* 49 U.S.C. §§ 41101, 41102 (2010).
[10] *Id.* at § 41105(a).
[11] *Id.* at § 41102(b).
[12] *See* Government Accountability Office, *Airfares at Concentrated Airports* (GAO/RCED-93-171).
[13] Transportation Research Board, *Entry and Competition in the U.S. Airline Industry: Issue and Opportunities* (1999), at 96.

point to low-cost carriers' ability – under the market structure that has existed until now – to exert price discipline on air fares in affected markets. Proponents say price discipline enforced by such carriers should minimize potential air fare increases in affected major markets. In this case, however, low-cost carriers are likely, at best, to exert price tension; industry experts say such carriers could increase their own fares if the combined United-Continental begins to exercise sufficient market power to sustain higher fares in affected markets. Moreover, low-cost carriers do not serve the majority of the small communities presently served by United, Continental, and other legacy carriers.

United's and Continental's domestic route networks overlap in certain major markets. Air fares will increase on nonstop flights among the major domestic markets where the route networks overlap and where the merger will necessarily reduce the number of competitors in those markets. The DOJ's most recent antitrust analysis, with the support of empirical data, economic studies, and precedent, generally assumed that air fares increase significantly in markets where the number of nonstop competitors decreases from two to one and that air fares increase to a lesser degree in markets where the number of nonstop competitors decreases from three to two.[14] The concentration of low-cost carriers and the extent of low-cost carriers' pricing power in affected markets may determine, to some degree, the effect on prices of such competitive reductions.

According to current and planned schedules, the United and Continental route networks overlap among 15 nonstop city-pairs markets as indicated in figure 1, below.

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[14] *See* Comments of DOJ on Order to Show Cause, *In re Joint Application of United Air Lines, Inc., et al.*, U.S. Dep't of Transp., Dkt. No. DOT-OST-2008-0234 (June 26, 2009), at 24-25, 25 n. 67 (citing, *inter alia*, Peters, "Evaluating the Performance of Merger Simulation: Evidence from the U.S. Airline Industry," 49 *Journal of Law and Economics* 627 (2006); Joskow, Werden & Johnson, "Entry, Exit and Performance in Airline Markets," 12 *International Journal of Industrial Organization* 457 (1994); Borenstein, "The Evolution of U.S. Airline Competition," 6 *Journal of Economic Perspectives* 45 (1992); Borenstein, "Hubs and High Fares: Airport Dominance and Market Power in the U.S. Airline Industry, " 20 *Rand Journal of Economics* 344 (1989); Brueckner, Dyer & Spiller, "Fare Determination in Hub and Spoke Networks," 23 *Rand Journal of Economics* 309 (1992); Morrison & Winston, "Enhancing Performance in the Deregulated Air Transportation System," 1989 *Brookings Papers: Microeconomics* 61 (1989) (hereinafter "DOJ Comments").

Figure 1. Network Overlap Between United and Continental.

NETWORK OVERLAP BETWEEN . . .	. . . AND . . .
Chicago	Cleveland Houston New York City
Cleveland	Denver
Houston	Denver Los Angeles San Francisco Washington, D.C.
New York City	Denver Los Angeles San Francisco Washington, D.C.
Los Angeles	Kahului, Hawaii Honolulu
Washington, D.C.	Cleveland

The merger will reduce, by one, the number of airlines competing for passengers in the city-pair markets listed in figure 1. In all but two city-pair markets, low-cost carriers presently compete with the two carriers.

However, a look at airport-pairs could raise concerns. Specifically, the merger will reduce the number of nonstop competitors from two to one among five airport-pairs:

- Cleveland (CLE) and Washington-Dulles (IAD);
- Denver (DEN) and Newark (EWR);
- EWR and IAD;
- EWR and San Francisco (SFO); and
- Houston-Intercontinental (IAH) and SFO.

