

File No. CT-2011-004

THE COMPETITION TRIBUNAL

IN THE MATTER OF the Competition Act, R.S.C. 1985, c.C-34, as amended;

IN THE MATTER OF the proposed transborder joint venture between Air Canada and United Continental Holdings, Inc.;

AND IN THE MATTER OF the "Marketing Cooperation Agreement" between Air Canada and United Air Lines, Inc.;

AND IN THE MATTER OF the "Alliance Expansion Agreement" between Air Canada and United Air Lines, Inc.;

AND IN THE MATTER OF the "Air Canada/Continental Alliance Agreement" between Air Canada and Continental Airlines Inc.;

AND IN THE MATTER OF an Application by the Commissioner of Competition for one or more Orders pursuant to sections 90.1 and 92 of the Competition Act.

BETWEEN:

THE COMMISSIONER OF COMPETITION, Applicant

- and -

AIR CANADA, UNITED CONTINENTAL HOLDINGS, INC.,

UNITED AIR LINES, INC., and CONTINENTAL AIRLINES INC., Respondents

AFFIDAVIT OF HUBERT HORAN

I, Hubert Horan, of Phoenix, Arizona, USA, make oath and say as follows:

I. INTRODUCTION AND BACKGROUND

1. I am a 30 year industry veteran, with substantial experience in international airline competition, airline alliances, mergers and industry consolidation. While at Northwest I was personally responsible for the original development of the KLM-Northwest Alliance network and introduced the intense hub-to-hub operations that became the template for all subsequent international alliances based on antitrust immunity (ATI), and the first alliance managed on a "metal-neutral" basis. I also managed strategic network and alliance issues at Swissair-Sabena, and thus have been involved in immunized alliance management on both sides of the Atlantic. I have not only helped build successful airline alliances, but I have worked to shut down alliances that did not generate meaningful benefits, such as the Continental-America West and the intra-European Qualifyer alliance. I have also worked directly on the business case and implementation requirements of nearly a dozen airline mergers, and thus have a strong

understanding of the financial and competitive impacts of all categories of airline combinations. I have significant experience with the management and airpolitical challenges of cross-border airline cooperation, and am one of the few people who has worked at the strategic management level of an actual cross-border airline merger (Swissair-Sabena).

2. My professional career has always been focused on transportation competition, deregulation and industry structure and I strongly believe that liberal competition has been hugely beneficial for both consumers and long-run industry efficiency. In the original development of the Northwest-KLM, one of my jobs was to determine exactly how the emerging alliance network created value for consumers that we could turn into returns for shareholders. Thus we developed a detailed understanding of exactly what aspects of our service drove major changes in consumer behavior, and which type of competitive situations our new services were likely to have the greatest competitive impact. Based on this knowledge, we focused network expansion on markets and competitors where it would be most successful, and carefully avoided markets where we had no competitive advantage, and this allowed Northwest to become the most profitable US carrier on the North Atlantic in the 1990s. I have published a number of articles explaining the economics and competitive impacts of the original international alliances and examining airpolitical issues related to alliances and international competition.

3. Given this experience, I became increasingly concerned when in recent years, the same immunized alliances that generated significant consumer and industry benefits in the 1990s became the vehicle for consolidation efforts that harmed long-range industry efficiency and created artificial, anti-competitive pricing power. I also became concerned as airline regulators in the US and the EU not only abandoned their longstanding commitment to liberal, market-based competition but abandoned their legal obligations to evaluate merger and ATI proposals on the basis of objective, verifiable evidence of efficiency gains that would create significant consumer benefits. I have conducted detailed analysis outlining the economic issues in terms of the actual operations and competitive dynamics of the large network carriers that have been pursuing this artificial consolidation. This has been presented in detailed testimony in antitrust immunity cases before the US Department of Transportation (DOT) including the Oneworld and US-Japan cases. I also testified before the US Congress on the consumer and competitive impacts of the Delta-Northwest and United-Continental mergers. I recently published a law review article summarizing these ATI decisions and the recent industry consolidation efforts, "Double Marginalization and the Counter Revolution Against Liberal Airline Competition"¹

¹ Horan (2010) "Double Marginalization and the Counter-Revolution Against Liberal Airline Competition" 37 Transportation Law Journal, pp. 251-291, hereinafter referred to as Horan, "Double Marginalization

II. OVERVIEW OF RESPONSE

4. These comments respond to major claims made by Air Canada and United Continental Holdings in their filings of 15 August 2011. As the claims by the two applicants that I am concerned with are virtually identical, source references will be limited to the more detailed Air Canada Response, however the comments will refer to the plural Applicants, as they apply equally to both carriers. In these filings, the Applicants' made three claims related to consumer benefits

- The freedom to collude on pricing and capacity levels that they have enjoyed for the past 14 years (based on documents that I will refer to as the "original 1997 ATI agreements") had directly caused enormous price reductions for consumers due to the elimination of an alleged structural barrier to efficient interline pricing that has become known as "double marginalization", and that implementation of the recently proposed transborder joint venture agreement ("the TBJV") would lead to further "double marginalization" driven consumer pricing benefits
- Additionally, implementation of the TBJV would lead to other significant non-price consumer benefits driven by the "metal-neutrality" of the inter-alliance accounting arrangements, including increased flight capacity and major schedule quality improvements relative to the quality of schedules currently offered in transborder markets under non-metal-neutral accounting arrangements
- Other vague and unsubstantiated claims of efficiency driven non-price benefits, including frequent-flyer benefits, pricing and marketing program alignments and other product quality improvements, driven by sources that are not defined or explained in the Applicants' submissions but clearly are separate from consumer benefits driven by "double marginalization" or "metal-neutrality" based efficiency gains.

5. The Commissioner's 29 August reply clearly addressed the third, general set of efficiency gains, correctly noting that they are "in fact, illusory, achievable without the detrimental effects of the Alliance Agreements or the Proposed Merger, and/or unlikely to be greater than, and offset, those detrimental effects"². The Commissioner clearly recognizes that it must reject consumer benefit claims out of hand where there is not only no quantifiable and verifiable evidence that any transborder consumer have ever, or will ever realize material benefits, but not even a plausible explanation of the exact form of the alleged benefits, or how they might be allegedly created in transborder markets, or the alleged magnitude that transborder consumers might actually realize. However neither the Commissioner's 29 August reply nor Westjet's 29 August submissions substantively addressed the specific claims that "double

² Commissioner's Reply, para. 4, 13

marginalization” or “metal-neutrality” based efficiency gains would generate significant consumer benefits. Neither specifically mentioned either “double marginalization” or “metal-neutrality”, even though those two issues constitute the most important of the Applicants’ 15 August substantive claims.

6. My testimony in this Affidavit can be summarized as follows:

- The Tribunal should reject all of the Applicants consumer pricing claims which are willfully false;
neither the original 1997 ATI agreements nor the TBJV will generate any consumer pricing benefits and there is clear evidence that these types of agreements have created billions in anti-competitive pricing power on the North Atlantic

- The Applicants’ claims that a “metal-neutral” TBJV will create incremental consumer benefits above those possible under the original 1997 ATI agreements are false, are designed to facilitate anti-competitive pricing power, and should be rejected by the Tribunal

7. My testimony is in support of the Commissioner’s Application. My interest in supporting the Commissioner’s position is primarily driven by my belief that liberal competition is critical to both long-run airline industry efficiency and the welfare of airline consumers. Liberal competition requires effective, honest administration of the antitrust/competition laws, including enforcement of evidentiary standards. Mergers and ATI proposals that can demonstrate objective, verifiable evidence of consumer benefits and pose no risk of creating anti-competitive market power should be approved. The current application is based on evidence that is willfully false and/or completely non-existent. If the Tribunal does not uphold the Commissioner’s Application, it would not only directly threaten transborder consumers but would further embolden carriers seeking to further reduce competition based on false and non-existent evidence about consumer benefits and market power. Growing market power from oligopoly and cartel conditions in international markets can directly distort competition in other markets, such as the domestic Canadian and domestic US markets.

