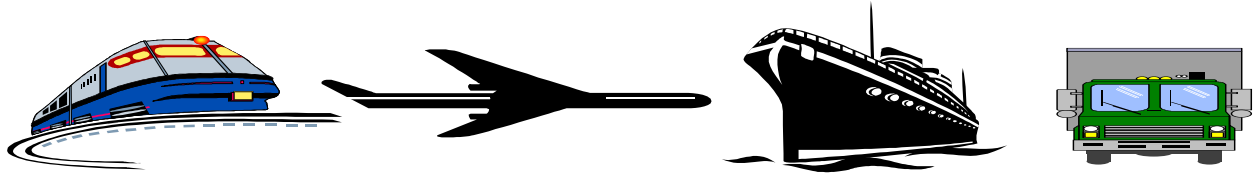




THE TRANSPORTATION ANTITRUST UPDATE



Transportation Industry Committee • Section of Antitrust Law • American Bar Association

IN THIS ISSUE:

Volvo Trucks North America v. Reeder-Simco GMC: Robinson-Patman Act Verdict Reversed Because Plaintiff in Competitive Bidding for Special Order Trucks Did Not Show Actual Competition or Competitive Injury
 by Terri L. Bowman 3

Canadian National Railway Company v. Western Canadian Coal Corporation: The Start of Something New?
 by François Tougas..... 7

Western States Paving Company v. Washington State Department of Transportation: Ninth Circuit Upholds Federal Disadvantaged Business Enterprise Program for Transportation Contracts But Strikes Down State’s Implementation of Program Regulations
 by Colette Holt and Jon Wainwright 9

U.S. Department of Transportation Rejects Antitrust Immunity for Northwest/KLM Addition to SkyTeam Alliance
 by James V. Dick..... 15

An Economic Analysis of How Antitrust-Immunized Alliances Have Affected Transatlantic Competition
 by James D. Reitzes and Dorothy Robyn 18

The Transportation Committee WEBSITE is located at <http://www.abanet.org/antitrust/committees/transportation/welcome.html>. Our website includes pages with reports of recent developments, announcements of upcoming meetings, and useful links. Back issues of this newsletter are available as well. We invite you to visit the website and provide us with your feedback.

Note from the Chair

In this issue of our newsletter, we lead off with an analysis of the Supreme Court’s 2006 decision in *Volvo Trucks North America v. Reeder-Simco GMC*, which applied Robinson-Patman Act jurisprudence in the context of competitive bidding. Next, François Tougas comments on *Canadian National Railway Company v. Western Canadian Coal Corporation*, the first case in which a railway governed by the Canada Transportation Act has filed an application for judicial review of final offer arbitration. Colette Holt and Jon Wainwright write about the Ninth Circuit’s decision in *Western States Paving Company v. Washington State Department of Transportation*, which upheld the federal Disadvantaged Business Enterprise Program for transportation contracts but struck down the State of Washington’s implementation of program regulations. Our final two articles discuss the decision by the United States Department of Transportation (“DOT”) to reject

antitrust immunity for the Northwest/KLM addition to the SkyTeam alliance. James V. Dick provides a summary of the proceedings before the DOT. Finally, James D. Reitzes and Dorothy Robyn offer an economic analysis of how antitrust-immunized alliances have affected transatlantic competition.

Please contact me or one of our Vice Chairs, Carolyn Feeney, Colin Flynn and Martin Low, if you are interested in contributing to an upcoming issue of this newsletter or otherwise getting more involved with the committee. Our contact information appears near the end of this newsletter.

Margaret Zwisler

**TRANSPORTATION INDUSTRY
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NEW MEMBERS INVITED

New members are cordially invited to join the Section of Antitrust Law and the Transportation Committee. Most of the Section's programs are developed by the Committees, giving members the opportunity to plan and participate in programs that will be of the most value to their practices. Similarly, the news-letters, handbooks, and monographs published by the Committees offer a unique chance to work on publications that will have a national distribution. At Transportation Committee programs, members can meet attorneys from across the country who share their interest in transportation antitrust law.

VOLVO TRUCKS NORTH AMERICA v. REEDER-SIMCO GMC

Robinson-Patman Act Verdict Reversed Because Plaintiff in Competitive Bidding for Special-Order Trucks Did Not Show Actual Competition or Competitive Injury

Terri L. Bowman

In *Volvo Trucks North America, Inc. v. Reeder-Simco GMC, Inc.*,¹ the Supreme Court reversed an Eighth Circuit decision that upheld a \$1.3 million verdict against a truck manufacturer who offered different wholesale prices to its dealers who resold specially-ordered trucks through a competitive bidding process. The Court held that the complaining truck dealer failed to prove a Robinson-Patman Act violation because it had failed to show that the manufacturer discriminated between dealers who were contemporaneously competing to resell to the same retail customer, or that the discrimination substantially affected competition between the dealers. This decision is significant for its application of traditional Robinson-Patman Act jurisprudence to a competitive bidding situation, but the decision does not make any new pronouncements regarding the scope of the Act generally.

¹ 126 S. Ct. 860 (2006).

Background Facts

Reeder-Simco GMC, Inc. (“Reeder”) was an authorized dealer in heavy trucks manufactured by Volvo Trucks North America, Inc. (“Volvo”). Reeder typically sold Volvo trucks through a competitive bidding process, initiated only when a potential customer sought a bid from Reeder on a special-order truck. Once Reeder received the potential customer’s specifications, Reeder turned to Volvo for a discount off the wholesale price of the truck. Reeder purchased the truck from Volvo only in the event its bid to the customer was accepted. Other Volvo dealers purchased trucks from Volvo in the same manner. Potential customers often sought bids from Volvo dealers in different geographic territories, and the dealers were not geographically limited in their ability to sell the trucks.

After Volvo announced an intention to reduce the number of its authorized dealers, Reeder began to suspect that Volvo had chosen Reeder for elimination. Reeder believed that Volvo, to effectuate its restructuring plan, began granting more favorable price concessions to other dealers in order to reduce Reeder’s margins and sales, and to eventually force Reeder out of business.

Reeder sued Volvo in the United States District Court for the Western District of Arkansas, claiming that it had suffered “secondary-line” injury, an injury to competition at the level of a customer of the discriminating seller, from price discrimination in violation of the Robinson-Patman Act. Reeder claimed that it was injured in its ability to compete with other dealers for customers of Volvo trucks because Volvo gave other dealers greater discounts.

At trial, Reeder presented evidence that: (1) Volvo offered smaller discounts to Reeder than it offered to other Volvo dealers when Reeder and the other Volvo dealers bid and won against non-Volvo dealers for different sales to different customers; (2) Volvo offered inferior discounts to Reeder in connection with its unsuccessful bids against non-Volvo dealers in comparison with the discounts Volvo offered to other Volvo dealers who bid successfully against non-Volvo dealers for sales on which Reeder did not bid; (3) on one occasion when Reeder bid against another Volvo dealer for the same sale, Volvo initially offered both dealers the same discount, but improved the discount to the other dealer after it had won the bid; and (4) on another occasion when Reeder bid against another Volvo dealer for the same sale, Volvo had initially offered an inferior discount to Reeder, but then raised the discount to match that offered to the competing Volvo dealer.

A jury returned a verdict against Volvo and awarded Reeder \$1.3 million in damages, which was automatically trebled by the trial court to \$3.9 million. The trial court also awarded attorney fees to Reeder.

Volvo appealed the judgment to the United States Court of Appeals for the Eighth Circuit, in part arguing that the Robinson-Patman Act did not apply because in competitive bidding there is only one completed sale, and thus Reeder did not qualify as a “purchaser.” Despite this argument, the Eighth Circuit affirmed, holding that Reeder had “‘purchaser’ status” to sue under the Robinson-Patman Act because it had purchased trucks on a regular basis from Volvo, even if those purchases were not simultaneous with purchases from other Volvo dealers.² The Eighth Circuit also held that a jury could reasonably find that Reeder was in

² *Reeder-Simco GMC, Inc. v. Volvo GM Heavy Truck Corp.*, 374 F.3d 701, 709 (8th Cir. 2004).

“actual competition” with favored dealers, even in the absence of direct competition, because Reeder operated at the same functional level and within the same geographic market as the other Volvo dealers. The court also affirmed the jury’s finding of competitive injury based on the evidence of Volvo’s intent to reduce the number of dealers, as well as evidence that Reeder lost sales to the non-Volvo dealers, and that Reeder’s overall margins decreased by more than seventy-five percent in the four years after the initiation of Volvo’s restructuring program.

The Supreme Court’s Decision

The Supreme Court held that Reeder failed to show actual competition or competitive injury, and thus, the Court “need not decide” the issue of whether Reeder qualified as a “purchaser” under the Act.³ The Court held that the first two categories of Reeder’s evidence – that Volvo provided better discounts to other dealers who were not bidding against Reeder and who were attempting to sell trucks to different retail customers – were insufficient to establish either the actual competition or the injury to competition requirements of the Robinson-Patman Act. There was no direct evidence of a diversion of sales or profits from Reeder to a “competing” Volvo dealer, and the Court “decline[d] to permit an inference of competitive injury” from Reeder’s selective and “mix-and-match” evidence of price comparisons.⁴

³ 126 S. Ct. at 872.

⁴ *Id.* at 871.