Among four airport-pairs, according to data provided to staff, the number of competitors will be reduced from two to one when both nonstop and connecting service is considered:

- EWR and Omaha, Neb. (OMA);
- Steamboat Springs, Colo. (HDN), and IAH;
- IAH and Montrose, Colo. (MTJ); and
- IAH and OMA.

Several airports in the lists (EWR, IAD, IAH, and SFO) are located in metropolitan areas served by alternative airports where competitors, including low-cost carriers that help keep fares low, may offer nonstop or connecting service to affected cities. For that reason, the DOJ tends to focus on the city-pair analysis instead of the airport-pair analysis; the former accounts for the fact that travelers in large metropolitan areas such as Washington, D.C., Houston, New York City, and San Francisco do not necessarily utilize a single airport to the exclusion of others.

The carriers appear to expect, based on recent DOJ practice, that the DOJ will apply the city-pair analysis when assessing the merger's competitive effects and will consider the merger's effects on all airports together in metropolitan areas instead of individual airports. Aggregation in that manner would significantly reduce the number of overlapping city-pairs, although the carriers themselves acknowledge that they will attain a market share of more than 50 percent for nonstop and connecting service to and from two cities: Steamboat Springs and Montrose, Colorado.

The merger will increase the concentration of U.S. domestic market share, as well. According to the most recent data available from the DOT's Bureau of Transportation Statistics (BTS), as well as data provided by the carriers, United's and Continental's combined share of the domestic market would approach 20 percent, as depicted in figure 2, below. The combined carrier would possess the largest domestic market share of any U.S. carrier, and the domestic market would be dominated by the merged United, Delta, American, and Southwest, according to DOT data on airlines' shares of total revenue passenger miles.

Figure 2. Current Domestic Market Shares (percentage of total revenue passenger miles)[15]

CARRIER	DOMESTIC MARKET SHARE (percent)
American	13.8
Southwest	13.8
Delta	11.3
United	**10.5**
US Airways	8.0
Continental	**7.7**
Northwest	5.3
JetBlue	4.2
AirTran	3.4
Alaska	3.1
Other	18.9

According to data compiled by OAG Aviation Consulting Services, the merged carrier and its regional affiliates will operate 70 percent of seat departures from Cleveland, 87 percent from Houston-Intercontinental, 48 percent from Chicago-O'Hare, and 73 percent from Newark.

[15] BTS, *Airline Domestic Market Share, March 2009-February 2010*. Data for Delta and Northwest are reported separately because, during much of the reporting period, Delta and Northwest had not yet moved to a single operating certificate.

B. Possible Effects on International Competition

The proposed transaction also has an international dimension and will permit the combined carrier, in at least one international market, to attain a market share that the DOJ has previously characterized as anticompetitive.

In most transatlantic city-pair markets, United and Continental do not presently compete against one another, having received government approval in 2009 to cooperate with one another and with their Star Alliance partners on pricing and schedules in many worldwide markets. [16] The carriers' joint venture in transatlantic markets received, with DOT approval, immunity from enforcement of Federal antitrust law (with conditions).[17] United and Continental have sought the same immunity for a similar type of cooperation with their Japanese partner on transpacific flights.[18]

The DOJ objected to Continental's application for antitrust immunity for cooperation with United and Star Alliance carriers because, *inter alia*,

> [t]he . . . proposed elimination of competition between United and Continental for transpacific and Latin American service threatens competitive harm in markets where entry is limited by restrictive bilateral agreements. It will, for example, substantially lessen competition in city pairs between the U.S. and Beijing, where United and Continental provide substantial connecting service.[19]

The DOJ found that, between the United States and Beijing, China, Continental and United together account for 57 percent of capacity on offer between the United States and Beijing. Similarly, the DOJ found that the carriers jointly control 28 percent of the capacity on offer for flights between the United States and Hong Kong.[20]

The DOT, which has statutory responsibility for ruling on carriers' requests to proceed with immunized joint business ventures, accepted the DOJ's arguments in part and rejected them in part. The final order granting antitrust immunity to United and Continental carved out, from the immunity awarded, flights from the United States to Beijing, among other destinations.[21] Accordingly, the merger will vest, in the combined carrier, a sizeable market share in Beijing – one of the several markets in which United and Continental presently compete and do not enjoy antitrust immunity.

