COMMENTARY

THE POOR FINANCIAL PERFORMANCE OF DEREGULATED AIRLINES: COMPETITION AS CAUSATION OR ONLY CORRELATION? REFLECTIONS ON PROFESSOR DEMPSEY'S ARTICLE

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I. INTRODUCTION

Professor Dempsey has provided us with a meaty and comprehensive description of the financial turbulence that has bedeviled America's commercial airlines.[1] Explicitly and implicitly he blames competition for the airlines' plight.[2] Further, I infer that he would have us return to the old system of rate and route regulation that existed prior to 1978.[3] To me this represents throwing out the competitive baby, the anticompetitive bathwater, and the entire legal bathtub. The fact that two events are correlated does not establish that one caused the other. The notorious example is that all drug addicts at young ages drank milk—a high correlation, but one that does not justify the conclusion that drinking milk causes drug addiction. The problem may have other causes; therefore, a remedy such as banning the drinking of milk might in fact cause much more harm than good.

My basic suggestion is that Professor Dempsey's detailed information reconfirms that profoundly flawed analysis of the airline industry guided and misinformed the original legislation deregulating airlines, which created opportunities for strategic conduct that combined with persistent managerial decisions to cause unnecessary losses to equity investors and unjustified price discrimination to travelers.[4] Moreover, the capacity to engage in largely unconstrained price discrimination is a major source of the long-term financial weaknesses of airlines.[5] Competition of this sort drives many prices below the average total cost of operating the business and can, therefore, result in total revenue below total cost. The problem is that, in the absence of legal standards that meaningfully constrain the discretion of airlines, individually rational competitors can, and apparently have, engaged in destructive competition.[6] This is not a necessary

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1. *See* Paul Stephen Dempsey, *The Financial Performance of the Airline Industry Post-Deregulation*, 45 HOUS. L. REV. 421 (2008).

2. *See, e.g.*, *id.* at 460 (discussing airlines' practice of pricing below cost); *id.* at 476 (examining the destructive impact of deregulation on competition in the industry).

3. In his oral response to my comments, as I understood it, Professor Dempsey advocated only allowing airlines to fix prices when they faced financial problems. For reasons that I will discuss subsequently, this is an even worse option than restoration of full-fledged regulation.

4. *See* PAUL STEPHEN DEMPSEY & ANDREW R. GOETZ, AIRLINE DEREGULATION AND LAISSEZ-FAIRE MYTHOLOGY 225–27 (1992) ("By 1991, the airline industry had lost all the profit it earned since the Wright brothers' inaugural flight at Kitty Hawk, plus $1.5 billion more.").

5. *Id.* at 226 ("Carriers competing head to head spiral downward in destructive competition.").

6. *See* Joanna Stavins, *Price Discrimination in the Airline Market: The Effect of*

result of competition in general. It is a consequence of the way in which law has defined the market for air travel.

Consequently, the failure to revisit and revise the competitive legal framework for airlines results in the continued persistence of these problems. My central insight is that the law can facilitate or frustrate the workings of a competitive market. The deregulation statute did not constitute the competitive market in ways necessary to take account of the characteristics that created serious risks of the kind that Professor Dempsey identifies.[7] A central, but too often ignored, insight is that few markets—especially complex ones—exist in a "state of nature" without any legal, i.e., regulatory, constitution.[8] Instead, the legal system by action and inaction defines the contours within which competitors act. Well-designed rules defining the market facilitate efficient, socially desirable competition[9] that benefits all stakeholders. Badly designed rules, or the lack of necessary rules, result in opportunistic, inefficient market conduct[10] that is, unfortunately, rational in context of the legal regime constituting that market. The present system of rules and regulations constituting airline markets is a good example of the second type of regulation.

But reform, and not repeal, should be the objective. However problematic a market approach might be, the direct command-and-control regulation typified by the Civil Aeronautics Board (CAB) was worse and would continue to be so. My colleague Neil Komesar has written at length that all alternatives are imperfect,[11] and this is a good example. One can point out the flaws in a given institutional approach and assume the

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Market Concentration, 83 REV. ECON. & STAT. 200, 202 (2001) (analyzing price discrimination trends and concluding that "price discrimination is higher on routes with more competition").