The evidence of the only two sales for which Reeder had bid against another Volvo dealer for the same retail customer was insufficient for a more basic reason – the Supreme Court held that the evidence did not show that Reeder was actually disfavored in those sales. In the first example, Volvo initially offered the dealers the same discount, and improved the discount to the other dealer only after it had won the bid. In the second example, Volvo initially gave Reeder an inferior discount, but then improved Reeder's discount to match the discount offered to the other dealer, but neither dealer won the bid. In short, Reeder could not prove that any difference in the discount offered for either sale had "substantially" affected its competition with the other allegedly "favored" Volvo dealer, as required under the Act.⁵

No Change in the Application of the Robinson-Patman Act

Contrary to some commentators' views, the *Volvo* decision is significant more for its unique facts than for any sweeping change in the interpretation of the Robinson-Patman Act. Some commentators have announced this decision as "restricting" the Robinson-Patman Act because it required competition for the exact same customer, rather than simply competition in the same geographic market. But *Volvo* illustrates only that under the facts of this case – where there was competitive

bidding for special-order goods – the requisite showing of actual competition necessarily required proof of Reeder's attempts to resell to the exact same customer. This is because the relevant market was factually limited to only those dealers selected by a particular end customer to compete for the sale. Nothing in the *Volvo* decision changes the long-standing rule that where resales are made from inventory, the actual competition requirement would be satisfied if the competition were for customers in the same geographic market. Of course, a successful plaintiff under either scenario would also need to show proof of injury to competition, either through direct evidence of a diversion of substantial sales or profits, or by qualifying for the inference of such an injury, as explained in *FTC v. Morton Salt*.⁶

Indeed, the *Volvo* decision may be most significant for reaffirming that the *Morton Salt* inference of competitive injury is still alive – something that has been questioned since the decision in *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*⁷ In *Volvo*, the Court confirmed that the inference "may arise from evidence that a favored competitor received a significant price reduction over a substantial period of time."⁸ Although Reeder's evidence did not qualify for the inference, the Court left open the possibility that an inference of competitive injury may apply in competitive bidding situations, even where there is little or no evidence of head-to-head bidding for the same customer. The Court twice hinted that Reeder may have been able to qualify for the inference had it established, through a systematic study or statistical analysis, that the other Volvo dealers were consistently favored in

⁵ The Court rejected the Eighth Circuit's view of the evidence supporting competitive injury, noting that the Robinson-Patman Act "does not bar a manufacturer from restructuring its distribution networks to improve the efficiency of its operations," and that inequitable treatment of a wholesaler by a manufacturer may still be actionable under state franchise or unfair competition laws. 126 S. Ct. at 872 n.4. Indeed, the jury in *Volvo* awarded Reeder \$500,000 in damages under the Arkansas Franchise Practices Act because of Volvo's attempts to eliminate Reeder as a dealer. That judgment was not at issue before the Supreme Court.

⁶ 334 U.S. 37 (1948).

⁷ 509 U.S. 209 (1993).

⁸ 126 S. Ct. at 870.

comparison to Reeder over a relevant and substantial time period.

Others who believe this decision narrows the Robinson-Patman Act point to the Supreme Court's observation that the Act's requirement of at least two different purchasers "ordinarily is not involved when a product subject to special order is sold through a customer-specific competitive bidding process."⁹ The Supreme Court, however, specifically declined to exempt all such sales from Robinson-Patman scrutiny, and specifically declined to decide whether Reeder qualified as a purchaser.¹⁰ Thus, there is no safe haven for special order or competitive bidding sales as a result of this decision.

⁹ *Id.* at 866.

¹⁰ *Id.* at 872. The FTC and DOJ, in their joint amicus brief, had requested the Court to hold all competitive bidding situations exempt from the Robinson-Patman Act. *See* Brief for the United States as Amicus Curiae Supporting Petitioner, *Volvo Trucks North America, Inc. v. Reeder-Simco GMC, Inc.*, 126 S. Ct. 860 (2006) (No. 04-905), 2005 WL 1248280, at *9. The Truck Manufacturers Association and the National Association of Manufacturers were among the organizations who also filed amicus briefs on behalf of Volvo. *See* Brief of the Truck Manufacturers Association, et al., as Amici Curiae Supporting Petitioner, *Volvo*, 126 S. Ct. 860 (No. 04-905), 2005 WL 1223156. The National Automobile Dealers Association and the North American Equipment Dealers Association were among the organizations filing amicus briefs on behalf of Reeder. *See* Brief of the National Automobile Dealers Association as Amicus Curiae Supporting Respondent, *Volvo*, 126 S. Ct. 860 (No. 04-905), 2005 WL 1749171; Brief of the North American Equipment Dealers Association, et al., as Amici Curiae Supporting Respondent, *Volvo*, 126 S. Ct. 860 (No. 04-905), 2005 WL 1801036.

The Court concluded its opinion by defending the decision as one promoting interbrand competition and consistency with the broader policies of the antitrust laws.¹¹ The holding of *Volvo* is indeed consistent with prior Robinson-Patman Act rulings, but also helps clarify the scope of lawful pricing activity under the Robinson-Patman Act in competitive bidding sales.

¹¹ 126 S. Ct. at 872-73.

CANADIAN NATIONAL RAILWAY COMPANY v. WESTERN CANADIAN COAL CORPORATION

The Start of Something New?

François Tougas*

On July 2, 2005, Western Canadian Coal Corporation (“WCCC”) submitted rates and conditions proposed by Canadian National Railway Company (“CN”) to final offer arbitration (the “FOA”) pursuant to the Canada Transportation Act (the “Act”).¹ CN’s proposed rates and conditions would have governed the transportation of coal between a single origin-and-destination – from WCCC’s British Columbia mine to a port facility located at Prince Rupert, British Columbia. The FOA concluded in September 2005, with the arbitrator selecting WCCC’s final offer.

In October 2005, CN filed an application for judicial review of the FOA before the Federal Court of Canada (“JR Application”), the first time any railway governed by the Act has elected to do so. CN’s filing of the JR Application is a first in a number of ways that may shape the future of Canada’s economic regulation of federal freight railways operating in Canada.² First, CN is seeking to have the

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1 1996 S.C., ch.10, as amended.

2 In addition to CN, federal freight railways in Canada include Canadian Pacific Railway, BNSF Railway Company, Union Pacific Railroad Company, CSX Transportation Inc., Norfolk Southern Railway Company, among many others.

entire FOA process declared inoperative as an offense against Canada’s Bill of Rights. Second, CN is seeking to have the arbitrator’s decision in the FOA with WCCC set aside. Third, because the JR Application is a matter of public record, the public may observe some of the FOA process and the substantive matters that were argued, which are otherwise private and confidential.

The FOA provisions have been a central feature of the Act’s remedies for shippers, largely because the other statutory remedies have not worked to countervail line haul rail carriers’ market power.³ Thus, for most shippers, FOA is their only meaningful and substantial remedy. A result of the JR Application is that it could be described as an attempt to undermine the equilibrium Parliament sought to create in 1988, when the remedy was first enacted as a part of the *National Transportation Act, 1987*.⁴ CN is on record as opposing the remedy,⁵ and has gone so far as to say that it “is not an effective means of resolving disputes between shippers and railways,” that the “process has an institutional, systemic bias toward shippers,” that it “is neither adequate nor balanced and that it does not meet its original objectives.”⁶ Not surprisingly, shippers have disagreed with CN’s position, arguing that rail carriers have used their market power to push shippers to use FOA, have found numerous ways to increase the costs to shippers who avail themselves of the remedy, and have used a variety of means to make the remedy

3 These remedies include running rights, competitive line rates and regulated interswitching.

4 R.S.C., ch. 28 (1985), repealed by 1996 S.C., ch. 10.

5 *Ex Parte No. 586*, “Initial Comments by Canadian National Railway Company and Canadian Pacific Railway Company,” made before the Surface Transportation Board, Nov. 21, 2001.

6 *Id.*

considerably less effective than originally intended.

On balance, FOA has achieved some of its intended remedial effects. FOA provides shippers with a measure of power to counterbalance the carriers' often overwhelming market power. Indeed, a Canadian review panel found that the FOA provisions "adequately address the problem of carrier dominance and potential abuse in a way that is fair to both shippers and carriers."⁷ Perhaps neither carriers nor shippers will ever fully agree with that finding, but they would certainly agree that the use of a JR Application to review the FOA process is a significant event. The primary effect of the FOA process has been to allow shippers and carriers to keep goods moving even while they are engaged in often difficult negotiations. With the specter of that remedy's inoperability, the balance has already shifted toward the carriers. To the extent that this chilling effect has a strategic impact, CN has already partially won the battle. Whether the carriers lose the war remains to be seen, however, as the matter has now been set for hearing. In the meantime, unanswered questions still exist regarding the JR Application's impact on future rail legislation, the viability of certain shippers, trade flows between Canada and the United States, and the ability of rail carriers to use market power to compel uneconomic and inefficient bargains with shippers.



⁷ Vision and Balance: Report of the Canada Transportation Act Review Panel, at 72 (2001).

WESTERN STATES PAVING COMPANY v. WASHINGTON STATE DEPARTMENT OF TRANSPORTATION

Ninth Circuit Upholds Federal Disadvantaged Business Enterprise Program for Transportation Contracts But Strikes Down State's Implementation of Program Regulations

Colette Holt* and Jon Wainwright**

In a challenge to the constitutionality of the Disadvantaged Business Enterprise (“DBE”) Program for federally-assisted U.S. Department of Transportation (“USDOT”) contracts,¹ the Ninth Circuit Court of Appeals held that the statute adopting the Program² and the federal implementing regulations³ satisfied strict constitutional scrutiny on their face. At the same time, however, the court struck down the 2000 implementation of that Program by the Washington Department of Transportation (“WSDOT”), finding that it was not sufficiently narrowly tailored.

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¹ *Western States Paving Co., Inc. v. Washington State Dep't of Transp.*, 407 F.3d 983 (9th Cir. 2005).

² Transportation Equity Act for the Twenty-First Century (“TEA-21”), Pub. L. No. 105-178, 112 Stat. 107 (1998).

³ 49 C.F.R. pt. 26 (2007).

Factual Background and Procedural History

The plaintiff, Western States Paving Co., Inc. (“Western States”), was a non-DBE asphalt and paving subcontractor. It alleged that it had submitted the lowest quotes on two WSDOT projects, but lost the subcontracts because the prime contractors chose to utilize DBEs to meet the subcontract goals pursuant to Part 26 of Chapter 49 of the Code of Federal Regulations. Western States filed suit to enjoin the operation of WSDOT’s USDOT-approved federal fiscal year 2000 goal and for damages related to denial of the subcontracts. USDOT intervened to defend the constitutionality of the statute and implementing regulations.

The United States District Court for the Western District of Washington entered summary judgment for the federal and state defendants. It held that Congress had established a compelling interest in remedying nationwide discrimination against DBEs in the highway construction industry, and that the implementing regulations were facially constitutional. The district court further held that WSDOT met its legal obligations by complying with the federal regulations; WSDOT was not required to independently establish that its Program satisfied strict scrutiny.