Concerns have been expressed that in transatlantic markets between the United States and Europe, where immunized alliances (SkyTeam, Star, and oneworld) already control a significant share of traffic, the consolidation of U.S. air carriers would further concentrate market share within

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[16] Final Order, *In re Joint Application of United Air Lines, Inc., et al.,* U.S. Dep't of Transp., Dkt. No. DOT-OST-2008-0234 (July 10, 2009) (hereinafter "DOT Final Order").
[17] *Id.*
[18] Joint Application of All Nippon Airways Co., Ltd., Continental Airlines, Inc., and United Air Lines, Inc., *In re Joint Application of All Nippon Airways Co., Ltd., et al.,* U.S. Dep't of Transp., Dkt. No. DOT-OST-2009-0350 (Dec. 23, 2009) (consolidated by order into Dkt. No. DOT-OST-2010-0059).
[19] DOJ Comments, *supra* note 14, at 2-3.
[20] *Id.* at 18-19.
[21] DOT Final Order, *supra* note 16, at 28, Appx. A.

these alliances, making it more difficult for new competitors to enter the market. Proponents of the merger claim United and Continental find it difficult to compete with well-capitalized foreign competitors and that antitrust-immunized alliances actually increase consumer choice. The merged carrier, together with its Star Alliance partners, will attain a substantial share of markets between the United States and international destinations and could, opponents say, engage in cartel pricing with the members of other airline alliances in international markets. At the least, the DOJ has expressed colorable concerns that, in certain international markets, collusion by United and Continental would be anticompetitive and result in air fare increases, as evidenced by the comments cited above.

C. Capacity Reductions

United and Continental executives maintain the merger will not, in and of itself, directly lead to significant reductions of capacity, although mergers tend to result in capacity reductions. The term "capacity" refers to the inventory of seats available to passengers. By adjusting capacity, airlines can move the supply of airline seats in relation to demand and can adjust air fares in accordance with the laws of supply and demand. Capacity is most routinely adjusted by disposing of certain aircraft and by reducing the inventory of seats and flights in certain markets. United and Continental executives say that, because the carriers' networks do not overlap significantly, the merger presents little opportunity to reduce capacity. The merger has been characterized as an end-to-end merger that will create cost synergies and new connecting opportunities for passengers.

Some industry analysts, however, hold a view that mergers make financial sense for carriers because they facilitate the elimination of capacity, constricting the supply of airline seats and increasing airfares. A J.P. Morgan report published on the eve of the merger announcement based its estimates as to cost and revenue synergies on an eight percent capacity reduction.[22] Barclays Capital has premised similar estimates on a nine percent capacity cut.[23] A UBS analyst has said a capacity reduction of 10 percent would be necessary to create the revenue synergies that United and Continental anticipate.[24] In such a scenario, the combined carrier would offer 10 percent fewer seats than United and Continental currently offer on a combined basis.

Although they are not necessarily reflective of competing airlines' strategic plans and outlooks, public comments by leaders of American Airlines and US Airways indicate United's and Continental's competitors anticipate benefits from the merger's potential effects on the industry: less competition, a reduction in industry fragmentation, and an adjustment of supply and demand,[25] which may result from capacity reductions.