7. I have elaborated on these issues before. *See generally* Peter C. Carstensen, *Evaluating "Deregulation" of Commercial Air Travel: False Dichotomization, Untenable Theories, and Unimplemented Premises*, 46 WASH. & LEE L. REV. 109, 115–30 (1989) (identifying and discussing the three types of errors that render airline deregulation ineffective).

8. *See* Peter C. Carstensen, *The Transformation of Economic Regulation: Market Dynamics and Legal Lag Comments on Professor Bush's* Mission Creep, 2006 UTAH L. REV. 811, 812 (2006) (recognizing that complex and long-lasting commitments do not take place in a "state of nature" and therefore require a legal framework).

9. *See* STEPHEN BREYER, REGULATION AND ITS REFORM 47–50 (1982) (discussing methods regulators use to create efficient competition in regulated industries).

10. *See id.* at 200–09 (observing that, under regulation, the pricing policy weakened market incentives for peak efficiency).

11. *See, e.g.*, NEIL K. KOMESAR, IMPERFECT ALTERNATIVES: CHOOSING INSTITUTIONS IN LAW, ECONOMICS, AND PUBLIC POLICY 274–75 (1994) (claiming that even the best regulatory options are flawed).

alternative is perfect, but that is unreasonable. If one option has flaws, it is almost certain that any alternative will also be flawed. The first question for good public policy is which institutional approach is less imperfect, and the second question is whether it is possible to ameliorate somewhat the flaws in that institution without creating other unacceptable and usually unanticipated effects. Charles Lindblom calls this "incremental policy-making,"[12] and there is too little of it in public policy.

It merits emphasis at the outset that Professor Dempsey has collected and organized a powerful argument for concern about the long-run viability of commercial airline services in this country.[13] So, despite the reservations that I express about some of Professor Dempsey's specific interpretations of the data and my strong disagreement with his underlying thesis that we should return to some stronger version of command-and-control type regulation, he has made another important contribution to the public discussion of how best to regulate the airline industry.[14]

These comments rest on five points that are significant to appreciating the relevance, as well as the limits, of Professor Dempsey's article.

II. ECONOMIC ANALYSIS OF FINANCIAL INFORMATION

Much of Professor Dempsey's financial analysis focuses on measures of profit as a percentage of revenue.[15] This is not an economically relevant measure of return on investment. Basically, if there is relatively low investment compared to the volume of sales, profits will be low as a percentage of sales while, on the other hand, if sales totals are relatively low in comparison to the total investment, one would predict that a profitable industry would have a high level of profit as a percentage of total revenue. Airlines appear, based on the data in the article, to fall somewhat on the high-volume, low-capital side of the equation.[16]

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12. DAVID BRAYBROOKE & CHARLES E. LINDBLOM, A STRATEGY OF DECISION: POLICY EVALUATION AS A SOCIAL PROCESS 71–72 (1963) (defining incremental policymaking as "decision-making through small or incremental moves on particular problems rather than through a comprehensive reform program").

13. *See* Dempsey, *supra* note 1, at 482–84.

14. *See id.* at 476–81 (arguing that deregulation has led to destructive competition among the airlines, which should be addressed through renewed intervention). As those well informed about the legal analysis of this industry clearly know, Professor Dempsey is and has been an insightful and prolific analyst of the industry and its regulation.

15. *Id.* at 424–28 (providing information on the net profit margin of the airline industry from 1950 to 2006).

16. *See id.* at 424–26 (showing that between 1950 and 2006 profit margins were

However, for reasons that I discuss below, any inference about profitability from an economic perspective is questionable. In any event, the relevant measure from an economic and policy perspective is the rate of return on the invested capital in the business.[17] Fortunately, some of the key data needed to support my argument is included in the charts that Professor Dempsey has provided. Significantly, returns on capital are slightly higher than the profits as a percentage of sales, and, in some years, returns on investment were positive even though, in the aggregate, profits were a negative percentage of total revenue.[18]

But here the deeper issue is whether accounting profits for equity stock reflect the economic profitability of airlines. In particular, as Professor Dempsey demonstrates, American airlines currently incur massive interest payments for debt and lease payments for airplanes.[19] Functionally, these are also returns on invested capital and so should be included on the "profit" side of the ledger rather than being treated as if they were operating expenses.[20]

Legally, of course, there is a great difference between equity that is dividends paid out of the residual earnings of the

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generally low for the entire airline industry).