On appeal, the United States Court of Appeals for the Ninth Circuit affirmed the district court’s holding as to USDOT, agreeing that Congress met its constitutional burdens, but reversed and directed the entry of judgment as against the state defendants. The court found that WSDOT’s DBE goal was not separately supported with controlled, statistical evidence of discrimination and therefore was not narrowly tailored to remedy discrimination in its marketplace.

Analysis

Federal Regulations Upheld as Facially Constitutional

The Ninth Circuit held that the statute adopting the DBE Program and the implementing regulations met both prongs of strict scrutiny.⁴ In harmony with every other court that has considered the question, the court held that Congress established its compelling interest in remedying discrimination in the highway construction industry through ample statistical and anecdotal evidence of discrimination. The evidence before Congress included:

- Disparities between the earnings of minority-owned firms and white-owned firms;
- Disparities between the loans received by black business owners compared to similar white business owners;
- The large decline in minorities' participation in the construction industry when affirmative action programs were struck down or abandoned; and
- Discrimination by prime contractors, trade unions, business networks, suppliers and sureties against minority contractors.

⁴ The Program's inclusion of women in addition to racial and ethnic minorities in the definition of presumptively "socially disadvantaged individuals" required discussion of the standard of review applicable to sex-conscious measures. While gender-based classifications must be supported by an "exceedingly persuasive justification" and "substantially related to the achievement of that underlying objective, in this case the application of intermediate scrutiny of the inclusion of women in the DBE program would not change the outcome." 407 F.3d at 987 n.1, citing *United States v. Virginia*, 518 U.S. 515, 524 (1996).

The court concluded that:

Although Congress did not possess evidence that minorities suffer discrimination in every State's public contracting market, Congress need not undertake such an onerous task when enacting legislation that is applicable on a nationwide basis. . . . Congress had a strong basis in evidence for concluding that in at least some parts of the country discrimination within the transportation contracting industry hinders minorities' ability to compete for federally funded contracts.⁵

The regulations also satisfied the narrow tailoring requirement. The maximum feasible portion of the recipient's DBE goal must be achieved through race-neutral means. The Program is flexible; there are no quotas and contractors' good faith efforts to meet goals are recognized. The statute is subject to periodic review and reauthorization, and grantees must tailor their goals to their specific marketplaces. The burden on non-DBEs is permissible and minimal: white males can qualify as DBEs if they can prove their social disadvantage, and the personal net worth limit ensures that "wealthy" minorities do not receive a windfall. "Overall," the court found, "[the statute] and its implementing regulations possess all the features of a narrowly tailored remedial program."⁶

⁵ 407 F.3d at 992-93.

⁶ *Id.* at 995.

WSDOT's Implementation Struck Down as Insufficiently Narrowly Tailored

Turning to the plaintiff's challenge to WSDOT's implementation of the Program, the Ninth Circuit first rejected the State's position that compliance with the federal regulations insulated it from strict scrutiny.⁷ The court agreed with the analysis of the Eighth Circuit in *Sherbrooke Turf, Inc. v. Minnesota Department of Transportation*,⁸ which held that although a recipient need not have an independent compelling interest for its DBE Program, courts must nevertheless undertake an "as applied" inquiry into whether the State's Program is narrowly tailored to its marketplace. In upholding the Minnesota Department of Transportation's DBE goal-setting based upon its Availability Study, the Eighth Circuit stated, "[t]o the extent the federal government delegates this tailoring function, a State's implementation becomes critically relevant to a reviewing court's strict scrutiny."⁹

The Ninth Circuit was persuaded by USDOT's argument that race-conscious goals can be applied only in those localities where the effects of discrimination are present: "As the United States correctly observed in its brief and during oral argument, it cannot be said that TEA-21 is a narrowly tailored remedial measure unless its application is limited to those States in which the effects of discrimination are actually present."¹⁰ The court required WSDOT to prove not only that discrimination had current effects in its market but also that such discrimination affected all

⁷ The plaintiff conceded that Washington's Program comports with the regulations.

⁸ 345 F.3d 964, 970 (8th Cir. 2003), *cert. denied*, 124 S. Ct. 2158 (2004).

⁹ 345 F.3d at 971.

¹⁰ 407 F.3d at 998.

of the presumptively socially disadvantaged groups included in the federal regulations.¹¹ "[E]ach of the principal minority groups benefited by Washington's DBE program . . . must have suffered discrimination within the State."¹²

The Ninth Circuit rejected WSDOT's goal-setting methodology, even though that methodology closely tracked the Sample Program¹³ developed by USDOT. The State had chosen option one in 49 CFR § 26.45(c) to determine its step one base figure of DBE availability: dividing the number of certified DBEs by the total number of establishments in the Census Bureau's *County Business Patterns* database. In step two, the State had followed the USDOT's guidance and adjusted the base figure of 11.17% to 14%, based upon the average of the step one estimate averaged with the median (18%) of prior years' DBE participation,¹⁴ without an explanation of how this figure reflected expected DBE availability in a race-neutral market. WSDOT was unable to make an adjustment for discriminatory barriers in obtaining bonding and financing or for the effects of past or present discrimination because it lacked statistical studies of such discrimination. WSDOT then projected that it would achieve the 14% goal through 9% DBE participation from race-neutral means, based upon its utilization on state-funded contracts

¹¹ The opinion recognizes in the discussion of Congress' narrow tailoring that the federal regulations do not permit disaggregated goals by race, ethnicity and gender. *Id.* at 990.

¹² 407 F.3d at 999.

¹³ See <http://osdbuweb.dot.gov/documents/pdf/dbe/SampleDB.pdf>.

¹⁴ See *Tips for Goal Setting in the Disadvantaged Business Enterprise (DBE) Program*, available at <http://osdbuweb.dot.gov/business/dbe/tips.cfm> ("[C]alculate your median past participation percentage and use that figure to adjust your Step One Base Figure by taking the average of your median past participation figure and your Step One Base Figure.").

without goals, and 5% DBE participation from race-conscious subcontracting goals.

Lacking other statistical evidence of discrimination, the State could rely only upon the gap between its estimate of 14% and the 9% DBE participation of DBEs on contracts without affirmative action remedies. The Ninth Circuit, however, held that WSDOT's 14% figure reflected the effects of the DBE Program, and thus was not indicative of DBE utilization in a race-neutral market. "Indeed, even in States in which there has never been discrimination, the proportion of work that DBEs receive on contracts that lack affirmative action requirements will be lower than the share that they obtain on contracts that include such measures because minority preferences afford DBEs a competitive advantage."¹⁵ According to the Ninth Circuit, the only figure upon which WSDOT could "plausibly rely to demonstrate discrimination is the disparity between the proportion of DBE firms in the state (11.17%) and the percentage of contracting funds awarded to DBEs on race-neutral contracts (9%)."¹⁶ The court found that this "oversimplified statistical evidence" was "entitled to little weight, however, because it [did] not account for factors that may affect the relative capacity of DBEs to undertake contracting work."¹⁷ According to the Ninth Circuit, the fact that DBEs may be smaller, less experienced and more expensive than non-DBEs may explain the difference. To the extent that this "small disparity has any probative value, it is insufficient, standing alone, to establish the existence of discrimination against DBEs."¹⁸ What is necessary is statistical significance.

¹⁵ 407 F.3d at 1000.

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.* at 1001.

The State did not rely upon any anecdotal evidence of discrimination in Washington's transportation marketplace in setting its goal. According to the Ninth Circuit, the affidavits required from applicants for DBE certification attesting that they have suffered discrimination established no more than general assertions of societal bias.¹⁹ The court concluded that:

The record is therefore devoid of any relevant evidence suggesting that minorities currently suffer – or have ever suffered – discrimination in the Washington transportation contracting industry. . . . The "exact connection" between means and ends that is a prerequisite to the use of racial classifications is demonstrably absent from Washington's DBE program.²⁰

Dissent

While agreeing with the majority that Congress met its constitutional burden, the dissent took issue with the holding that WSDOT must independently establish discrimination in the State. "[O]nly when the state exceeds its federal authority is it susceptible to an as-applied constitutional challenge."²¹ Since the majority relies heavily upon *Sherbrooke*, it should follow that court's inquiry into whether the state complied with the regulations not impose the additional requirement that the discrimination already found by Congress must also be proved to exist in Washington. A contractor who is concerned that certain minorities are receiving a "windfall" should challenge the certification of those firms, "not file a federal lawsuit."²²

¹⁹ *Id.* at 1002.

²⁰ *Id.*

²¹ *Id.* at 1004.

²² *Id.* at 1005.

Implications

With *Western States*, the Ninth Circuit is the eighth court to find the DBE Program to be constitutional on its face. In view of the unanimous rejection of the argument that the DBE program *per se* fails strict scrutiny, and the Ninth Circuit's imposition of the requirement that recipients identify discrimination in their local markets, it is likely that the focus of anti-affirmative action efforts will shift to grantees' (often *pro forma*) adoption of annual goals.

It is unclear how much evidence of discrimination in a recipient's jurisdiction is necessary. The Ninth Circuit somewhat collapsed the requirement of "strong evidence" of discrimination to establish a compelling interest with the requirement that the remedy be narrowly tailored to that evidence. Although the federal implementing regulations explicitly disavow the need for grantees to conduct disparity studies, the Ninth Circuit demanded evidence closely resembling a disparity study.

Perhaps this merely illustrates that when a party presents no evidence and no expert testimony the court then lacks guidance on the correct economic and legal analysis of discrimination. As a result, the Ninth Circuit made several serious errors:

- Contrary to the Ninth Circuit's assertion that a state is "required" to adjust its base figure of DBE availability to account for the effects of discrimination, the federal implementing regulations mandate only *consideration* of such an adjustment.²³

²³ 407 F.3d at 989; *cf.* 49 CFR §226.45(d)(3) (2007) ("If you *attempt* to make an adjustment to your base figure to account for the continuing effects of past discrimination (often called the "but for" factor) or the effects of an ongoing DBE program, the adjustment must be based on demonstrable evidence that is directly and logically related

- Factors affecting the competitiveness of DBEs, such as firm revenues, length of time in operation, and bonding capacity, are infected by discrimination. It has long been established that proper statistical analysis should not control for the variables affected by the behavior sought to be isolated. As recognized by the Tenth Circuit Court of Appeals in holding that Denver's local Minority and Women Business Enterprise program met strict scrutiny, DBEs may be smaller, newer and otherwise less competitive because of the very discrimination sought to be remedied by the adoption of the Program. It is simply wrong to use the outcomes of discrimination as the measure of a race-neutral market.²⁴
- The disparity between the estimated 11.17% DBE availability and the actual 9% utilization of DBEs on contracts without goals is not "small." On the contrary, a disparity of .8 would be considered "large" pursuant to, for example, the Equal Employment Opportunity Commission's four-fifths rule.²⁵

What WSDOT lacked was the type of expert statistical evidence that the Minnesota Department of Transportation ("MNDOT") presented in support of the Program upheld in

the effect for which the adjustment is sought.") (emphasis added).