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[22] J.P. Morgan, *Airlines: Pro Forma UAUA-CAL Model* (April 30, 2010), at 1.
[23] Lori Ranson, "United Forces the Merger Pace," *FlightGlobal* (May 20, 2010).
[24] Jeremy Lerner, "Airlines Try to Get Merger Off the Ground," *Financial Times* (May 28, 2010).
[25] *See, e.g.,* "Merger and union talks to help AMR cut costs: AMR CEO," Reuters (May 19, 2010) (quoting American CEO Gerard Arpey as saying, "A combined United/Continental would mean one fewer choice in the marketplace, and may result in a better balance between industry supply and demand, potentially resulting in a more rational competitive environment."); "US Air CEO Supports United/Continental Merger," Reuters (May 18, 2010) (quoting US Airways CEO Doug Parker as saying, in context of United-Continental merger, that consolidation "makes the industry more efficient. We end up with less fragmentation. It makes the industry stronger and therefore makes US Airways stand-alone stronger.").

D. Prospects for Further Industry Consolidation

The press has widely reported views from industry stakeholders and analysts who believe the merger is likely to lead to further consolidation as the merged United's competitors struggle to offset its sizeable market share and to compete with its globe-encircling network. In 2008, the Aviation Subcommittee held a hearing on the Delta-Northwest merger and received substantial testimony about the merger's potential effects for consumers and the industry. In particular, industry analysts and observers testified that the Delta-Northwest merger was likely to trigger further consolidation activity among U.S. carriers. The merger now at issue was widely predicted when Delta and Northwest merged.

Executives with US Airways have publicly said recently that they regard a merger as a likely strategic move in the future. US Airways president Scott Kirby, in fact, said on May 27 that, "[f]urther down the road, there's a high probability that US Airways will wind up merging with either United, Delta, or American."[26] Airline analyst Bob McAdoo recently concluded US Airways and American are increasingly likely to participate in consolidation activity as a result of market conditions created by the United-Continental merger.[27] Any further consolidation within the industry would, of course, be subject to competitive analysis, scrutiny, and approval by the DOJ's Antitrust Division.

Carriers appear to regard participation in an antitrust-immunized international joint venture as an unacceptable substitute for merging, as evidenced by the fact that the Delta-Northwest and United-Continental mergers have been proposed despite the carriers' participation in such joint ventures. United and Continental have said they cannot capture the same efficiencies and synergies in their existing immunized joint venture with Star Alliance carriers as would be available through a merger. Other U.S. carriers' participation, either now or in the future, in antitrust-immunized ventures is not likely, in staff's view, to deter those carriers from engaging in consolidation activity.

IV. <u>The Merger's Social Dimension</u>

Like any airline merger, the United-Continental merger will have a social dimension and will affect substantial numbers of the 89,000 employees of both carriers. United and Continental executives have said on numerous occasions that the merger will not result in significant involuntary reductions of frontline employees, although it is likely to result in some redundancies among central management employees. The executives have said they hope any reductions to frontline staffing can be effectuated through voluntary programs, retirement, and attrition.

In terms of major employee groups, both Continental and United pilots are represented by the Air Line Pilots Association (ALPA). ALPA represents more than 7,700 total pilots at United and more than 4,800 total pilots at Continental. The International Association of Machinists and Aerospace Workers (IAM) represents 9,500 Continental flight attendants and 16,000 ramp, service, stores, public contact, and food service workers, fleet technical instructors, maintenance instructors, and security guards. The Association of Flight Attendants (AFA) represents 17,000 flight attendants

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[26] Ted Reed, "US Airways: Merger Probability Is High," *The Street* (June 1, 2010).
[27] Linda Loyd, "Analyst: US Airways Is Attractive Merger Partner," *Philadelphia Inquirer* (May 26, 2010); Ted Reed, "American Needs US Air Merger: Analyst," *The Street* (May 26, 2010).

at United. The International Brotherhood of Teamsters represents 8,000 mechanics at United, 5,000 mechanics at Continental, and 8,000 fleet service workers at Continental.

The merger announcement comes at a strategically significant time for Continental and United pilots and flight attendants, all of whom are presently in contract negotiations with management. The United and Continental pilot groups, represented by ALPA, acknowledge the merger is expected to create value for stakeholders and said in a statement that they "fully expect to share in that value."[28] If the merger proceeds, the AFA and IAM would participate in a representational election among United and Continental flight attendants. Labor unions in general have said they will work to ensure the merger will benefit airline workers.

