VIEWPOINT

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The proposed alliance between Air Canada and United Continental

by Yanick Labrie | February 2012

Traditional airlines have had a lot of trouble remaining profitable over the past decade. In order to cut costs, they formed partnerships to coordinate ticket sales, flight schedules and baggage handling among other things, while simplifying connections. This need to reduce costs has become even more crucial with recent increases and constant fluctuations in the price of oil and with the greater competition stemming from the arrival of a large number of "low-cost" carriers onto the market.

Last June, however, Canada's Competition Bureau filed an application with the Competition Tribunal in order to block such agreements between Air Canada and United Continental.[1] The two companies are already members of the Star Alliance network, a strategic grouping of 28 airlines from around the globe. The venture would have allowed them to share revenue and coordinate their operations more closely on flights between Canada and the United States.

While numerous similar projects have been approved both in Europe and in the United States,[2] the Bureau claims that this joint venture would hold dangerously high market shares on 19 cross-border routes, which could lead to fare increases and a reduction of choice for passengers. The Tribunal has yet to render its decision.

The hackneyed concept of "barriers to entry"

The hypothesis that underlies the Competition Bureau's analysis of the situation is that the existence of "barriers to entry" in these markets would prevent the arrival of competitors willing to offer flights, which would allow the new joint venture to maintain high prices.

The economic concept of "barriers to entry" has become somewhat of a hackneyed expression in recent decades, to the point that it now tends to repeatedly mislead the authorities charged with applying competition laws. It is used not only to describe legal barriers, but also any exceptional difficulties or challenges involved in funding a project, getting a foothold on a market or developing a product.[3] But the fact that a company does not find a certain commercial project attractive does not necessarily point to the existence of any barriers to entry. For instance, it could be the case that entry into certain markets is not profitable simply because competition is already very strong.

Several indicators lead us to believe that competition is indeed quite strong in the airline industry. In the United States, traditional carriers have seen their market share eroded over the last decade and a half, with cost structures an average of 40% higher than low-cost carriers, whose market share rose from 10% in 1994 to 24% in 2009.[4] Within the airline industry, profit margins have never been smaller than in the last decade. From 2000 to 2009, combined losses for U.S. carriers totalled 54 billion dollars.[5] Several airlines have even had to seek bankruptcy protection in recent years, including Air Canada in 2003.[6]

In this context, it is hard to give much credence to the argument that the Air Canada-United Continental joint venture would benefit from a monopoly allowing it to raise fares significantly. Low-cost carriers have the power to considerably pull prices down simply by threatening to enter a market. A recent study based on U.S. data from 1993 to 2004 showed that when low-cost carrier Southwest Airlines threatened to fly certain routes but did not follow through, fares fell by an average of 24%, and in those cases when the company did begin offering flights on new routes, fares dropped by an average of 29%.[7]

1. Competition Bureau of Canada, "Competition Bureau Seeks to Block Joint Venture between Air Canada and United Continental," press release, June 27, 2011.
2. See especially: Kaveri Niththyananthan, "Lufthansa, ANA get antitrust clearance," *The Wall Street Journal*, June 1, 2011. Also, in July 2009, the U.S. Department of Transportation granted antitrust immunity to some Star Alliance member airlines on the basis that the network "creates new service options and substantially reduced fares for consumers."
3. Dominick T. Armentano, "A Critique of Neoclassical and Austrian Monopoly Theory," in Louis M. Spadaro (ed.), *New Directions in Austrian Economics*, Sheed Andrews and McMeel, 1978, pp. 94-110.
4. Severin Borenstein, "Why Can't US Airlines Make Money?," *American Economic Review*, Vol. 101 (2011), No. 3, pp. 233-237.
5. *Id.*
6. "Climbing through the clouds," *The Economist*, July 7, 2011; Mike Tretheway, "Comment on 'legacy carriers fight back'," *Journal of Air Transport Management*, Vol. 17 (2011), No. 1, pp. 40-43.
7. Austan Goolsbee and Chad Syverson, "How do incumbents respond to the threat of entry? Evidence from the major airlines," *Quarterly Journal of Economics*, Vol. 123 (2008), No. 4, pp. 1611-1633.