²⁴ See, e.g., *Concrete Works of Colo., Inc. v. City & County of Denver*, 321 F.3d 950, 981, 983 (10th Cir. 2003), *cert. denied*, 124 S. Ct. 556 (2003) ("M/WBE construction firms are generally smaller and less experienced *because* of discrimination.... Additionally, we do not read *Croson* to require disparity studies that measure whether construction firms are able to perform a *particular contract*.") (emphasis in the original).

²⁵ 29 C.F.R. § 1607.4(d) (2007).

Sherbrooke.²⁶ The MNDOT Availability Study provided a comprehensive, market-wide estimate of DBE availability weighted by the geographic and product markets in which MNDOT did business.²⁷ This addresses the court's concern that DBEs may not be located where WSDOT's prime contractors awarded subcontracts. The study further provided a detailed step 2 analysis of statistical disparities in DBEs' formation and earnings relative to similarly situated non-DBEs and summarized the anecdotal evidence extant in that jurisdiction. Thus, the *Sherbrooke* court had ample evidence of DBEs' availability to perform on MNDOT contracts and subcontracts as well as evidence of the discriminatory barriers those firms faced in pursuing those contracts and subcontracts.

There is also the interesting question of the correct response when a recipient determines that not all the enumerated groups have suffered discrimination in its market. Must the recipient petition USDOT for a waiver of the prohibition against separate goals for racial and ethnic minorities and white women? Or will such a finding prohibit the operation of race-conscious goals for any group, given the regulations' prohibition against separate goals? The Ninth Circuit has voiced "concerns about the haphazard inclusion of minority groups in affirmative action programs ostensibly designed to remedy the effects of discrimination. . . . The overly inclusive designation of benefited minority groups was a 'red flag' that the legislation is not narrowly tailored."²⁸ The court's concern about the application of TEA-21's "laundry list" of racial and ethnic minorities to

particular markets suggests that serious consideration must be given to a waiver petition to permit the use of disaggregated subcontracting goals to remedy identified discrimination in a particular jurisdiction.

At a minimum, *Western States* counsels that the USDOT Sample Plan must be significantly customized to withstand strict scrutiny. It is not enough to plug the step one availability estimate into a formula without consideration of the effects of discrimination on the analysis. While the opinion affirms that the step two adjustment is the appropriate point at which to undertake this inquiry, a conceptually rigorous model must be applied. That does not mean that an adjustment is always warranted or supportable, but there must be evidence of and discussion of discrimination in the goal-setting submission. The court's analysis also casts doubt on the value of using the recipient's past levels of DBE utilization as a measure of the availability of DBEs "but for" discrimination. In any event, any adjustment undertaken must be statistically valid. It must be a quantifiable representation of the qualitative judgment whether the ongoing effects of past or current discrimination continue to impede DBEs' full and fair access to the recipient's market.

In sum, recipients can no longer assume that compliance with USDOT's guidance or USDOT's approval of their goal-setting methodology provides a safe harbor. It would be prudent to draft future submissions to ensure that they are based upon defensible statistical and anecdotal evidence that narrowly tailors the goals to their jurisdictions. If WSDOT had presented a *Sherbrooke*-type study and proffered expert testimony in support of its analysis, the Ninth Circuit may very well have upheld the Program.

²⁶ To its credit, WSDOT had already commissioned such a study, which formed the basis for its FFY 2006 DBE goal submission.

²⁷ The authors were counsel and principal investigator, respectively, on the MNDOT Study.

²⁸ 407 F.3d at 998.

**U.S. DEPARTMENT OF
TRANSPORTATION
REJECTS ANTITRUST
IMMUNITY
FOR NORTHWEST/KLM
ADDITION TO SKYTEAM
ALLIANCE**

James V. Dick*

In September 2004, the airline members of two alliances – the Northwest/KLM alliance and the SkyTeam alliance, including Delta, Air France, Alitalia, and Czech Airlines – filed applications with the U.S. Department of Transportation (“DOT”) for authority to code share with one another and for antitrust immunity for their transatlantic operations.¹ Each of the alliances already possessed code share authority and antitrust immunity among its members. Their applications sought to extend that authority and immunity between and among all six airlines. In essence, they were asking the DOT to approve the merger of two existing, immunized alliances, each of

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¹ The airlines filed joint applications for both antitrust immunity and code share authority on Sept. 24, 2004. Joint Application of Alitalia, et al., for Antitrust Immunity, No. OST-2004-19214-1, available at http://dmses.dot.gov/docimages/pdf90/297484_web.pdf; Joint Application of Delta, et al., for Code-Sharing Authority, No. OST-2004-19215-1, available at http://dmses.dot.gov/docimages/pdf90/297485_web.pdf. On Oct. 18, 2004, the Department consolidated these motions for review. Order Consolidating Proceedings, No. OST-2004-19214-10, available at http://dmses.dot.gov/docimages/pdf90/300428_web.pdf. The joint application sought blanket code share authority under 14 C.F.R. Part 212, and antitrust immunity under 49 U.S.C. §§ 41308 and 41309.

which included a U.S. carrier, to create an enhanced SkyTeam alliance.

In its Order to Show Cause, issued on December 22, 2005,² the DOT had little trouble concluding that the requested expansion of code share authority among the six applicants was in the public interest because it could lead to new online service and more frequent and convenient service options. The DOT therefore tentatively approved the request for blanket code share authority, subject to its usual conditions.³ The request for antitrust immunity, however, presented DOT with a more difficult decision.

Describing the airlines’ request for six-way antitrust immunity as one of “first impression,” DOT wrote:

Here the Department faces a request for antitrust immunity that would not create a new transatlantic alliance network or expand an existing network, but would fully consolidate and immunize two existing transatlantic immunized alliances, each with a major U.S. partner, whose respective networks overlap substantially. This case also marks the first time that the Department has been asked to immunize an alliance that includes more than one U.S. carrier, a circumstance that raises the novel issue of the potential for competitive harm in domestic markets.⁴

² Order to Show Cause, No. OST-2004-19214-195, available at <http://dmses.dot.gov/docimages/p84/378442.pdf>.

³ *Id.* (Appendix A).

⁴ *Id.* at 31-32.

The immunity applications were hotly contested. American Airlines vigorously opposed any grant of immunity for the merged alliance.⁵ It argued that such immunity would provide few consumer benefits, while enabling the alliance members to leverage their combined market share to obtain higher fares on international flights. American also contended that the requested immunity would reduce domestic competition between Northwest and Delta, because cooperation on international routes would necessarily diminish competitive incentives on domestic routes. American was supported by several economists, including James D. Reitzes and Dorothy Robyn of The Brattle Group, whose article appears in this issue.

The Department of Justice (“DOJ”) also opposed any grant of immunity that would permit the two alliances to act as one.⁶ The DOJ concluded that immunizing an alliance that included Delta and Northwest would risk significant harm to international competition on the routes where Delta and Northwest compete with one another, and to domestic competition in the domestic markets related to those international routes. The DOJ also contended that immunity would create opportunities for collusion between Delta and Northwest. In the absence of detailed information about the proposed implementation of the alliance agreement, the DOJ asserted that there is no guarantee that the applicants would not exchange competitive information or engage in activities that undercut domestic competition. The DOJ further argued that, to the extent the proposed combination might produce consumer

benefits, those benefits could be substantially achieved without a grant of immunity.

The applicants responded that American’s and DOJ’s concerns were overblown. They stated that a large majority of passengers would continue to have three or more independent carriers or alliances from which to choose for transatlantic service. The applicants also contended that they would be able to agree on matters relating to transatlantic air transportation without discussing or agreeing on domestic fares or sharing competitively-sensitive domestic information. Several economists also filed statements in support of the applicants’ position.

After summarizing the parties’ positions, the DOT’s analysis began with a review of the decisional standards for approving, and granting antitrust immunity to, cooperative agreements relating to international air transportation, with an emphasis on the “public interest” considerations. The DOT noted that 49 U.S.C. § 41309 essentially requires it to approve agreements that are “not adverse” to the public interest, if they satisfy the other standards for approval. By contrast, DOT wrote, 49 U.S.C. § 41308 permits DOT to grant immunity only if it determines that immunity is required by the public interest.⁷ It emphasized that public interest issues are always considered on a case-by-case basis, in light of the specific facts and circumstances affecting that case. It also noted that “the public interest requires a strong showing that immunity is justified to achieve specific, demonstrable public benefits at the time the immunity is requested.”⁸

⁵ Public Answer of American Airlines, Inc., No. OST-2004-19214-97, available at http://dmses.dot.gov/docimages/pdf92/336705_web.pdf (Jun. 24, 2005).

⁶ Public Comments of the Department of Justice, No. OST-2004-19214-164, available at http://dmses.dot.gov/docimages/pdf93/342755_web.pdf (Aug. 19, 2005).

⁷ Order to Show Cause, No. OST-2004-19214-195, at 34, available at <http://dmses.dot.gov/docimages/p84/378442.pdf>. (Dec. 22, 2005).