8. Throughout these comments I will use the term “Collusive Alliance” to refer to cooperation between carriers with antitrust immunity that no longer function as independent competitors and “Branded Alliance” to refer to cooperation between airlines that may pursue various joint marketing programs (codesharing, frequent flyer reciprocity, etc) but do not have ATI and cannot legally collude on prices, capacity, schedules or service levels. This is intended to avoid the confusion caused by the Applicants’ discussion of Star Alliance arrangements, which encompass both “Branded” and “Collusive” cooperation.

Branded Alliances --global scope	start date	Collusive Alliances --primarily trans- Atlantic <i>North American members listed in parentheses</i>	Start date
Global Excellence (Delta)	1990 (x)	KL-led alliance (Northwest)	1992 (x)
Star (United, USAirways, Continental, Air Canada)	1997	SR-led alliance (Delta, later American)	1995 (x)
One World (American, Canadian)	1998	LH-led alliance (United/Continental, Air Canada)	1997
Skyteam (Delta, Northwest)	2000	AF-led alliance (Delta, Northwest)	2000
(x) <i>defunct</i>		BA-led alliance (American)	2010

9. The Tribunal’s final decisions will obviously be strictly limited to the transborder markets. But its analysis of transborder competitive issues must incorporate some analysis of Collusive Alliance experience on the North Atlantic, because the Applicants’ claims are explicitly based on theories derived from North Atlantic experience, and the Applicants’ claims cannot be evaluated without reviewing North Atlantic evidence. The applicants’ claims about efficiency and consumer benefit are identical in every respect to the arguments they (and other ATI applicants) have made in the North Atlantic ATI cases. If objective evidence of major efficiency and pricing gains can be found on the North Atlantic, than the parallel claims for the transborder market are far more credible. Likewise, objective evidence that ATI has created artificial pricing power on the North Atlantic would underscore the Commissioner’s concerns about ATI creating artificial market power in transborder markets. The Applicants’ primary justification for the TBJV is that it is identical to the North Atlantic “A++” arrangements. Since the Applicants have not submitted any efficiency or pricing data from transborder markets, the Tribunal’s only practical options are to reject all “double marginalization” and “metal-neutrality” based claims out of hand due to the lack of proper evidence, or to consider evidence from North Atlantic market history and from previous North Atlantic ATI cases that might explain those claims.

A. The Tribunal Should Reject All of The Applicants Consumer Pricing Claims Which Are Willfully False; Neither the Original ATI Agreements nor The TBJV Will Generate Any Consumer Pricing Benefits and There Is Clear Evidence That These Types of Agreements Have Created Billions in Anti-Competitive Pricing Power on the North Atlantic

A1. The Sole Basis of All Applicant Consumer Pricing Claims Is an Unsubstantiated Theory From A Single 2003 Paper claiming that Airlines are Structurally Incapable of Setting Efficient Interline Prices; Neither The Current Application or any ATI Application In The Past Decade Provides Any Legitimate, Objective Evidence That ATI Created Any Consumer Pricing Benefits Since the 1990s.

10. In at least nine places, the Air Canada Response explicitly claims that the original ATI agreements has, and the new TBJV would lead to lower fares for consumers.³ Even though the applicants have enjoyed ATI since 1997, they provide absolutely no objective, verifiable evidence that ATI ever drove down transborder fares and they make no attempt to even suggest the order of magnitude of the alleged consumer gains. The Applicants are explicit asking the Tribunal to approve arrangements that will reduce competition without reviewing any transborder pricing data whatsoever. Similarly, none of the many recent ATI requests filed with the US DOT provide any objective, verifiable evidence of past consumer pricing gains attributable to ATI in the specific markets affected by ATI grants, and (with one exception noted below) make no attempt to quantify the future consumer pricing gains that new ATI grants would create in markets served by applicants.⁴

11. The only explanation of these alleged consumer pricing benefits occurs at paragraph 94 where the Applicants claim that their alliance would eliminate “inefficiencies created by the “double marginalization” problem, that is the imposition of successive “mark-ups” on airline tickets involving flight segments operated by different carriers. Double marginalization occurs in the absence of revenue sharing integration between the carriers on such interline flights, because each carrier has an incentive to mark up the fare for its own flight segment(s) with regard only to the impact on demand for its own flights, but not the demand for flights of the carrier operating the other segment(s). It results in higher fares (and lower demand and output) than would be optimal if an effectively single entity were responsible for determining the price on the routes”⁵. This “double marginalization” theory is not only the sole basis of all applicant consumer pricing benefit claims in this case, it is the sole basis for all consumer pricing benefit claims in every ATI application that has come before the US DOT and other regulators in the past decade. The legitimacy of this claim can only be evaluated with reference to the “double marginalization” claims made in past ATI cases before the US DOT.

12. The Applicants make multiple vague and unsubstantiated references to other types of “efficiency gains,” separate and in addition to claims of efficiency gains justified by oblique references to “double marginalization” or “metal-neutrality”⁶. These are the claims that the Commissioner has already correctly rejected as not only but “illusory (and) achievable without the detrimental effects of the Alliance

³ Air Canada Response, para 3,9,21,45,56,94,95,116,117. These do not include general efficiency claims or claims of harmonized price structures (which would not necessarily involve lower fares).

⁴ The consumer pricing benefit claims in the recent Skyteam I and II ATI cases, the Continental/Star Appliance ATI case, the Oneworld ATI case and the US-Japan Alliance ATI case all rested completely on “double marginalization”

⁵ Air Canada Response para. 94. Other general references to “double marginalization” as the driver of lower consumer prices occur at paragraphs 95, 116 and 117.

⁶ Air Canada Response para. 3, 5, 20, 56, 84, 90, 92, 116

agreements”.⁷ The Applicants have not backed these multiple claims with any evidence whatsoever. The Tribunal cannot accept any claim that does not meet its evidentiary standards. Such claims of consumer pricing benefits would have to demonstrate that the magnitude of the cost reductions and that they are very likely to be achieved (and are not purely speculative), that the carriers have clear incentive to pass on efficiency gains to consumers (instead of retaining the gains as profit improvement), explain which portion of the alleged benefits passed to consumers would be in the form of service/capacity changes as opposed to price cuts, and demonstrate that portion passed to consumers in the price cuts would actually be large enough to make a material impact on overall transborder price levels. Since the Applicants have not submitted any evidence linking “other efficiencies” to price cuts, and since current industry financial conditions create strong incentives for the carriers not to pursue such price cuts, the Tribunal should assume that the sole source of the Applicants’ price cut claims is “double marginalization”.

13. The base of legitimate research (i.e. conducted by objective analysts using verifiable data) as to the actual impacts of airline antitrust immunity on consumers is very limited, and almost exclusively focuses on the first decade of Collusive Alliances (the 1990s)⁸. The primary studies were conducted by the US DOT⁹ and found strong “network innovation” driven consumer pricing and service benefits. Based on my personal experience developing the original (Northwest-KLM) Collusive Alliance, and by subsequent work managing Swissair’s North Atlantic alliances, I believe that the original 1990s did create material consumer benefits, although primarily in the form of capacity growth and schedule improvements—not price reductions. I believe total consumer benefits were seriously overstated in the DOT study because the benefits of many unrelated changes were improperly attributed to ATI¹⁰. More importantly, these consumer benefits were fully exhausted by the late 90s. Prior to 1992, a large segment of North Atlantic demand—nearly 30% of the total market--could only be served on an interline basis, and this traffic endured poorer schedules and higher fares than traffic in online (single carrier) markets. The consumer benefits created by the original three North Atlantic alliances were due to an efficiency-enhancing network

⁷ Commissioner’s Reply, para. 4, 13

⁸ Morrish, S., Hamilton, R. (2002), “Airline alliances. Who benefits?” *Journal of Air Transport Management*, v8 p401. summarizes the academic literature on pre-2003 alliance development. This paper—like most of the sources it mentions, are of limited value because the authors consistently conflated “alliances” in different types of markets with vastly different economic characteristics without attempting to identify the factors most relevant to consumers or competition. To cite one example, Park, J. and Zhang, A., (2000), “An Empirical Analysis of Global Airline Alliances: Cases in North Atlantic Markets”, *Review of Industrial Organization* v16 p367, estimated smaller alliance consumer benefits but failed to clearly distinguish between immunized and non-immunized alliances.