17. PETER S. MORRELL, AIRLINE FINANCE 61–62 (2d ed. 2002) ("[Return on investment] gives an indication of how successful the airline . . . is in its investment of all long-term capital under its management.").

18. *See* Dempsey, *supra* note 1, at 424 (displaying in Table 1 the net profits and returns on investment industry-wide).

19. *Id.* at. 441–43.

20. Economics conventionally defines profit as the excess over a normal return on capital committed to an enterprise, while accounting considers profits as the residual left after paying all bills including interest on loans for capital investments and lease payments. RICHARD H. LEFTWICH, THE PRICE SYSTEM AND RESOURCE ALLOCATION 183–84 (Holt, Rinehart & Winston, Inc. 1966) (1955). From an investment perspective, neither definition is helpful. What is relevant is the amount of income available, after current operating expenses are paid, to cover the costs of capital investments. Hence, a rational owner would consider all such revenue as available to pay the costs of the capital investment in the business. The next consideration is how much of the capital in an enterprise should be derived from common stock (no duty to pay dividends), preferred stock (a duty to pay a set dividend, but no bankruptcy if there is no payment), bonds, i.e., debt (a duty to pay with bankruptcy if no payment) or leasing the capital (like bonds a duty to pay with serious consequences to the firm if no payment is made). The fundamental theory of corporate finance rests on the "capital structure irrelevance principle" derived from the work of Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261, 291–92 (1958) (theorizing that, absent other costs, such as taxes, and in an efficient market, the value of a firm is unaffected by how that firm is financed). In real world terms, of course, the fluctuations in the flow of revenue, and the other considerations that are assumed away by the theory, are crucial to determining the optimal capital structure. The central point remains that regardless of its form, the proper measure of the capacity of an enterprise to pay for capital investments is the sum of its payments to stockholders, debt holders, and leasers.

enterprise and fixed debt or lease payments that must be met on pain of suffering default and bankruptcy. The information in Professor Dempsey's article does not allow us to estimate the total return net of operating expenses for airlines. My expectation is that the return is positive by a significant margin—the reasoning is that both lenders and lessors are charging relatively high actual or implicit rates of return because of the very thin equity capital in the airline industry.[21] Add those payments back on the profit side and deduct any net loss to equity, and the result is likely to be a clearly profitable business. Even if many airline owners may be romantics who like to lose money on "slow horses, fast women, and airlines," lenders and lessors are much less impulsive and much more concerned with getting paid. Hence, overall the industry is making money, but it is not making much money for shareholders.

The poor capital structure of airlines is attributable to bad managerial decisions and foolish efforts to gain short-term advantages by selling planes and leasing them back, as well as management buyouts that burdened these companies with vast and unnecessary debt. Professor Dempsey notes some of these issues in his article and has elsewhere expounded on them in more detail.[22]

The implication of deficient capital structures is that the market for corporate capital, and not the market for air travel, is functioning poorly. The remedies for this could include capital regulations, similar to those that exist for banks and insurance companies,[23] or a more focused criticism of the way in which investment bankers manipulate enterprises to advance their own strategic goals[24] without regard to the underlying merits of the structures they have created.

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21. *See* ADAM M. PILARSKI, WHY CAN'T WE MAKE MONEY IN AVIATION? 97–101 (2007) (arguing that the airline industry has easy access to financing from lenders due to the mobility of their operations); *see also* MORRELL, *supra* 17, at 72–75 (describing shareholder capital equity in the airline industry).

22. *See* Dempsey, *supra* note 1, at 441–43 (describing the debt load and leveraged buyouts many airlines faced in recent years); *see also* DEMPSEY & GOETZ, *supra* note 4, at 21–24 (depicting the "huge amounts of debt with which the nation's airlines have been burdened by virtue of gluttonous acquisitions, mergers, and buyouts in recent years" and noting the contribution of aircraft leasing practices to the debt).