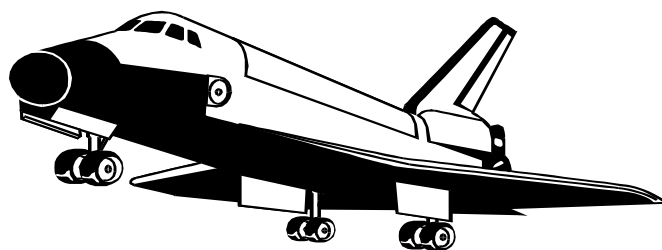
⁸ *Id.*

DOT tentatively concluded that the applicants' showing of public benefits attributable to a grant of antitrust immunity "falls well short of what we would expect in order to conclude that such an unprecedented antitrust exemption is required by the public interest."⁹ It wrote that the "Joint Applicants have not demonstrated to the Department's satisfaction that substantial and proximate benefits, beyond those made by arms-length code sharing or other lawful forms of collaboration, will be produced if we were to make an additional grant of immunity to the expanded SkyTeam alliance."¹⁰ Contrasting the immunity request at issue here with past cases, which involved alliances that combined end-to-end networks, the DOT stated that relatively few travelers would benefit from new online service if the existing alliances in this case were merged. To the extent that a merger of the alliances could produce non-stop service in markets that now have no such service, moreover, the DOT contended that such a benefit could be achieved by virtue of the expanded code share authority alone, even without immunity. DOT did not create any *per se* rule against immunizing the merger of alliances that involve two or more U.S. carriers. Indeed, the DOT expressly declined to consider whether the expanded alliance in this case, if granted immunity, would produce an adverse spillover effect on domestic competition. Its tentative decision rested solely on the applicants' failure to satisfy their burden of proving that the public interest requires DOT to grant immunity under § 41308.

⁹ *Id.*

¹⁰ *Id.* at 3.

In light of the DOT's tentative decision in its Order to Show Cause, the applicants filed a motion to withdraw their request for antitrust immunity without prejudice.¹¹ In the final order in this matter, on February 6, 2006, the DOT affirmed its decision to grant only blanket statements of authorization to engage in reciprocal code shares to each of the applicants.¹² It also granted the applicants' motion to dismiss their application for six-way antitrust immunity without prejudice.¹³



¹¹ Joint Applicant's Response to 2005-12-12 and Motion to Dismiss, No. OST-2004-19214-201 available at http://dmses.dot.gov/docimages/pdf95/381621_web.pdf (Jan. 11, 2006).

¹² Final Order, No. OST-2004-19214-202, available at http://dmses.dot.gov/docimages/pdf95/385506_web.pdf.

¹³ *Id.*

AN ECONOMIC ANALYSIS OF HOW ANTITRUST- IMMUNIZED ALLIANCES HAVE AFFECTED TRANSATLANTIC COMPETITION

James D. Reitzes and Dorothy Robyn*

In December 2005, the U.S. Department of Transportation (“DOT”) took the aviation industry by surprise when it issued a show cause order denying a request for antitrust immunity from six U.S. and European air carriers: Delta Air Lines, Northwest Airlines, Air France, KLM, Alitalia and Czech Airlines.¹ The request, which followed the merger of Air France and KLM, sought to consolidate two of the three antitrust-immunized airline alliances – Wings (Northwest and KLM) and SkyTeam (Delta, Air France, Alitalia and Czech Airlines). The DOT tentatively concluded that the carriers (the “Joint Applicants”) failed to show that sufficient public benefits would result if the consolidated SkyTeam Alliance received antitrust immunity.

A sharply contested issue in the case was the impact of the existing immunized alliances on competition in the transatlantic market. In a report submitted on behalf of American Airlines, which opposed the antitrust immunity request, The Brattle Group (“Brattle”) presented an update of a 2000

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¹ Order to Show Cause, No. OST-2004-19214-195, at 34, *available at* <http://dmses.dot.gov/docimages/p84/378442.pdf> (Dec. 22, 2005). DOT never issued a final order because the Joint Applicants subsequently withdrew the request.

DOT study of alliances’ impact on transatlantic fares and traffic.² The Brattle analysis, of which we were the principal authors, showed that from 1999 to 2004, air fares in Open Skies transatlantic markets – those markets dominated by the immunized alliances – had increased significantly compared to fares in non-Open Skies markets. We examined several possible explanations for this disturbing result – an apparent reversal of the pro-consumer trends that characterized the initial period of immunized alliance development. We concluded that a major factor was the exercise of (increased) market power by immunized alliances, reflecting a lack of sufficient inter-alliance competition. Although our findings did not suggest that, on balance, consumers had been harmed by the formation of immunized alliances, we concluded that what was a positive trend had begun to change direction.

The Joint Applicants responded with their own economic experts – Daniel Kasper and Darin Lee of LECG – and the exchange between opposing teams consumed a large portion of the record in the SkyTeam case.³ In

² Public Answer of American Airlines, Inc., No. OST-2004-19214-97, at exhibit 1, *available at* http://dmses.dot.gov/docimages/pdf92/336705_web.pdf (June 24, 2005). This and subsequent reports submitted by Brattle were prepared by James D. Reitzes, Dorothy Robyn and Kevin Neels.

³ *See* Declaration of Daniel M. Kasper and Darin N. Lee, submitted as part of the Reply of the Joint Applicants, No. OST-2004-19214-114, *available at* http://dmses.dot.gov/docimages/pdf92/338280_web.pdf (July 6, 2005); Reply by The Brattle Group, submitted as part of the Motion for Leave to File and Surreply of American Airlines, Inc., No. OST-2004-19214-128, *available at* http://dmses.dot.gov/docimages/pdf92/339585_web.pdf (July 15, 2005); Surrebuttal of Daniel M. Kasper and Darin N. Lee, No. OST-2004-19214-181, *available at* http://dmses.dot.gov/docimages/pdf93/343808_web.pdf (Aug. 30, 2005); Surreply by The Brattle Group, submitted as part of the Motion for Leave to File and Surreply of American Airlines, Inc., No. OST-2004-19214-186, *available at* http://dmses.dot.gov/docimages/pdf93/344930_web.pdf (Sept. 9, 2005).

the end, the DOT's decision to deny the Joint Applicants' request turned largely on domestic competition considerations, and the DOT explicitly declined to take a position on the controversy over transatlantic competition.⁴ Nevertheless, the concerns that Brattle and American raised may have undermined the Joint Applicants' claims that antitrust immunity would benefit consumers by enhancing transatlantic competition.

In this article, we summarize Brattle's analysis of the competitive impact of immunized alliances, as set out in the SkyTeam case. First, we identify the potential benefits and costs of alliances based on economic theory and briefly discuss the early empirical studies of alliance effects. Second, we summarize our update of one such study – the DOT's 2000 report. Third, we explore alternative explanations for the disturbing fare trends that the updated study revealed.

Immunized Alliances: Economic Theory and Early Empirical Research

International air travel is dominated by four global alliances: Star, SkyTeam, Wings and oneworld. Three of the four (all but oneworld) have immunity from U.S. antitrust laws to jointly set prices and allocate capacity on those international routes covered by the immunity grants.

Immunized alliances provide a way for airlines to work around bilateral air services restrictions as well as national laws, such as those in the United States, that prohibit cross-border airline mergers. In addition, the U.S. government has used antitrust immunity as a carrot to induce foreign governments to liberalize their international aviation markets, by making immunity conditional on the

existence of an Open Skies arrangement with the foreign carrier's home country. The DOT approved the first immunized alliance in 1992, between Northwest and KLM, after the Netherlands agreed to Open Skies with the United States – the first such accord. Similarly, DOT approval of immunity for United Airlines and Lufthansa (Star Alliance) followed Germany's entry into an Open Skies arrangement in 1996.⁵

Notwithstanding its strategic value in promoting aviation liberalization, antitrust immunity is a double-edged sword, with the potential to harm as well as help competition. On the benefit side, the formation of an immunized alliance can lead to lower airfares for interline traffic: because alliance partners can coordinate pricing and share revenue, in theory, each partner "internalizes" the effect of its fare on demand for travel on the other leg of the interline route, resulting in the elimination of double marginalization (i.e., successive markups). Immunized alliances also facilitate the scheduling of connecting flights and related activities, such as gate location and baggage handling, and the improvement in connections can stimulate passenger demand and permit carriers to offer service across a wider and more efficient network.

⁴ Order to Show Cause, No. OST-2004-19214-195, at 34, available at <http://dmses.dot.gov/docimages/p84/378442.pdf>. (Dec. 22, 2005).

⁵ The 70-plus Open Skies agreements that the U.S. government has negotiated since 1992 represent a major and unambiguous source of economic benefits to U.S. consumers. In other work, we have quantified the consumer gains from transatlantic Open Skies agreements, specifically, and estimated the additional benefits that a fully deregulated transatlantic market would bring. See Boaz Moselle, et al., *The Economic Impact of an EU-U.S. Open Aviation Area*, The Brattle Group, Dec. 2002. More recently, Dorothy Robyn has written in support of the DOT's 2005 proposal to allow greater foreign control of U.S. airlines which, among other things, would have facilitated approval of a U.S.-EU aviation agreement. See Alfred E. Kahn & Dorothy Robyn, "The Sky Must Be No Limit to Global Competition," *Financial Times* (London), Feb. 15, 2006.

On the cost side, the formation of an immunized alliance enhances the incentive for and ability of alliance members to engage in exclusionary behavior, such as discriminatory interline access designed to divert connecting passengers from a non-partner carrier to a partner carrier.⁶ Although inter-alliance competition limits the potential for harm in connecting markets that are conveniently served by several alliances, connecting markets that are effectively “captive” to a specific alliance hub (e.g., New York-Toulouse, which is more conveniently served by connections through Paris) may be vulnerable. In addition to the direct harm to competition in connecting markets, access discrimination can cause indirect harm in gateway-to-gateway markets, as non-partner carriers, deprived of connecting passengers, are forced to reduce capacity. Separate from these potential vertical effects, alliance formation typically produces some horizontal consolidation, which can reduce gateway-to-gateway competition between allied carriers.

Despite the potential for competitive harm, early studies concluded that the impact of immunized alliances was on balance highly beneficial. Using pre-2000 data on transatlantic interline fares, the authors of one journal article found that alliance partners charged fares that were 18 to 28 percent below those charged by non-allied airlines, presumably due to elimination of double

⁶ A transatlantic carrier, let’s call it EU Air, is normally indifferent to which airline brings a connecting passenger across the Atlantic. But if EU Air is part of a revenue-sharing alliance, it potentially benefits if the transatlantic passenger arrives on a partner airline. This creates an incentive for EU Air to “inconvenience” interlining passengers that arrive on non-partner carriers, for example, by raising pro-rate charges (the charge to another airline for carrying one of its passengers on the connecting segment of the trip) or reducing seat availability.

marginalization.⁷ And in two widely disseminated papers that analyzed changes in transatlantic traffic and fares from 1992 to 1999, the DOT found that immunized alliances contributed to substantial increases in passenger volumes and significant declines in average fares.⁸ These output and price effects were particularly pronounced in connecting markets – precisely where one would expect alliances to generate the largest efficiency benefits.