⁹ US Department of Transportation, Office of the Secretary, (1999) “International Aviation Developments: Global Deregulation Takes Off; US Department of Transportation, Office of the Secretary, (2000), “Transatlantic Deregulation: The Alliance Network Effect”.

¹⁰ Unrelated factors improperly lumped in with the benefits of immunized alliances included market liberalization in Europe, the widespread replacement of 747s and DC10s with 767s, ongoing advancements in hub networks and revenue management systems, and scale economies driven by robust demand growth. Market growth also reduced the value of Collusive Alliances since profitable industrywide capacity growth meant more and more of the market could be served on a single carrier basis.

innovation—the use of fully integrated scheduling and pricing to create a “quasi-online” product for that 30% of the market. Consumers stopped using badly timed Pan Am to Alitalia connections and shifted to Northwest-KLM connections offering faster schedules and a full range of discount fares. Collusive Alliances offered no pricing benefits to the other 70% of the market, but did offer additional schedule alternatives to the longstanding single carrier services. Old-style interline connections had been eliminated as a competitive factor on the North Atlantic by 1999, and thus the Collusive Alliances stopped generating new consumer benefits, but continued to serve 40-45% of all North Atlantic traffic.¹¹ Any analysis purporting to show a link between ATI (or mergers) and consumer benefits would need to demonstrate innovations solely attributable to consolidation that created a clear competitive advantage that had not existed before, and define the market segments where this price or cost advantage actually shifted competition. The competitive advantages of the original 90s Collusive Alliances can be clearly demonstrated. After 1999, further ATI grants did not create any meaningful new competitive advantage. As will be discussed below, subsequent analysis of the impacts of ATI and industry consolidation are almost exclusively limited to paid advocates of the airlines seeking ATI and consolidation. Despite the dramatic subsequent changes in the industry, neither DOT nor any other US government agency has conducted any independent analysis of these issues since 1999.

14. The sole source of the theory that a “double marginalization” problem exists is a wholly unsubstantiated theoretical claim in a paper published by J.K. Brueckner in 2003. In this and various other papers¹², Brueckner presents statistical analysis showing correlations between ATI agreements and airline price levels from the 1990s, and then states a theory purporting to explain the observed correlations. For the purposes of this (and any other regulatory review of ATI) it is important to separate Brueckner’s statistical analysis from the explanatory theory. Unsurprisingly, the regression analysis found the same trend to lower prices that the DOT studies had found, which any time series of 1990s North Atlantic average fares will clearly show. However, there is no defensible relationship between Brueckner’s explanatory theory and the data he presents. Brueckner attributes virtually all of the observed price changes to the introduction of ATI, totally ignoring (like the DOT studies) the likelihood that much of the observed price changes were actually driven by other supply/demand conditions unrelated to ATI (i.e. strong cyclical market growth, aircraft and network driven productivity gains). More importantly, Brueckner’s “structural pricing barrier” explanation of how ATI might have driven lower prices (described

¹¹ For a more detailed discussion of the economics and consumer benefits of the original North Atlantic Alliances, see Horan (2010) “Double Marginalization” pp. 262-269 and Horan Oneworld Comments, 31 January 2010, DOT Docket OST-2008-0252-3389, pp.7-9; historical Collusive Alliance market shares are discussed at para. 25 below

¹² The specific “double marginalization” theoretical claim was first made in Brueckner, J. K., (2003), “International Airfares in the Age of Alliances: The Effects of Codesharing and Antitrust Immunity”, *Review of Economics and Statistics* v85 n1, p105. (a paper that was actually completed in 2001). The original regression analysis was presented in Brueckner, J. K. and Whalen, W. T., (2000), “The Price Effects of International Airline Alliances”, *The Journal of Law and Economics* v43 n2, p. 503. Bruckner and Whalen’s subsequent alliance papers are described in detail at Horan “Double Marginalization” pp. 270-275 and Horan Oneworld Comments, 31 January 2010, DOT Docket OST-2008-0252-3389, pp.3-6.

below) is totally unsupported by any of the data in his regressions or any other evidence. The regressions support the uncontroversial claim that North Atlantic airline prices were falling during the 1990s when ATI was first introduced, but do not in any way support Bruckner's claim that ATI caused all of the observed price changes and do not in any way support his claim about how ATI might have caused price changes. The Applicants' consumer pricing benefit claims in this and every previous ATI case are solely based on Brueckner's explanatory theory, and are not supported in any way by the data or statistical analysis. Brueckner's other papers provide alternate versions of the regression analysis, but since none of the various regressions demonstrate the alleged existence of "structural pricing barriers" they are totally irrelevant to the Applicants' pricing claims. Since the other papers merely repeat the 2003 explanatory theory, that single paper should be considered the sole source of the Applicant's pricing claims.

15. The key to Applicants' reliance on "double marginalization" theory in this and all previous ATI cases, is that the theory alleges that the consumer pricing benefits created by ATI have nothing to do with schedule convenience or any other type of competitive advantage, but are solely due to the claim that interline pricing suffers from a "market failure" or "negative externality" problem that can only be solved by merger or ATI grants. The theory claims that airlines face a "structural pricing barrier" to efficient, revenue maximizing interline pricing. When two carriers set a joint interline fare the two carriers apply separate "markups" (thus "double marginalization") over marginal costs and they do so without regard to what the other is doing and without regard to whether the resulting fare would be competitive with other prices in the marketplace. As a result the theory claims that interline fares on carriers that do not have antitrust immunity are always 15-25% higher than interline fares (based on coefficients from Brueckner's regressions). As a result the theory states that whenever competition is reduced via merger or ATI, major consumer pricing benefits are created because interline fares always, immediately and automatically fall by the same 15-25% because of the elimination of "double marginalization." Crucially, the theory claims that "double marginalization" is an unavoidable structural barrier to efficient interline pricing, akin to a law of physics--it is physically impossible for non-ATI carriers to avoid the separate "markups" that result in fares 15-25% higher than online or immunized carriers can set for connecting itineraries. This structural problem is claimed to be universal—inefficiently high non-ATI interline prices will be found in every market and occurs independently of supply/demand or competition conditions. The "double marginalization" theory claims that an Air Canada-Royal Air Maroc interline fare from Canada to Morocco will always be 15-25% higher than the online fares that Air France can set or that immunized alliance carriers can set, and even if Air Canada and Royal Air Maroc recognize that they will carry no traffic under the higher fare, there is no way they can overcome this structural barrier and file a competitive fare. The only possible way to reduce these fares to efficient levels is merger (or an ATI grant equivalent to merger) which eliminates the incentive for the double markup, and immediately reduces interline fares by the same 15-25%. The "double marginalization" theory claims that granting ATI would reduce fares by the exact same 15-25% regardless of whether ATI was granted in the midst of a major recession or in the middle of an

economic boom. The “double marginalization” theory claims that when ATI is granted 100% of the efficiency gains from the removal of this “negative externality” are realized by consumers (since ATI automatically and immediately causes the full 15-25% reduction interline fares) and consumers realize 100% of these gains regardless of whether ATI is granted in an oligopoly market with large entry barriers or in a market with robust competition.

16. Brueckner and the ATI applicants who have used his theory as justification for their consumer pricing benefit changes claim that Brueckner’s regressions “prove” the existence of this universal “structural barrier” to efficient interline pricing, thus Brueckner’s analysis of 1990s data¹³ can be used to predict the consumer pricing benefits in ATI grants in any future airline market¹⁴. Brueckner and the ATI applicants are not claiming that theory suggests the mere possibility of structural pricing barriers—barriers that might only be found in certain types of markets, or barriers that might be stronger under some conditions than others. If that were the case, the current Applicants would have needed to provide empirical evidence that these barriers existed in transborder markets, and would needed to present analysis showing the specific consumer pricing impacts under current transborder market conditions. Previous ATI applicants would have needed to present the DOT with comparable evidence relevant to their specific trans-Atlantic and trans-Pacific markets. They did not do so because they believe that Brueckner’s original regression coefficients provide all the evidence required to quantify consumer pricing benefits in today’s markets. Because Brueckner’s 2003 theoretical claim “proves” the existence of a universal structural pricing barriers, any future ATI applicant (such as the Applicants in this case) can “prove” that their application will generate significant consumer benefits, merely by footnote reference to Brueckner’s theory—a theory that short-circuits longstanding regulatory review processes by completely eliminating the need for any case or market specific evidence.