V. Prospects for Sustained Profitability

United and Continental expect the merger to generate substantial cost synergies: roughly $1 billion to $1.2 billion over the long term. According to materials provided by the carriers, those synergies will result from optimization of schedules, integration and rationalization of fleets and seat inventory, use of integrating pricing, elimination of administrative overhead redundancies at headquarters and airports systemwide, integrated computer systems, and optimal use of real estate and staffing, among other things. United and Continental pilot leaders informed staff that they view the Delta-Northwest merger as having created such synergies.

As a general matter, the airline industry has encountered challenges in recovering the cost of its capital, due in part to the highly technical and complex nature of airline operations, their exposure to numerous sources of risk around the world, and the volatile nature of oil prices. According to data released by the DOT's BTS, jet fuel prices have been exceptionally volatile over the last two years, although in April they receded to an average of $2.31 per gallon, down from an all-time high of $3.69 per gallon in July 2008. U.S. carriers in general say they are unable to compete with well capitalized foreign carriers – at least those foreign carriers with which they are not in immunized alliances – in the world market. Moreover, United and Continental argue that average one-way airfares, when adjusted for inflation, fell from $253 in 1990 to $142 in 2009.

Neither United nor Continental has regained sustained profitability, although United recorded an operating profit for the first quarter of 2010 – its first such profit since 2000. The carriers' most recent financial statements indicate net losses for the first quarter of this year and for full-year 2009, as depicted in figure 3 below.

[28] ALPA, Joint Statement of United and Continental Master Executive Councils (May 3, 2010).

Figure 3. Recent Financial Data, As Reported By United And Continental.

	1Q 2010 RESULTS	2009 FULL-YEAR RESULTS
UNITED[29]	Net loss of $92 million. Operating profit of $58 million.	Net loss of $1.1 billion.
CONTINENTAL[30]	Net loss of $136 million.	Net loss of $282 million.

Mergers, however, have not always succeeded in creating sustained value for shareholders, passengers, employees, and other airline stakeholders. No evidence exists that mergers have directly resulted in the failures of air carriers, but the history of consolidation in the U.S. airline industry likewise does not support the conclusion that mergers have been directly linked to sustained profitability. Despite mergers with Trans World Airlines (in 2001) and Reno Air (in 1999), American has not achieved consistent profitability since 2001. The 2005 merger of US Airways and America West has been beset by challenges over the integration of competing labor groups. On the other hand, some transactions among carriers have added value for stakeholders. The merger of Delta and Western Airlines in 1987 was an end-to-end combination that made new connections possible for travelers on the East and West coasts. United's purchase of the Pacific operations of Pan American World Airways (Pan Am), Delta's purchase of Pan Am's transatlantic routes and Northeast shuttle, and American's purchase of Eastern Air Lines' Caribbean and Latin American networks are examples of limited scenarios in which acquisitions have broadened the scope of U.S. carriers' networks and have potentially enhanced the level of choice for air travelers.

[29] UAL Corp., U.S. Secs. and Exchange Comm'n Form 8-K (April 27, 2010); UAL Corp., U.S. Secs. and Exchange Comm'n Form 8-K (Jan. 27, 2010).
[30] Continental Airlines, Inc., U.S. Secs. and Exchange Comm'n Form 8-K (April 22, 2010); Continental Airlines, Inc., U.S. Secs. and Exchange Comm'n Form 8-K (Jan. 18, 2010).

WITNESSES

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Mr. Robert Roach, Jr.
General Vice President of Transportation
International Association of Machinists and Aerospace Workers

Mr. Albert A. Foer
President
The American Antitrust Institute

Mr. Hubert Horan
Aviation Analyst and Consultant

Mr. William McGee
Consultant on Travel and Aviation Issues
Consumers Union

Mr. David Strine
Portfolio Manager
Impala Asset Management, LLC