Update of the DOT’s 2000 Study

To evaluate the recent impact of immunized alliances, we updated the DOT’s 1999 and 2000 reports using data for the five-year period from 1999 to 2004. In order to update the DOT analysis, it was necessary first to replicate it.

Price Effects

The DOT used data from its Passenger Origin and Destination Survey, as obtained from U.S. carriers, to analyze changes over time in fares and traffic in four broad market categories:

1. *Gateway-to-gateway (G-G)*: travel from a U.S. gateway to a European gateway (e.g., New York to Paris);

⁷ Jan K. Brueckner & W. Tom Whalen, *The Price Effects of International Airline Alliances*, 43 J.L. & ECON. 503 (2000); see also Jan K. Brueckner, *The Economics of International Codesharing: An Analysis of Airline Alliances*, 19 INT’L J. INDUS. ORG. 1475 (2001); Jan K. Brueckner, *International Airfares in the Age of Alliances: The Effects of Codesharing and Antitrust Immunity*, 85 REV. OF ECON. & STAT. 105 (2003).

⁸ U.S. Dep’t of Transportation, “International Aviation Developments: Global Deregulation Takes Off,” Office of the Secretary, Dec. 1999, available at <http://ostpxweb.dot.gov/aviation/Data/globalderegtake.pdf>; U.S. Dep’t of Transportation, “International Aviation Developments: Transatlantic Deregulation: The Alliance Network Effect,” Office of the Secretary, Oct. 2000, available at <http://ostpxweb.dot.gov/aviation/Data/transatlantdereg.pdf>.

2. *Behind-gateway-to-gateway* (B-G): travel from behind a U.S. gateway to a European gateway (e.g., Ithaca, New York to Paris);
3. *Gateway-to-beyond-gateway* (G-B): travel from a U.S. gateway to beyond a European gateway (e.g., New York to Lyon, France); and
4. *Behind-gateway-to-beyond-gateway* (B-B): travel from behind a U.S. gateway to beyond a European gateway (e.g., Ithaca, New York to Lyon, France).

The DOT’s 2000 report analyzed fare trends from 1996 (the first year in which all three immunized alliances had antitrust immunity) through 1999. The DOT found that fares in transatlantic Open Skies markets, the markets dominated by immunized alliances, went down by 20 percent overall, with the declines approaching 25 percent in connecting markets to destinations beyond European gateways. Although fares in non-Open Skies markets also fell during that period, the decrease was only half as large.

Figure A below is our replication of the relevant chart (Chart 1) from the DOT’s 2000 report. The DOT’s own numerical results are arrayed in tabular form at the bottom of Figure A.

Figure A

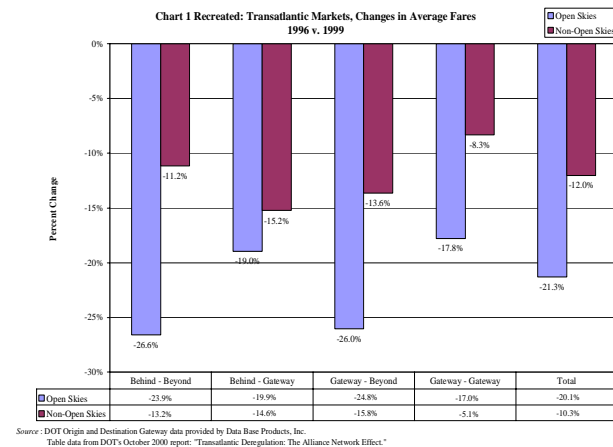
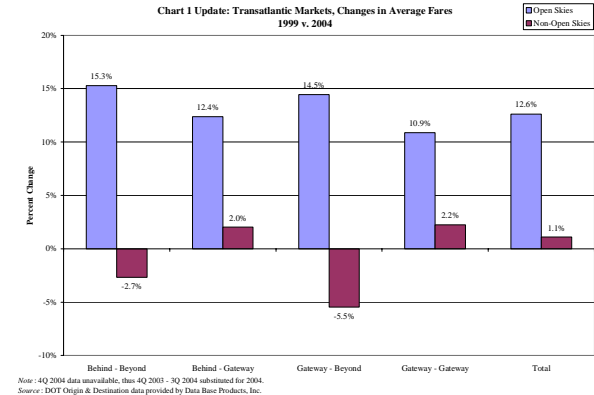


Figure B, which shows our update of fare trends, presents a starkly different picture.⁹ From 1999 to 2004, all four categories of transatlantic Open Skies markets experienced double-digit fare increases; on average, fares from the United States to and through European Open Skies gateways went up by about 13 percent. Moreover, the largest fare increases occurred in just the type of connecting markets that experienced the largest fare declines from 1996 to 1999 – specifically, B-B markets (up 15.3 percent) and G-B markets (up 14.5 percent). By contrast, all four categories of transatlantic non-Open Skies markets experienced either decreases or modest increases in fares. In sum, the five-year period we examined saw a striking turnaround in the positive fare trends that characterized Open Skies markets from 1996 to 1999, and a role reversal in the price performance of Open Skies markets and non-Open Skies markets.

Figure B



⁹ In Figure B, “Open Skies” refers to those European countries with which the United States had an Open Skies Agreement as of 2004. In Figure A, as in DOT’s Chart 1, “Open Skies” refers to those European countries with which the United States had an Open Skies Agreement as of 1999. The most significant addition to the list of Open Skies countries post-1999 was France, which entered an Open Skies agreement with the United States in 2002. The other post-1999 signatories are Malta, Turkey and the Slovak Republic (2000); and Poland (2001).

Output Effects

We also updated the DOT's analysis of airline output, which found that, from 1996 to 1999, passenger traffic on alliance carriers grew dramatically relative to traffic on non-alliance carriers. (Consistent with the DOT study, we use the term "alliance" or "alliance carrier" to refer to immunized alliances.) Like the DOT, we used T-100 data, which reports the total number of passengers onboard transatlantic flights by carrier. But whereas the DOT study focused on a period of steady industry expansion, our update covered a period (1999-2004) in which the industry experienced several major shocks and weathered a sharp decline from which it is still recovering. These dramatic changes in the market environment make it almost impossible to interpret trends in traffic carried by alliances as compared to non-alliance carriers.

To gain insight into a related phenomenon, we compared the change in airline output in Open Skies markets with that in non-Open Skies markets from 1999 to 2004. (In addition to passenger traffic, we looked at two other measures of output – flight frequency and number of available seats.) However, the differences in output growth rates between Open Skies and non-Open Skies countries during that period are so small as to be inconsequential. Moreover, data limitations make it difficult to draw any firm conclusions on traffic trends.¹⁰

¹⁰ The only readily available source of information on connecting passengers is drawn from the ticket sample that U.S. carriers are obliged to provide as part of the DOT's Origin and Destination Survey. However, the Origin and Destination data exclude transatlantic passengers who purchase their ticket from a foreign carrier and whose itinerary does not involve a U.S. operating carrier on any leg of the trip. Because of this limitation, it is difficult to determine whether a decline in the number of passengers carried by U.S. alliance members signifies a decline in overall passenger volume on alliance carriers or simply a shift from U.S. carriers to their foreign alliance partners.

Why Have Fares Gone Up in Open Skies Markets?

Our principal finding – that Open Skies fares increased significantly relative to non-Open Skies fares from 1999 to 2004 – suggests that Open Skies markets were less competitive during that period. Since Open Skies markets are, by definition, "open," bilateral restrictions cannot be the source of the problem. Thus, it makes sense to look at the role of immunized alliances, which dominate Open Skies markets. The fact that the largest fare increases occurred in connecting markets suggests that immunized alliances may have engaged in the kind of exclusionary behavior we posited earlier.

Alternatively, our fare results may have a "benign" explanation. One hypothesis is that Open Skies fares have gone up more because of relative improvements in the quality of the alliance product. Another possible explanation is that the decline in transatlantic fares at London's Heathrow airport, which largely accounts for the fact that non-Open Skies fares remained flat, is due to exogenous factors.

Below, we look at each of the benign hypotheses. Then we look at the non-benign hypothesis – namely, that immunized alliances have exercised increased market power.

Hypothesis # 1: Immunized Alliances Have Improved Their Product Quality

The relative increase in Open Skies fares may be the result of improvements in the quality of the alliance carriers' product compared to that of their non-alliance competitors. However, if this were the case, one would expect to see a relative increase in airline output in Open Skies markets, since an improvement in product quality is equivalent to a decline in (quality-adjusted) fares, and declining fares should stimulate demand. In fact, we found almost no difference in output growth rates between Open Skies and non-Open Skies markets.

Additional evidence that “quality” is not the primary explanation for our fare results comes from a comparison of connecting and non-stop Open Skies markets. Alliances offer less of a quality advantage for passengers who do not have to connect. Thus, if quality were the explanation for the increase in Open Skies fares, we would expect the fare increase to be much more modest in non-stop (G-G) markets. However, Figure B showed that G-G fares increased significantly in Open Skies markets, albeit less than in the other three market categories.

A variation on the quality hypothesis is that high-yield passengers now make up a greater portion of immunized alliances’ traffic than they did prior to 1999 – presumably because of the increased quality of the alliance product. Such an improvement in passenger mix would have the effect of raising average fares in a statistical sense even if actual fares did not go up. The Origin and Destination Survey provides selected evidence for this passenger-mix argument, which represented Kasper and Lee’s principal challenge to our analysis. For example, Kasper and Lee showed that between the second quarters of 1999 and 2004, the proportion of transatlantic passengers purchasing roundtrip tickets priced at \$2000 or more increased from 6.8 percent to 10.0 percent for Northwest/KLM and from 8.8 percent to 10.7 percent for Delta/Air France.¹¹

However, an analysis of changes over time in the entire fare distribution shows that fares increased significantly at all levels, not just at the top end, as the Kasper and Lee claim would suggest. Figures C and D present the cumulative fare distributions for Northwest/

¹¹ Declaration of Daniel M. Kasper and Darin N. Lee at 31-33, submitted as part of the Reply of the Joint Applicants, No. OST-2004-19214-114, available at http://dmses.dot.gov/docimages/pdf92_338280_web.pdf (July 6, 2005).