17. As noted above, neither the Applicants in this case or any other Star ATI application has presented a quantification the alleged consumer pricing gains when “double marginalization” markups are eliminated, although this can be readily calculated from the underlying theory, as the Oneworld carriers did in their US DOT filings. They estimated US\$92 million in annual consumer benefits by simply applying the coefficients from Brueckner’s regression to actual 2007 American Airlines/British Airways/Iberia/Finnair interline connecting traffic levels—and (following the logic of Brueckner’s theory) this US\$92 million gain

¹³ Brueckner’s 2003 paper used a cross section sample of 1999 data updating 1997 data from an earlier paper. Co-author Whalen later published regression results based on 1990-200 panel data, Whalen, W. T., (2007) “A Panel Data Analysis of Code Sharing, Antitrust Immunity and Open Skies Treaties in International Aviation Markets”, *Review of Industrial Organization* v30 (although this analysis was conducted years before and was originally presented in a 2003 working paper). None of the Brueckner and Whalen papers use any post-2000 data.

¹⁴ Brueckner first demonstrated how his earlier statistical analysis could be used to “predict” future consumer pricing impacts in Brueckner, J. K., (2003), “The Benefits of Codesharing and Antitrust Immunity for International Passengers, with an Application to the Star Alliance”, *Journal of Air Transport Management* v9 n2, p83

was claimed to be an annual, permanent consumer benefit from ATI that could never be competed away by the marketplace¹⁵. Thus it was claimed that “double marginalization” adds US\$200 (roughly 25%) to the price of each round-trip interline trans-Atlantic ticket in the Oneworld sample. This directly implies that granting ATI would create an efficiency gain equivalent to eliminating all of these airlines’ wage and benefit expenses related to transport of these passengers.¹⁶ Since these Applicants (and all prior ATI Applicants) clearly believe that Brueckner’s analysis of 1990s data “proves” the existence of universal structural pricing barriers, and that the consumer pricing benefits created by ATI grants do not vary with market or competitive conditions, the Tribunal must assume that the Applicants are explicitly claiming that Transborder realized very large percentage fare cuts following ATI in 1997 directly comparable to those in the Oneworld estimates.

A2. Interline “Double Marginalization” Does Not Exist, Never Existed, and the Issues Improperly Attributed to “Double Marginalization” Can be Fully Explained By Other Factors Unrelated to Antitrust Immunity

18. The “double marginalization” claim of structural barriers to efficient interline pricing was never true. None of Brueckner’s papers provide any evidence whatsoever on this claim and no other independent researcher has ever found any evidence supporting this claim. If there had ever been structural inefficiencies in these pricing processes that led to uncompetitive fares, as Brueckner claims, one would have observed major industrywide efforts to investigate and solve these problems. Since the “structural barriers” are a complete fiction, no such effort has ever been undertaken.

19. The “double marginalization” theory is based on totally false assumptions about how airline pricing actually works. It falsely assumes that interline prices are set with respect to the separate marginal costs of the separate flight legs (which the theory claims are separately “marked-up”). No network airline pricing function is based on either marginal costs or the independent costs of each flight leg. If prices were set this way, one would observe wild fluctuations in connecting fares when fuel prices are volatile, since fuel consumption per passenger varies widely by flight leg. If prices were set this way, one would observe major differences in fares offered by airlines or alliances on the same O&D since the marginal costs of different airlines and aircraft vary significantly. Brueckner’s “double marginalization” theory explicitly assumed the type of fixed (per route) mileage based interline prorates (derived from IATA practices) that

¹⁵ Oneworld ATI Application (DOT-OST-2008-0252-0001) p. 7. 24, exhibit JA-13, JA-19. Simplifying slightly, Brueckner’s regression coefficients suggested ATI interline fares were 25% higher than non-codeshare interline fares and 15% higher than codeshared interline fares, thus he claimed that ATI grants immediate reduce interline fares by a minimum of 15%.

¹⁶ Wages, salaries and benefits accounted for 26% of American Airlines’ reported total 2008 operating expenses.

were abandoned decades ago. Almost all interline fares are based on “special prorate agreements” that are totally inconsistent with all “double marginalization” based pricing claims.

20. The “double marginalization” theory totally ignores the existence of modern revenue management systems, which have long been capable of efficiently incorporating interline fares based on special prorate agreements into the yield management algorithms that govern seat and fare availability on individual flights. Even carriers with less sophisticated automation tools have always been capable of managing interline fares in revenue-maximizing ways. And carriers such as United, Continental and Air Canada, with world-class revenue management systems have never suffered from systematically suboptimal interline fares.

21. The “double marginalization” theory falsely assumes that “high” interline fares are always less efficient (non-revenue maximizing) than “low” interline fares. Many of the original Northwest-KLM connecting alliance fares in the 90s were lower than alternative interline fares, but this a historical anomaly due to the IATA-derived interline fare structures of the late 80s, which did not allow for the deeply discounted (APEX, Supersaver, etc) fare types that had only recently come in to widespread use on the North Atlantic. All connecting market pricing and revenue management (online or interline) is based on “opportunity cost” logic based on potential revenue contribution/dilution. Carriers will rationally set “high” interline prorate levels protect sales in other higher-yielding O&D markets, and will set “low” prorates for connections where there is ample seat capacity available and alternative local fares are low. The applicants’ claim that all connecting Air Canada-United fares in markets such as Montreal-Chicago-St. Louis automatically fell 15-25% after they received ATI in 1997 is completely false. There is no reason to believe Air Canada-United interline fares had been at inefficient levels before 1997, and if these fares changed after 1997, there is absolutely no reason to believe they would have all automatically gone down.¹⁷

22. All of the issues that Brueckner’s theory improperly attributed to “double marginalization” can be readily explained by rational, profit-maximizing airline behavior totally unrelated to antitrust immunity. The consumer pricing benefits actually observed in the early/mid 90s had nothing to do with the removal of structural inefficiencies, but were a purely function of the early market liberalization on the North Atlantic. As noted in paragraph 13 the original Collusive Alliances helped spread these discount fares to the 30% of the market that did not already have them in 1992 but price cuts were not an inherent benefit of

¹⁷ Further discussion and documentation of the pricing and revenue management issues in this section can be found at Horan “Double Marginalization” pp. 273-274 and Horan Oneworld Comments, 31 January 2010, DOT Docket OST-2008-0252-3389, pp.12-15

Collusive Alliances—joint alliance services from Northwest-KLM or Delta-Swissair were no more efficient than online connections on Lufthansa or American. The Collusive Alliances did not generate any further consumer pricing benefits after the mid 90s because they no longer offered lower prices than the competitive alternatives. Highly discounted interline fares were not ubiquitous because of physical barriers to rational pricing, but because these fares did not maximize revenues or profits for the airlines involved.

A3. There is No Evidence That Antitrust Immunity Created Any Consumer Pricing Benefits Since The Mid-90s, and There Is Substantial Evidence That Antitrust Immunity Helped Create Billions in Consumer Welfare Losses Due to Artificial Pricing Power in US-Europe Markets in Recent Years

23. As already noted, there is no legitimate evidence on the record of this (or any other ATI) case that consumers have realized any pricing benefits from ATI in the last decade. The other studies filed in these cases that attempted to replicate the Bruckner analysis with post-2000 market data found no general correlation between ATI expansion and lower prices, and of course found no evidence of structural barriers to efficient interline pricing.¹⁸ If evidence of recent consumer pricing benefits existed, it would have been presented in this, or other recent ATI cases.