The positive effects of strategic alliances

We can expect large efficiency gains as a result of the agreements between Air Canada and United Continental. Indeed, traffic volume increases should lead to reductions in cost per passenger due to the use of larger, more efficient aircraft and the spread of fixed costs over a greater number of passengers.[8]

Among other things, these efficiency gains and cost reductions could make the companies more competitive in global markets, free up capital for new investments, create or preserve jobs, and above all improve the quality and range of services offered to consumers.[9]

Neither does such an alliance exclude the possibility that cost savings could be passed on to consumers in the form of price reductions, as numerous studies of the matter have shown. Indeed, coordination agreements between airline carriers over the past two decades have led to fare reductions of as much as 30% for interline passengers (see Table 1).[10]

Competition: a discovery process

Competition in a market brings worthwhile benefits for consumers, and protecting it remains an important goal. However, economists who specialize in antitrust matters are increasingly rejecting the argument that the level of competition can be measured simply by counting the number of competitors operating in a market. This conception obscures the fact that competition is a discovery process,[11] which has more to do with the number of "potential" competitors than with the number of "actual" ones.

Using a static analysis to evaluate competition in a dynamic economy, where innovation and technological changes are omnipresent, is therefore very unlikely to improve the wellbeing of consumers or of society as a whole.[12] Indeed, researchers have shown that over the course of the last century, the record of antitrust measures as tools for the defence of consumers' interests was poor at best.[13]

In light of this, we should worry that the position of Canada's Competition Bureau with regard to the Air Canada-United Continental joint venture, although motivated by the laudable goal of promoting competition, may well in the longer term hurt the very consumers the Bureau wishes to help.

Table 1
Results of studies of coordination agreements between airline carriers on interline airfares

Authors	Data	Effects on airfares for connecting flights
G. Bamberger et al. (2004)	1994-1996	Fares 5 to 7% lower
V. Bilotkach (2007)	1999	Fares 30% lower
J.K. Brueckner (2003)	1999	Fares 17 to 30% lower
J.K. Brueckner et al. (2011)	1998-2009	Fares 8 to 16% lower
T. Whalen (2007)	1990-2000	Fares 18 à 30% lower

Source: See footnote 10. The studies deal with different aspects of coordination agreements, namely membership in an alliance, codesharing and antitrust immunity.

8. Jan K. Brueckner and Stef Proost, "Carve-outs under airline antitrust immunity," *International Journal of Industrial Organization*, Vol. 28 (2010), pp. 657-668.
9. S.C. Morrish and R.T. Hamilton, "Airline alliances — who benefits?," *Journal of Air Transport Management*, Vol. 8 (2002), pp. 401-407; Dennis W. Carlton, "Does Antitrust Need to be Modernized?," *Journal of Economic Perspectives*, Vol. 21 (2007), No. 3, pp. 155-176.
10. See especially: Jan K. Brueckner, "International airfares in the age of alliances: the effects of codesharing and antitrust immunity," *Review of Economics and Statistics*, Vol. 85 (2003), No. 1, pp. 105-118; Gustavo E. Bamberger, Dennis W. Carlton and Lynette R. Neumann, "An Empirical Investigation of the Competitive Effects of Domestic Airline Alliances," *Journal of Law and Economics*, Vol. 47 (2004), pp. 195-222; Jan K. Brueckner, Darin Lee and Ethan Singer, "Alliances, Codesharing, Antitrust Immunity and International Airfares: Do Previous Patterns Persist?," *Journal of Competition Law and Economics*, Vol. 7 (2011), No. 3, pp. 573-602; Volodymyr Bilotkach, "Price effects of airline consolidation: evidence from a sample of transatlantic markets," *Empirical Economics*, Vol. 33 (2007), pp. 427-448; W. Tom Whalen, "A panel data analysis of code-sharing, antitrust immunity, and open skies treaties in international aviation markets," *Review of Industrial Organization*, Vol. 30 (2007), pp. 39-61.
11. Friedrich A. Hayek, "Competition as a Discovery Procedure," *Quarterly Journal of Austrian Economics*, Vol. 5 (2002), No. 3, pp. 9-23.
12. J. Gregory Sidak and David J. Teece, "Dynamic Competition in Antitrust Law," *Journal of Competition Law and Economics*, Vol. 5 (2009), No. 4, pp. 581-631.
13. Robert W. Crandall and Clifford Winston, "Does Antitrust Policy Improve Consumer Welfare? Assessing the Evidence," *Journal of Economic Perspectives*, Vol. 17 (2003), No. 4, pp. 3-26.

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