KLM and Delta/Air France for the second quarters of 1999 and 2004; a cumulative distribution shows the fraction of passengers who paid fares equal to or below *any* given level. For example, in Figure C, 59 percent of Northwest/KLM transatlantic passengers paid \$700 or less for their roundtrip air fare in 1999. That number dropped to 35 percent in 2004. Similarly, in Figure D, about 53 percent of Delta/Air France transatlantic passengers paid \$700 or less for their roundtrip air fare in 1999, while only 32 percent of passengers paid fares within that range in 2004.¹² Overall, the proportion of passengers paying lower fares dropped by 15 percentage points or more at many fare levels. The fact that fares increased significantly at all levels, not just at the top end, severely undermines Kasper and Lee’s improved-passenger-mix argument.¹³

¹² One can read these charts “horizontally” as well as “vertically.” For example, in 1999, 80 percent of Northwest/KLM passengers paid fares below \$900. In 2004, the equivalent fare (i.e., the fare below which 80 percent of passengers fell in the fare distribution) was \$1,250. For Delta/Air France, 80 percent of passengers paid fares below \$1,050 in 1999; the equivalent fare in 2004 was \$1,300.

¹³ The shift in the fare distribution charts shown in Figures C and D conceivably could reflect a change in product mix as opposed to passenger mix – specifically, an increase in the proportion of passengers flying connecting flights, which typically have higher fares than non-stop flights. To control for that possibility, we calculated the cumulative fare distributions for non-stop passengers only. Those distributions show a similar pattern to the distributions for all passengers, where fares increase across the board, not just at the highest levels. See Reply by The Brattle Group at Appendix A, submitted as part of the Motion for Leave to File and Surreply of American Airlines, Inc., No. OST-2004-19214-128, available at http://dmses.dot.gov/docimages/pdf92/339585_web.pdf (July 15, 2005).

Figure C

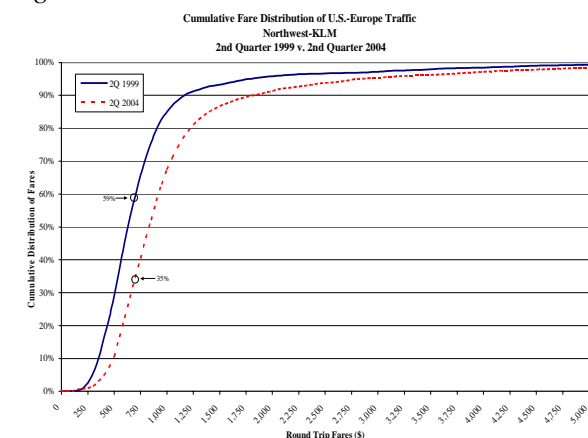
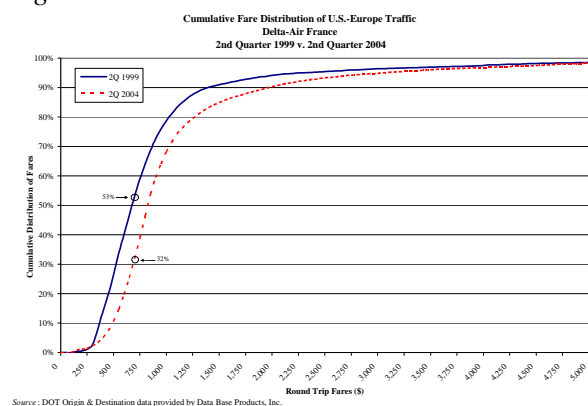


Figure D



Moreover, insofar as the alliances' passenger mix did improve, it may be because reduced competition in Open Skies markets forced more passengers to buy high-priced tickets. The increase in the fraction of "high-yield" passengers that Kasper and Lee identified appears to be driven by Unrestricted Coach class passengers – i.e., those passengers at the low end of the high-yield range. This is significant because these are the passengers most likely to be paying high-yield fares "involuntarily," as a result of restrictions and capacity limitations that airlines are able to impose on discount (Restricted Coach) fares when competitive conditions permit.

Hypothesis # 2: Heathrow Fares Have Declined for Exogenous Reasons

A second benign hypothesis for our results concerns Heathrow airport. The U.S.-United

Kingdom (UK) market – a non-Open Skies market – accounts for 40 percent of all transatlantic traffic, and more than two-thirds of it goes to or through Heathrow. Transatlantic fares to and through Heathrow declined from \$613 in 1999 to \$544 in 2004 on average – the key reason that non-Open Skies fares remained virtually flat during that period. If the decline in Heathrow fares can be explained by exogenous factors – i.e., factors unrelated to competition in the U.S.-UK market – then non-Open Skies fare trends might not be a valid benchmark for our analysis.

Kasper and Lee argued that one such exogenous factor was the change in the fraction of non-stop "premium" (First, Business and Unrestricted Coach class) passengers at Heathrow, which dropped by 8.1 percentage points from 1999 to 2004, according to the Origin and Destination data. Such a shift could produce a statistical decline in average fares at Heathrow even if actual fares did not go down.

However, a disaggregation of "premium" passengers reveals that this change was due largely to a fall-off in Unrestricted Coach class passengers (6.6 percentage points). By contrast, First and Business class passengers experienced a significantly smaller decline (1.5 percentage points). As we noted earlier, Unrestricted Coach class passengers are the ones most likely to be paying high fares involuntarily, as a result of capacity limitations that airlines are able to impose when competition is limited. Thus, the drop in such passengers at Heathrow – and the related statistical decrease in fares – seems to reflect a genuine increase in competition in the U.S.-UK market, as opposed to an exogenous market development, as Kasper and Lee maintained.

Second, Kasper and Lee argued that limitations in the Origin and Destination data – specifically, the exclusion of transatlantic passengers who do not fly on a U.S. carrier on any leg of the trip – may have served to

overstate the decline in fares at Heathrow, by failing to fully capture a shift there in non-stop First and Business class passengers from U.S. to British carriers.¹⁴ But Kasper and Lee's calculation of that alleged shift, based on data from computer bookings, inexplicably used 2000 as the starting point rather than 1999. When we approximated their results using Origin and Destination data (we did not have access to booking data), the decline was significantly more modest when the starting point was 1999 as opposed to 2000.

Finally, Kasper and Lee argued that the decline in Heathrow fares was due to competitive pressures generated by the immunized alliance hubs (Amsterdam, Frankfurt and Paris), which provided transatlantic passengers with an alternative to Heathrow as a connecting gateway. However, this argument is undermined by the fact that transatlantic non-stop fares for Heathrow also dropped, from \$574 in 1999 to \$533 in 2004. Moreover, connecting fares at the three alliance hubs increased from 1999 to 2004. A decrease in the price of one product (Heathrow) cannot logically be attributed to competition from an existing substitute product (Amsterdam, Frankfurt and Paris) whose price increased (or decreased by a smaller amount) simultaneously.

In sum, the decline in fares at Heathrow cannot be explained by exogenous factors. To the contrary, it is likely a result of factors indigenous to that non-Open Skies hub, including increased competition from Virgin

¹⁴ More generally, Kasper and Lee argued that the limited coverage of the Origin and Destination data renders them unreliable for the analysis of transatlantic fare trends. However, the DOT apparently disagrees, because it has used the same data for just such purposes, including the study of alliance effects that we replicated. Kasper and Lee's argument is valid only if missing data relating to foreign carriers would show a pattern of fares that is markedly different, *over time*, from that seen in the available U.S. carrier data. There is no evidence that this is the case.

Atlantic and its code-share partner, Continental, and from United and its UK-based partner, bmi. (Note that Virgin and Continental have a non-immunized relationship, as do United and bmi.) The fact that these services may exert competitive discipline at Heathrow is entirely consistent with our argument. It shows the price benefits that global airline alliances can bring to markets where no single alliance or carrier is dominant.

Hypothesis # 3: Alliance Carriers Have Exercised Increased Market Power

The non-benign explanation for the relative increase in fares in Open Skies markets is that the immunized alliances that predominately serve those markets have exercised increased market power. At least two mechanisms appear to be at work.

Actions to Raise Rivals' Interlining Costs

First, members of immunized alliances have acted to increase the input costs facing rival carriers, specifically with respect to interline passengers. In June 2004, Air France began restricting inventory for non-SkyTeam interline carriers. And in September 2004, Air France filed a memorandum with the International Air Transport Association which specified that it would accept only fares above a certain level in the settlement process for purposes of establishing prorate charges for interline traffic. By refusing to accept lower fares, Air France effectively raised interlining costs for American and other carriers that did not have a Special Prorate Agreement, making it impossible for them to offer discounted through-fares at a profit.

The impact of Air France's discriminatory interline policies was dramatic. In the second half of 2004, the number of American Airlines passengers connecting in Paris fell dramatically compared to the second half of 2003. As shown in Figure E, American's connecting traffic in Paris fell even more sharply in the last quarter of 2004, the period

during which Air France’s new prorated policy took effect.

By contrast, the number of American Airlines passengers terminating in Paris increased substantially over the same period (Figure E). This is predictable. Access discrimination by Air France would inevitably lower American’s volume of connecting passengers and reduce its profits. American in turn would be expected to reduce fares in G-G and B-G markets, which do not require interlining, in an effort to fill empty seats. Although these fare reductions benefit travelers in the short run, they are probably not sustainable. Rather, American would have to withdraw capacity to Paris, leading to lower passenger volumes and higher fares in the long run.

Figure E



Although the Joint Applicants argued that the drop in American-Air France interlining activity at Paris was benign, their evidence was far from persuasive. First, in an effort to show that American had alternatives to Paris, Kasper and Lee pointed out that the overwhelming majority of American Airlines passengers who had previously connected through Paris on Air France were destined to points in Europe that were served by at least one, and usually several, of American’s European alliance partners. But this is beside the point: the question is not whether Paris is American’s only choice as a connecting hub, but whether Paris is its preferred choice.