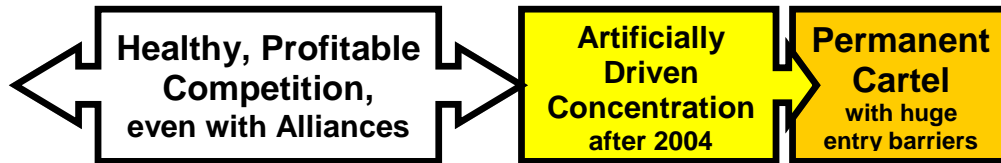
24. The potential for airline mergers or ATI to generate consumer benefits (or conversely, create the risk of artificial market power) cannot be evaluated independently of market or competitive conditions, and competitive trends over time. While any competitive analysis must start with market share and concentration data, that data must be evaluated in light of other evidence, including entry barriers and the airline business models in use. Markets predominately served by megahub-based network carriers face market power risks at lower concentration levels than markets where “point-to-point” services play a larger role because the large minimum scale required to operate an efficient megahub limits the total number of competitors that a given level of market demand can support. The North Atlantic market is almost exclusively served by network airlines. The transborder and domestic US markets are predominately served by network airlines; although non-hub “point-to-point” services play an important secondary role, services operated by the historic “low cost” carriers (i.e. Westjet, Southwest, JetBlue) have become much similar to the network model, with much greater use of international codesharing and connecting hubs.

25. The US-Europe concentration table below illustrates that ATI and mergers are not inherently pro- or anti-competitive, but can be either depending on overall market conditions¹⁹. The original three Collusive Alliances were pro-competitive (or at worst, benign) for the first 10-12 years after they were first introduced in 1992. They had strong competitive advantage in certain markets (just as the traditional carriers such as British Airways and American had strong competitive advantage in other markets) and

¹⁸ Robyn, J., Reitzes, J. (2005) untitled paid analysis of the Skyteam antitrust immunity application prepared on behalf of American Airlines DOT-OST-2004-19214; Robyn, J., Reitzes, J. (2006) untitled paid analysis of the Star Alliance antitrust immunity application prepared on behalf of American Airlines DOT-OST-2005-22922; Department of Justice, Comments on the Continental/Star Alliance Show Cause Order, DOT-OST-2008-0234, pp.49-51; Department of Justice, Comments on the Oneworld Show Cause Order, DOT-OST-2008-0252-3374, pp.22-24 and Appendix A and B

¹⁹ Seat share using DOT Form 41 Schedule T100 data.

were strongly profitable even though the overall market was robustly competitive. The competitive situation changed dramatically after the approval of the KLM-Air France merger (first announced in 2003), which not only eliminated the major source of longhaul price competition in Europe, but forced the subsequent Northwest-Delta merger²⁰.



1995	1997	1999	2001	2003	2005	2007	2009	2011
Top 3 Concentration of US-Continental Europe market (40 million annual pax)								
47%	55%	56%	61%	67%	85%	88%	98%	98%
Top 3 Concentration of total North Atlantic market (55 million annual pax)								
42%	45%	47%	47%	54%	68%	66%	92%	98%
Collusive Alliance Share of total North Atlantic market (55 million annual pax)								
7%	26%	42%	44%	49%	54%	55%	97%	98%
number of total North Atlantic competitors with minimum 2% share								
13	13	11	11	9	7	6	4	3

26. The shift to today's 90%+ concentration in US-Europe markets is almost totally explained by antitrust immunity. It had nothing to do with the exit of small, inefficient carriers or other forms of "marketplace competition"; in fact the last carrier to exit due to competitive failure was Pan Am nearly twenty years ago. This concentration has been exclusively due to large incumbent carriers petitioning their governments to allow them to collude on pricing and capacity²¹. The table illustrates the modest consolidation rate in the 1990s (where evidence of consumer benefits from ATI exists) and the rapid recent acceleration of consolidation, creating permanent today's cartel-like conditions. None of this consolidation has been offset by new entry. The last new US-Europe entrant that ever achieved a 2% market share was Piedmont (now USAirways) which entered the market in 1987.

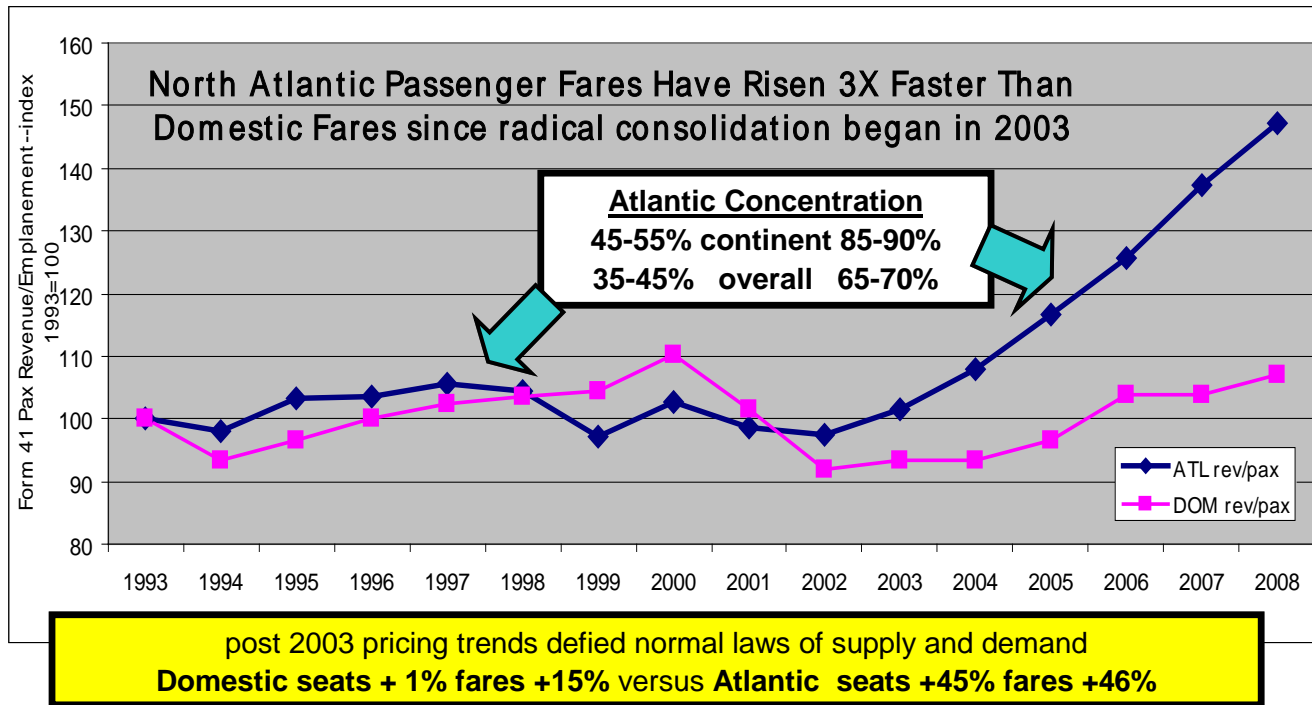
<i>carrier</i>	<i>exit</i>	<i>reason</i>	<i>action causing market exit</i>
Pan Am	1993	market forces	

²⁰ Northwest had no hope of independent survival since large US network carriers cannot survive without a large North Atlantic operation, and the KLM-Air France merger eliminated the possibility of maintaining Northwest's Amsterdam based Atlantic network. Thus this merger created artificial market power –the power to eliminate an efficient competitor and destroy its corporate value.

²¹ Although some carriers on the table eventually were acquired or merged (Swiss, Continental) previous ATI grants had already eliminated them as independent competitors.