23. *See, e.g.*, 12 U.S.C. § 1831o (2000) (outlining capital requirements for national banks); CAL. INS. CODE §§ 700.01–700.05 (West 2005) (establishing capital requirements for insurance).

24. *See, e.g.*, Dwight Jaffe & Andrei Shleifer, *Costs of Financial Distress, Delayed Calls of Convertible Bonds, and the Role of Investment Bankers*, 63 J. BUS. S107, S110–11 (1990) (noting that investment banks' position on bond conversions is based on the banks' own risk positions).

III. DIRECT COMMAND-AND-CONTROL WAS A BAD AND CORRUPT SYSTEM

When considering whether to reform an existing institution or move to a different one, it is important to begin with the understanding that all institutions have flaws. Markets fail to perform well in some contexts, but direct command-and-control regulation has also proven to be a deeply flawed and unsatisfactory method of overseeing many kinds of businesses.[25] The old system, described in part by Michael Levine, involved high cost, limited access, and great inefficiency.[26] Many scholars have discussed the substantive failings of direct command-and-control regulation in the airline business.[27] Indeed, even Professor Dempsey acknowledged that he did not want to return to full command-and-control regulation. Instead, he only advocated allowing airlines to work together to agree on prices free from the antitrust laws.

Before turning to the merits of unregulated, private cartels, it bears emphasis that when the government is awarding market rights and setting prices, the risks of corruption are very high. In fact, the old CAB had recurring problems of exactly that sort.[28] One of the great political virtues of workably competitive markets is that they operate outside the direct control of

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25. *See, e.g.*, Bruce A. Ackerman & Richard B. Stewart, *Reforming Environmental Law*, 37 STAN. L. REV. 1333, 1334–36 (1985) (explaining how command-and-control regulation in the environmental arena wastes resources, restricts innovation, and discourages investment); Philip J. Weiser & Dale N. Hatfield, *Policing the Spectrum Commons*, 74 FORDHAM L. REV. 663, 690 (2005) (outlining the "failings" of the command-and-control model: "rigidity, inflexibility to change, and invitations to rent-seeking behavior").

26. *See, e.g.*, CONG. BUDGET OFFICE, POLICIES FOR THE DEREGULATED AIRLINE INDUSTRY 1–4 (1988) (describing the state of the industry prior to deregulation and the subsequent improvements).

27. These criticisms began in the 1950s and increased during the 1960s. *See, e.g.*, RICHARD E. CAVES, AIR TRANSPORT AND ITS REGULATORS: AN INDUSTRY STUDY 438–39 (1962) (criticizing the CAB for not expanding competition and not recognizing change in the industry); Horace M. Gray, *The Airlines Industry*, *in* THE STRUCTURE OF AMERICAN INDUSTRY 468, 490–507 (Walter Adams ed., 3d ed. 1961) (arguing that CAB policy "serves to promote monopoly, to suppress competition, and to frustrate the dynamic development of the industry"). There was also an increasingly critical view of regulation as a whole. *See, e.g.*, LOUIS M. KOHLMEIER, JR., THE REGULATORS 6 (1969) (explaining the costs passed on to consumers because of inefficient regulations); Louis B. Schwartz, *Legal Restriction of Competition in the Regulated Industries: An Abdication of Judicial Responsibility*, 67 HARV. L. REV. 436, 442–43 (1954) (criticizing the notions of competition that underlie airline regulation).

28. *See, e.g.*, ROBERT N. ROBERTS & MARION T. DOSS, JR., FROM WATERGATE TO WHITEWATER: THE PUBLIC INTEGRITY WAR 43 (1997) (listing allegations of ex parte contacts between the CAB and the Eisenhower administration in an attempt to help airlines facing license revocation in 1958).

regulators and legislators.[29] By limiting the direct control the political process has over the market, the incentives to corrupt the political and administrative process are lessened.[30] Historically, this has been a major reason for this country's reliance on antitrust law and markets.[31]

Even when not corrupt, the decisions of regulators are often wrong because they are poorly informed,[32] they fail to predict changes in technology,[33] or they seek to respond to special interest political and social concerns that impose unnecessary costs on the consumers of regulated goods.[34] These failings characterize the old CAB, which saw its role as keeping all airlines solvent—regardless of the merits.[35] As a result, the CAB granted routes and encouraged mergers to preserve financial stability at the expense of travelers.[36] It failed to recognize that there would be substantial demand for air travel if prices were lower. Consequently, the CAB created and retained a high-price, low-volume business that it shielded from various efforts to achieve more efficient and lower priced services.[37] Although this

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29. *See* George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3, 3–6 (1971) (contending that businesses demand government regulation and then control the regulators via lobbying for their own benefit).