Second, Kasper and Lee maintained that the number of American Airlines passengers traveling to these same final destinations typically rose after the alleged anticompetitive behavior occurred – further evidence in their view that the behavior was benign. However, Kasper and Lee’s own data disproved their point in a dramatic way. On the “top 30” origin-destination city pairs where it depended most on Air France for interlining, American sustained significant passenger volume losses between 2003 and 2004. In fact, American’s passenger volumes decreased substantially to all “top 30” European destinations where 50 percent or more of its passenger traffic was served by interlining with Air France. By contrast, with one exception, American’s passenger volumes increased to all “top 30” European destinations where less than 50 percent of its passenger traffic was served by interlining with Air France.

These results illustrate precisely what economic theory predicts regarding the potential for an immunized alliance to harm competition. For “captive” destinations – i.e., those European destinations that are more conveniently served by connections through a particular alliance hub (in this case, Paris) – inter-alliance competition may not be sufficient to discipline fare increases by the dominant alliance. Moreover, the European member of the “dominant” alliance has the incentive as well as the ability to increase the cost of its interlining services to rival airlines, because such discriminatory behavior will divert passenger traffic to its alliance partners.

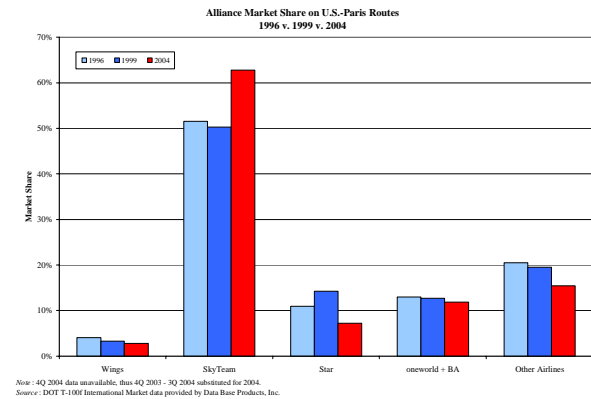
Diminished Competition from Non-Dominant Carriers

A second reason that immunized alliances may have exercised increased market power is that they face diminished competition. The dominant alliance has been able to increase its market share at both Paris and Frankfurt even as its fares there have gone up. This phenomenon suggests that U.S. carriers that are not a member of the dominant alliance at those two hubs have become competitively

weaker and thus unable to discipline the dominant alliance carrier. That weakened competition could be a result of an increase in the quality of the product offered by the dominant alliance, although this seems unlikely for the reasons discussed earlier. Alternatively, it could indicate that the non-dominant carriers face higher costs, including higher interlining costs. Yet another possible explanation is mutual forbearance – that is, an implicit agreement among the immunized alliances to stay out of one another’s hubs.

Figure F shows each alliance’s market share, as measured by number of passengers, on transatlantic routes to and through Paris. SkyTeam member carriers increased their collective market share by approximately 13 percentage points between 1999 and 2004. At the same time, the Star Alliance’s market share declined substantially, largely because United significantly reduced the number of flights it operated to Paris: United’s share of the U.S.-Paris market declined by 7 percentage points between 1999 and 2004. If one includes U.S. Airways, a non-immunized member of the Star Alliance, Star’s market share declined by 9 percentage points.

Figure F



Kasper and Lee countered by observing that it is natural for an immunized alliance to gain market share at its principal hub, as member carriers exploit network economies and offer greater and greater scheduling convenience than non-alliance carriers. They observed, correctly, that DOT gave individual

alliances antitrust immunity in part to promote these very efficiencies.

But what makes SkyTeam’s growth in market share unusual – and what distinguishes it from the DOT vision – is that it occurred even as SkyTeam fares were increasing. Figure G below shows that SkyTeam fares at Paris increased significantly in all traffic categories after the alliance received immunity in 2002. Air fares generally decreased from 1999 to 2002, and then increased from 2002 to 2004. Particularly noteworthy is the reversal beginning in 2002 in what had been a steady, several-year decline in air fares for passengers traveling to points beyond European gateways (B-B and G-B markets). These are the very passengers that immunized alliances are thought to benefit the most.

Figure G

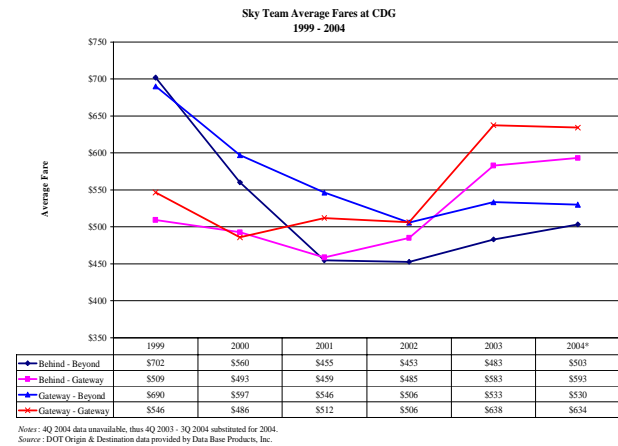
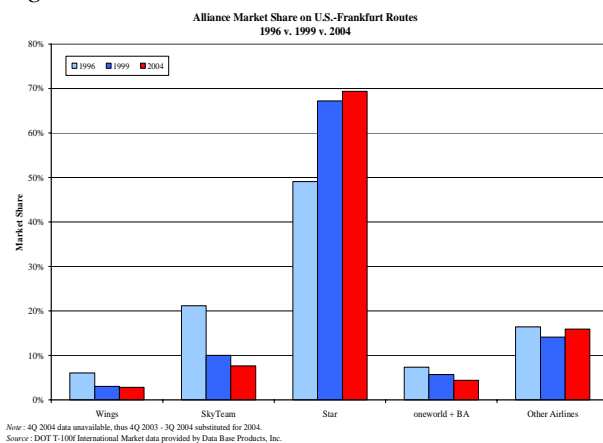


Figure H shows a remarkably similar pattern on U.S.-Frankfurt routes. The Star Alliance increased its share of this market by more than 20 percentage points between 1996 and 2004; most of that increase occurred between 1996 and 1999. SkyTeam’s share of the U.S.-Frankfurt market decreased approximately 14 percentage points over the same eight-year period, as Delta substantially reduced the number of flights it operated to Frankfurt. And between 1999 and 2004, Wings and oneworld each dropped below a 5 percent market share. Moreover, as with SkyTeam, the Star Alliance increased market

share at its major hub even as its fares there were going up.

Figure H



Conclusion

The vertical and horizontal integration associated with the formation of an immunized alliance has always had the potential to generate costs as well as benefits. Concern about the possible anticompetitive effects of alliances was mitigated by the move toward Open Skies regimes that necessarily accompanied grants of immunity. This linkage fostered a reasonable expectation that any anticompetitive behavior by alliance members would be constrained by the response of new competitors. And, indeed, early research found that alliances generated significant benefits.

However, some of the early studies, including the DOT's, were not equipped to isolate the net effects of immunized alliance formation. Those studies were forced to address the market as it existed. Of necessity, therefore, they measured the joint effects of immunized alliance formation and increased competition stimulated by the generally simultaneous adoption of Open Skies. Since Open Skies would almost certainly be beneficial for consumers, there was a potential for these early studies to overstate the benefits attributable solely to alliances.

Our findings do not suggest that, on balance, the operation of immunized alliances

has harmed consumers. But they do suggest that what was a positive trend has begun to move in the wrong direction. The fare reductions in Open Skies markets that earlier studies identified have been followed by significant fare increases. And it is the markets served predominately by non-alliance carriers and non-immunized alliances that have enjoyed more restrained fare increases in recent years. By way of explanation, there is evidence that immunized alliances have undertaken actions that raise their rivals' costs of interlining at certain alliance-dominated hubs. The decline in competition at these hubs is further evidence of market power: immunized alliances have gained market share at their respective European hubs even as their fares there have risen.

One can argue that it is normal for an alliance to gain market share at its principal hub, as allied carriers exploit network economies and offer greater scheduling convenience than their rivals. But if alliances are in fact more efficient, then fares on routes served predominately by alliances should be falling (or rising at a slower rate) compared to those on other routes. The fact that the opposite has occurred suggests that the alliances are exercising (increased) market power.

These two explanations – efficiency and market power – are not necessarily inconsistent. If an alliance exhibits significantly greater efficiencies, weakened rival carriers will be forced to cut back their service or exit alliance-dominated markets altogether, allowing the alliance carriers to gain market share and raise fares over time. This explanation is consistent with the trends in transatlantic fares that have been observed since the mid-1990s. Thus, the initial, large fare declines in Open Skies markets were the result of increased competition made possible by the liberal agreements themselves as well as efficiencies generated by vertically integrated alliances. Over time, these efficiencies forced rival carriers to cut back or

exit the alliance-dominated hubs. At the same time, as the alliances matured, they displayed less of their initial eagerness to accommodate non-alliance traffic and, in fact, began to engage in discriminatory behavior. Both of these dynamics have served to drive alliance fares up, and they continue to do so.

Whatever the explanation, the move toward alliances has brought increased concentration to the transatlantic market, which highlights the importance of competition among alliances. This argues for caution on the part of regulatory officials in evaluating proposals likely to result in further increases in concentration. At a minimum, any substantial expansion in the scope of antitrust immunity offered to particular alliances (or combinations of alliances) should require compelling evidence that there are economic efficiencies that would justify the expanded immunity and that could not be achieved absent the immunity.

Moreover, even if the current level of inter-alliance competition is sufficient to discipline fares to destinations that can be served through more than one alliance hub, it cannot do the same for destinations better served through a particular hub. Passengers to those destinations may be “captive” to the dominant alliance at that hub, in the absence of non-alliance competition.

Granted, by the very nature of competition among networks – whether railroads, pipelines or telecommunications – some locations are better served by a particular network. As a result, service to those locations is susceptible to the exercise of market power. Some industries require the “favored” network to provide interconnections on regulated terms, including price, in order to mitigate this threat. By contrast, the aviation system relies on competition to maintain separate online networks that will connect passengers from their origin to their destination.

With this in mind, aviation regulators should have as their goal to increase the number of competing global alliances (networks), while at the same time making it easier for individual alliances to interconnect. Aviation policy should strive to have fewer “captive” passengers.

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