Northwest	1993	artificial	joined KL, then AF-led collusive alliance
Delta	1995	artificial	joined SR, then AF-led collusive alliance
Sabena	1995	artificial	joined SR-led collusive alliance
Austrian	1995	artificial	joined SR, then LH-led collusive alliance
United	1997	artificial	joined LH-led collusive alliance
SAS	1997	artificial	joined LH-led collusive alliance
British Midland	2001	artificial	joined LH-led collusive alliance
TWA	2002	artificial	acquired by AA
Alitalia	2002	artificial	joined AF-led collusive alliance
CSA Czech	2002	artificial	joined AF-led collusive alliance
USAirways	2004	artificial	joined LH-led alliance (w/o immunity to date)
KLM	2004	artificial	acquired by AF
Swissair/Swiss	2005	artificial	joined LH-led collusive alliance
LOT Polish	2005	artificial	joined LH-led collusive alliance
TAPAir Portugal	2005	artificial	joined LH-led collusive alliance
Turkish	2008	artificial	joined LH-led collusive alliance
Continental	2009	artificial	joined LH-led collusive alliance
American	2010	artificial	joined BA-led collusive alliance
Iberia	2010	artificial	joined BA-led collusive alliance
Finnair	2010	artificial	joined BA-led collusive alliance

27. The graph below illustrates the linkage between ATI-driven radical consolidation and anti-competitive pricing power, and provides a basis for estimating the (growing) magnitude of consumer welfare losses due to artificial pricing power. The graph contrasts aggregate US-Europe price levels, with those in the domestic US market, where there was no comparable trend towards radical consolidation.



From deregulation until 2003, US-Europe price trends closely tracked domestic price trends. From 2003 onward, a totally new pattern emerged, with North Atlantic fares rising three times faster than domestic fares²². This fundamental shift in pricing behavior exactly tracks the move towards extreme North Atlantic concentration, which started when Air France bought KLM, previously the largest single driver of price competition in European longhaul network markets. The market power already created by consolidation is actually worse than the simple Atlantic/Domestic fare comparison suggests. Under normal, healthy competitive conditions, airline fares are highly responsive to changes in capacity. Domestic US fares increased 15% since 2003 because the industry did not add capacity. When Atlantic capacity spiked in the late 90s, average fares fell, even though this was the peak of the dot-com era. But the market power

²² Statement of Hubert Horan, "The Anti-Competitive Impacts of a United-Continental Merger and the Consolidation of 80% of the US Aviation Market Into Just Three Competitors" House Committee on Transportation and Infrastructure, Aviation Subcommittee Hearings, 16 June 2010. Data in the graph is total Domestic and Atlantic entity totals for all US carriers from DOT Form 41; passenger revenue data is from schedule P12, segment passengers from schedule T100. Transatlantic revenue on non-US carriers is not publicly available, but since US flag carriers serve the identical markets with comparable schedules and capacity, the aggregate US carrier Atlantic unit revenue data shown in the graph should very closely track aggregate market levels. capacity comparison is total Domestic and Atlantic entity seat capacity for all (US and non-US) carriers from DOT Form 41 schedule T100.

created on the Atlantic in recent years meant normal supply/demand relationships would not work. Atlantic fares increased 46% since 2003, even though capacity also increased 45%. If 2008 capacity levels were operated under pre-2003 competition conditions, 2008 Atlantic unit revenues might well be 30-40% lower than observed, suggesting an annual consumer welfare loss due to increased market power of US\$9-12 billion²³. Keep in mind that 2008 pricing conditions do not reflect subsequent market consolidation, including the elimination of independent competition from Continental, American, Iberia and others. Counterfactual historical analyses such as this are a bit complicated²⁴; but the actual losses that a more elaborate analysis might suggest would undoubtedly have been at least US\$5 billion a year in 2008. Prices in both domestic and North Atlantic markets collapsed with the start of the global financial crisis in 2009, but 2010 prices rebounded much further on the North Atlantic than in domestic markets, further confirming that the transatlantic alliances enjoy artificial market power not seen in the domestic market, even with depressed demand conditions.

28. As the US-Europe pricing history illustrates, the potential threat to consumers from ATI and other forms of consolidation must be evaluated in the context of longer-term competitive conditions and trends. The original three Collusive Alliances were developed and reached full maturity under the highly dynamic competitive conditions of the 1990s, and were highly profitable even when they carried less than half of total market traffic. The Collusive Alliances approved in the last decade were clearly part of a deliberate movement to dramatically reduce competition, and occurred in a time period when there was clearly no possibility that future entry would ever discipline anti-competitive abuses. As the Commissioner correctly noted in the 29 August reply, decisions regarding the Air Canada/United Collusive Alliance that were taken in the mid-90s were based on the market conditions of the mid-90s, and cannot serve as precedent for decisions that will impact consumers under today's substantially less competitive conditions. The Tribunal cannot evaluate consumer pricing impacts on the narrow basis of how prices might change in the week following a decision, because the critical risks to consumers, such as market power, do not appear spontaneously following merger transactions or ATI grants, but develop more gradually. United and the other Star Alliance carriers have been aggressively fighting to reduce competition in all their major markets over the past decade. The original 1997 ATI agreements, the incorporation of Continental into all of United's Collusive Alliances and the current United/Air Canada TBJV are all part of that ongoing

²³ The total 2008 US-Europe revenue base is conservatively assumed to be \$30 billion, based on DOT Form 41, US carrier Atlantic passenger revenue of \$15,058 million and a 46% US carrier share of combined total available seat miles. This estimate does not include non-passenger revenue or the portion of transatlantic ticket revenue flown on domestic US or intra-EU connecting flights that would not be categorized as Atlantic revenue in Form 41

²⁴ A more detailed analysis would likely show relatively large consumer welfare losses in the connecting US-Continental Europe markets where the duopoly of the Lufthansa and Air France-led collusive alliances have had an 85% share for over five years, and smaller welfare losses in other market categories. Some marginal, higher-cost capacity would have been withdrawn in a more competitive environment, although the increased competition may have driven industry productivity improvements, and share shifts favoring more efficient carriers, and lower fares would have stimulated demand growth. A complete analysis would need to consider the consumer welfare losses created due to the reduced efficiency of oligopoly cartel markets, in addition to the direct pricing impacts.

process. The Tribunal must evaluate the 1997 ATI agreements and the TBJV in terms of where this process will lead in the future, and must keep in mind that supra-normal pricing is not the only way that this developing market power can reduce industry efficiency and consumer welfare.

A4. Air Canada and United's "Double Marginalization" Based Consumer Pricing Claims Are Willfully Dishonest and Must Be Completely Rejected By The Tribunal

29. Air Canada and United's "double marginalization" based consumer pricing claims are based on willfully dishonest economic assumptions—ones that the Applicants know are untrue, would be unwilling to defend, and are not the basis of any airline actions other than these regulatory filings. The key assumptions behind their claim can be summarized as follows:

- Airline fares fall automatically, immediately and dramatically every time competition is eliminated (via merger or ATI)
- When competition is eliminated (via merger or ATI), airline fares fall by the same dramatic rate independent of market/competitive conditions
- When structural pricing inefficiencies are removed 100% of the gains are automatically passed on to consumers regardless of competitive conditions or carrier efficiency.
- Airlines are completely incapable of setting rational, revenue-maximizing interline prices.

Air Canada and United management do not believe any of these four assumptions yet testimony based on "double marginalization" theory is indefensible unless all four are completely true. The first assumption violates all known theories of competitive markets. The relationship between prices and competition may not be simple or linear, but much more often than not one observes lower prices correlated with more competition and higher prices correlated with reduced competition. It is certainly possible to find cases where consolidation leads to lower prices, but it is preposterous to claim, as the applicants are in this case, that reduced competition always and automatically causes very large (15-25%) price cuts. The second assumption directly violates the laws of supply and demand in order to claim that interline prices will always fall by the same amount regardless of market and competitive conditions. The third assumption improperly assumes airlines do not attempt to maximize profitability. The fourth assumption claims liberal, market-based competition cannot work in international markets (where interline travel is significant) because airlines will always set interline prices 15-25% above efficient levels, so the pricing signals that consumers and competitors depend on are doomed to fail, and airlines will thus massively misallocate resources in these markets. United and Air Canada management knew these four assumptions were untrue at the time they filed their Response to the Commissioner.

30. Air Canada and United management knew that their repeated claims that prices fell after ATI was granted in 1997 and would fall further if the TBJV is approved were untrue when they submitted those

claims in their Response. They knew that no ATI grant anywhere in the industry had ever caused interline fares to fall 15-25%. They knew there was no legitimate evidence linking price cuts to any of the ATI grants in the last decade. They knew that the claimed “double marginalization problem” does not exist. They knew that interline fares between non-immunized carriers are not set on the basis of separate, independent “mark-ups”, and knew that all of Brueckner’s assumptions about airline pricing were inconsistent with the way they and other airlines actually set prices and manage revenue across their networks. They knew that there are no structural barriers preventing airlines from publishing efficient, revenue-maximizing interline fares.

31. J.K. Brueckner, who provide the sole basis for this and all other regulatory ATI consumer pricing claims of the past decade depend, did not conduct an independent, objective analysis of ATI pricing issues. He has long been a paid consultant to United Airlines and the Star Alliance. United hired Brueckner as part of an ongoing program that employed academics to conduct research that would provide ammunition for United’s pro-alliance and pro-consolidation agenda,²⁵ similar to advocacy research programs in other industries. Brueckner never disclosed these financial ties in any of the journals that published his papers, and United and other ATI applicants have always portrayed Brueckner’s “double marginalization” claims in DOT filings as if they were the result of disinterested academic research.

32. In addition to misrepresenting the independence of the original Brueckner claims in past ATI cases, the applicants willfully misrepresented “double marginalization” as “well documented in the economics literature”²⁶ and that the overall efficiency gains are supported by “leading economists around the world.”²⁷ These claims are demonstrably false, and Air Canada and United management knew them to be false when their Response was filed. No independent researcher has ever published findings based on verifiable, empirical data supporting the claims that there are structural barriers to efficient non-immunized airline pricing, or that ATI automatically leads to consumer pricing benefits. No independent researcher has found any objective, verifiable evidence of consumer benefits that can be attributed to the expansion of ATI in the last decade. I have extensively searched all publication databases as part of my recent research without finding anything supporting any aspect of these applicant claims, and one would assume that their past ATI applications would have included this research, if it existed. The claimed “economics literature” consists solely of Brueckner’s various papers (only one of which is relevant to the ATI pricing claims made here and in other regulatory cases) and papers that happen to have footnoted Brueckner as

²⁵ Moorman, R. (2000) “United Turns to Academics to Show Alliances Aid Consumers”, Aviation Week and Space Technology v153 n14 2 October 2000 p. 56. Brueckner (who is currently on the faculty of University of California-Irvine) submitted testimony in support of Star Alliance positions other ATI cases including, “An Evaluation of the Skyteam-Wings Antitrust Immunity Application”, and “An Evaluation of the Latest Star Alliance Application for Antitrust Immunity”.

²⁶ Air Canada Response para 96

²⁷ Air Canada Response para 65

part of their general literature search.²⁸ The entire “economics literature” supporting the United/Air Canada pricing claims is a single paper by one researcher who was being paid to support to produce pricing claims that could be used to justify consolidation in regulatory cases.

33. This pattern of deliberate misrepresentation can be seen in other parts of the Response. Benefits that can be achieved with non-immunized Branded Alliance arrangements, such as frequent flyer reciprocity, airport facility consolidation, codesharing and connecting schedule alignment are conflated with claimed Collusive Alliance impacts, even though the applicants’ management and legal counsel are fully aware that these are completely irrelevant to the current case. Repeated claims that their immunized collusion would not significantly reduce the level of competition in the transborder market are obviously absurd on their face as the Commissioner has already recognized. But it is not terribly surprising that applicants who are willing to base their central consumer pricing claims on obvious falsehoods might also play fast and loose with the truth about market share measures, or frequent flyer benefits, or the supporting “economic literature”.

34. These willful falsehoods and misrepresentations are not the work of isolated, rogue parties. The false testimony in this case reflects a longstanding, well-planned, and highly rational program that scores of airline managers (and their paid advocates) have full knowledge of. The pattern of dishonestly and willful disregard for traditional antitrust law that led to the Applicants’ testimony here also produced the testimony in every Star, Skyteam, and Oneworld regulatory ATI application in recent years. The Applicants willfully false testimony in this case is the direct result of a nine step process:

- A paid consultant represented as an independent academic runs regressions on pricing data from periods with vastly different market conditions than today
- The consultant states a theory that purports to be based on the market data and statistical analysis but was actually a total fabrication
- The theory is deliberately designed to establish a universal rule that “predicts” that any future ATI grant will automatically create huge consumer benefits, a rule designed to supersede the laws of supply and demand and all other traditional antitrust analytical approaches
- The airlines pursuing ATI pay the consultant to publish a large set of papers to create the false appearance that the theory is supported by an ongoing body of research, and actively publishes false claims that the theory is supported by an extensive set of independent peer-reviewed economists

²⁸ For more details on the limited “economic literature” and for further examples of deliberate misrepresentations of this literature by consolidation advocates see Horan “Double Marginalization” pp. 270-273

- The airlines find antitrust regulators willing to accept footnote references to the theory as fully satisfying the need for evidence that ATI applications will create significant consumer benefits
- Having established the theory as a “proven” antitrust rule, airlines dramatically accelerate the pace of industry consolidation, since applicants no longer need to collect or present any case or market specific evidence that their applications will create consumer benefits, or any objective evidence that any past case actually created consumer benefits
- These airlines invest tens of millions of dollars in PR programs around the theme that “airline industry consolidation is inevitable” in order to limit potential media and political opposition; this meme becomes common (and is even repeated in this case) even though none of this consolidation is market-driven, and not a single dollar of private, at-risk capital has been invested in any of the recent consolidation among large airlines
- Since the theory has been established as a “proven” antitrust rule, regulators can reject objective verifiable evidence that consolidation has led to consumer welfare losses due to anti-competitive market power because the theory has “proven” that reducing competition via merger or ATI always creates significant consumer benefits
- The airlines submit the same rule as the basis for reduced competition in other countries, hoping that the local regulators will naively assume the rule has already received rigorous objective scrutiny and thus not demand verifiable, market-specific evidence.

B. The Applicants' Claims That a "Metal-Neutral" TBJV will Create Incremental Consumer Benefits Above Those Possible Under The Original 1997 ATI Agreements Are False, Are Designed to Facilitate Anti-Competitive Pricing Power, and Should Be Rejected By The Tribunal

35. On at least ten occasions²⁹, the Applicants' Response claims that approval of the "metal-neutral" TBJV will create material benefits for consumers above and beyond the consumer benefits that it is asking the Tribunal to believe were generated by the original 1997 ATI agreements. As with "double marginalization" based pricing benefits, the Applicants are asking the Tribunal to accept consumer benefit claims without providing any objective, verifiable evidence that "metal-neutral" agreements have ever generated tangible, unique benefits for any consumers in any airline market in the past, and without any attempt to quantify the value of benefits that transborder consumers and the Tribunal should expect to witness in the future. As with "double marginalization" based pricing benefits, the Applicants are asking the Tribunal to accept consumer benefit claims without bothering to even provide a logical explanation of exactly how a "metal-neutral" agreement would translate into material cost savings and then translate in turn into material consumer benefits. As with "double marginalization" based pricing benefits, the Applicants' claim consists of nothing more than, "we've found regulators elsewhere who accept our claims without demanding any objective supporting evidence, you should too".

36. The Applicants' claim that implementation of the "metal-neutral" TBJV will create incremental price reductions for transborder consumers is willfully false, as it based on the same "double marginalization" theory discussed above, and nothing more. Even more incredibly, the Applicants are asking the Tribunal to believe that the "structural pricing barriers" that it claimed were eliminated by ATI in 1997 can be eliminated a second time. This further demonstrates that the Applicants' believed the Tribunal would rubber-stamp all claims without making any effort to determine whether any of the claims were legitimate. Nothing in Brueckner's papers or the application of the theory in past cases allows for any possibility that pricing benefits depend on market condition, implementation approach, or any other case-specific condition. In this case, the Applicants are now claiming that Brueckner's papers and all of their past ATI application claims were wrong—their ATI grant only solved some of the "double marginalization" problem, and in the subsequent 14 years since there have still been many United/Air Canada interline fares that are irrationally marked-up to uncompetitive levels, but golly, if you approve the TBJV, we'll finally get this nasty problems fixed. Needless to say, none of these problems were disclosed in recent Star Alliance applications (as when Continental joined); in fact there was no evidence of them until the Applicants discovered they needed a "consumer pricing" claim to help justify approval of the TBJV.

37. The non-price TBJV consumer benefit claims do not insult the intelligence as directly as the pricing claims do, but are also illegitimate. The TBJV will not create abilities to "tap passenger traffic originating in the US cities behind its Canadian gateways" as alleged in para. 57, or new pricing capabilities (para. 99). These abilities always existed under the original ATI agreements, and were fully exploited to the extent

²⁹ Air Canada Response para 1, 3, 10, 21-22, 45, 57, 59, 94-5, 98-99, 116

that it was jointly profitable to do so. The paragraph 98 claim that 20 new trans-Atlantic routes introduced in the last two years because of efficiency solely attributable to the introduction of the “metal-neutral” A++ arrangement is completely unbelievable. If this was true, one would have witnessed the “metal-neutral” Northwest-KLM alliance expanding much, much faster than the non-metal neutral United-Lufthansa-Air Canada alliance over the past decade. These flights were justified by a variety of economic factors, probably including the steady growth in anti-competitive pricing power documented in paragraph 27.

38. I helped develop the original Northwest-KLM Collusive Alliance, which for 18 years was the only Collusive Alliance structured on a “metal neutral” basis. The Star Alliance Collusive Alliance was always free to structure itself on the same basis, or on any other basis that made sense for its members. Similarly, financial arrangements between mainline and regional airlines can be structured many different ways, and airlines that have used one approach for many years sometimes change to a different approach. Regulators should not dictate what revenue accounting arrangements and approaches alliances must use, any more than they should dictate mainline-regional accounting arrangements, or internal airline accounting arrangements and approaches. The Tribune should dismiss the Applicants’ claim that the new structure will lead to significant efficiency gains unless they (a) provide quantified and verifiable evidence of the gains and also (b) acknowledge that they have running a massively suboptimal alliance for 18 years to the detriment of their shareholders and customers, and they have done some deliberately, since they always had full knowledge of the alternative Northwest-KLM approach. Lacking this evidence and acknowledgement, the Tribunal should assume that there is no material efficiency gain from “metal-neutrality”, assume that different joint venture arrangements have different sets of advantages and disadvantages for their members but none are overwhelmingly superior for all airlines in all situations, and assume that Air Canada and United had not been mismanaging their alliance for all these years, but had been rationally favoring the structure they felt would produce the best results for them.

39. As with “double marginalization”, the claim that “metal-neutrality” magically generates a cornucopia of consumer benefits is a pure fiction designed to facilitate regulatory approval of moves designed to increase anti-competitive pricing power. As noted above, “metal-neutrality” was one of several possible internal accounting arrangements, and for 18 years no one (including those of us that worked under metal-neutrality) claimed that accounting arrangements contributed significant profits above the value of the prices and schedules the alliance offered in the marketplace. All of the original 1990s ATI cases explicitly acknowledged that the Collusive Alliances involved a tradeoff between increased competition in thousands of very small connecting markets versus reduced competition in a handful of very large hub-to-hub markets such as Chicago-Frankfurt, and demanded those markets be “carved-out” from the immunity grant. However, these markets are one of the most easily exploitable targets for carriers with artificial market power, and the Star Alliance began demanding that its pricing immunity be extended to the

“carved-out” markets. It commissioned another Brueckner study³⁰ to create the appearance that their demand was justified by objective “research.” The A++ arrangement cited in this case was introduced prior to the 2008 Continental/Star Alliance case³¹ to serve as the vehicle justifying the elimination of route carve-outs, under the (false and totally unsubstantiated) claim that carve-outs of isolated routes would somehow totally destroy the economics of an alliance. This is an absurd claim—every alliance carrier must figure out how to account for routes that may exclusively serve a single alliance, overlap several alliances, or serve a variety of alliance and non-alliance markets. Toronto-Chicago is part of the Atlantic A++, feeds the new US-Japan alliance with ANA, could potentially be part of TBJV, as well as serving the online AC and UA networks. How are ANA’s revenue sharing rights protected if it feels too many seats are feeding United connections in Chicago? If Air Canada believes it can manage these issues (which it undoubtedly can), it could easily manage route carve-outs. As there was no legitimate evidence that could possibly justify why “metal-neutrality”, after 18 years in the marketplace, was suddenly an independent source of consumer benefits that would be destroyed with carve-outs, the US DOT ruled that the evidence demonstrating these benefits and carve-out risks did not have to be disclosed publically, as even high-level summary data would threaten the ATI applicants with unacceptable confidentiality risks. I do not believe there is any legitimate evidence showing material, incremental consumer benefits are generated or any legitimate evidence showing that carve outs would significantly undermine the economics of alliances. If this evidence existed, it would be easy to document these claims without compromising sensitive competitive data. I believe the only reason for sudden 2009 discovery of competitively sensitive data showing “metal-neutrality”-driven consumer benefits was the pursuit of additional anti-competitive pricing power.

40. The Tribunal should recognize that this recent trend towards “metal-neutral” alliance agreements such as A++, where both the agreement terms and alleged consumer benefits are only known by the airlines benefiting from them, raises new competitive issues that could affect this and other future cases. The lack of transparency makes scrutiny of airline claims much more difficult for competitors, regulators, or anyone concerned with consumer interests. The actual competitive and consumer impacts of the original 1990s alliances were readily measurable with public data but no one will be able to tell whether the A++ agreement actually created the consumer benefits originally claimed, because no one knows what those claims are. Likewise no one will be able to tell if A++ actually harms consumers in the formerly carved-out markets. Skyteam and Oneworld members will not be able to tell if the Star A++ arrangements were approved on more favorable terms than their arrangements, and will not be able to tell if A++ actually

³⁰ Brueckner, J. and Proost, S. (2009) “Carve-outs under antitrust immunity” CESIFO working paper 248

³¹ See Continental/Star Alliance ATI Show Cause Order DOT-OST-2008-0234-0193 p.20. After the Department of Justice attacked this Show Cause Order for having rubber-stamped a range of totally unsubstantiated Star claims, the DOT restored limited carve-outs to its Final Order, but implemented its new “no-carve-out” policy in the Oneworld and other subsequent cases. For details of the deficiencies of the DOT’s Continental/Star decision, and the DOJ attempt to demand the use of legitimate evidence in ATI cases, see Horan “Double Marginalization” pp. 253-257, section I: “Copy/Paste as Antitrust Jurisprudence”

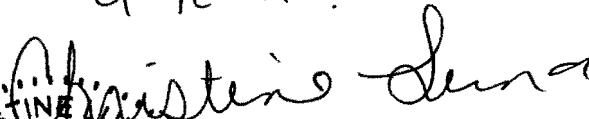
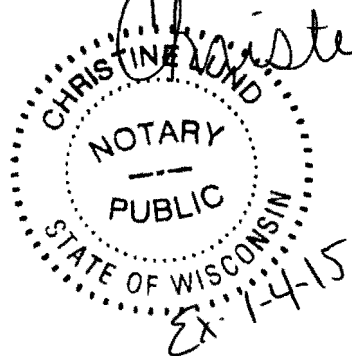
achieves the "metal neutrality" that was a prerequisite for the immunity grant. Claims in all past cases, such as "double marginalization", were properly documented on case records, and were subject to full scrutiny. "Metal-neutral" arrangements create new risks of cross-subsidies between regions that could undermine legitimate competitors who do not have the same opportunities. On a route such as Vancouver-San Francisco, it was historically fairly easy for a carrier such as Westjet (or for regulators) to evaluate its competitive performance based on public data. But the performance of the competing United and Air Canada flights in that market is no longer a function of the traffic it carries, but of complex financial allocations between a large set of international airlines in an overlapping set of alliances. Westjet will have no way to tell if it is doing well or poorly in this market. No one will be able to tell if United/Air Canada competition against Westjet is being distorted by cross-subsidies from other airlines playing under totally different competitive rules than Westjet faces.

Sworn on 12 September 2012



Hubert Horan

Signed in my presence
9-12-11

CHRISTINE BOND
NOTARY
PUBLIC
STATE OF WISCONSIN
EX. 1-4-15

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