30. Bruce L. Benson & John Baden, *The Political Economy of Governmental Corruption: The Logic of Underground Government*, 14 J. LEGAL STUD. 391, 393–95 (1985) ("Corruption is a consequence of discretionary political authority").

31. F. M. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 11–12 (2d ed. 1980) ("[T]he political arguments for competition . . . and not the economists' abstruse models have tipped the balance of social consensus toward competition.").

32. *See, e.g.*, Paul R. Joskow & Richard Schmalensee, *Incentive Regulation for Electric Utilities*, 4 YALE J. ON REG. 1, 12–13 (1986) (describing how regulators suffer from information asymmetry in the utilities regulation context).

33. *See, e.g.*, Robert W. Crandall, *The Remedy for the "Bottleneck Monopoly" in Telecom: Isolate It, Share It, or Ignore It?*, 72 U. CHI. L. REV 3, 4–5 (2005) (explaining how regulators are unlikely to be able to predict the state of the broadband telecom industry in just a few years).

34. *See, e.g.*, Hope M. Babcock, *Chumming on the Chesapeake Bay and Complexity Theory: Why the Precautionary Principle, Not Cost-Benefit Analysis, Makes More Sense as a Regulatory Approach*, 82 WASH. L. REV. 505, 507–08 (2007) (explaining the social and political motivation of regulators in environmental regulation).

35. *Cf.* ELIZABETH E. BAILEY ET AL., DEREGULATING THE AIRLINES 16 (1985) (explaining that CAB's policy was to ensure overall industry profitability rather than fare competition between airlines).

36. Elizabeth E. Bailey, *Aviation Policy: Past and Present*, 69 S. ECON. J. 12, 13 (2002) ("Throughout the regulatory period, the focus of the CAB was on strengthening existing carriers, not authorizing new carriers. If a carrier was nearing bankruptcy, it would be merged into a financially healthy carrier." (citation omitted)).

37. *See* Leonard J. Kennedy & Heather A. Purcell, *Wandering Along the Road to Competition and Convergence—The Changing CMRS Roadmap*, 56 FE. COMM. L.J. 489, 550–51 (2004).

litany could continue for pages, many others have already made the point.[38]

Acknowledging to some degree that these criticisms are valid, Professor Dempsey has retreated to urging that airlines should have an unregulated right to create price-fixing cartels under circumstances that are not clearly defined.[39] This is in fact an even worse alternative. The incentives of private parties to eliminate price competition and exploit the high-demand traveler would be overwhelming whenever the incumbent airlines could in fact agree. Of course, to be effective, this kind of cartel must also control entry; otherwise, a carrier not currently serving the route would have a strong incentive to enter the market and offer discount services. In addition, the source of problems for an airline is not one route or another, but rather it is the revenue generated by its entire system. Even without creative accounting, an airline is able to allocate losses to any set of routes it so desires.[40] The strategic implication is that the airlines would select routes with relatively high-price, inelastic demand. Finally, airlines with fixed prices would have incentives to compete in other ways by providing more frequent service or better amenities in order to capture customers. In a moderately competitive world, those efforts would consume most, if not all, of the revenue again and leave the overall airline no better off. Hence, to achieve the objective of higher revenue net of costs, the airlines would need an outside regulator to enforce rules against various strategic actions by incumbents, limit entry, and oversee prices to ensure reasonable fares. In short, it is not practical from the standpoint of the airlines or the public to imagine that an unregulated cartel would serve anyone's interest.

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38. *See, e.g.*, ANTHONY E. BROWN, THE POLITICS OF AIRLINE DEREGULATION 99–102 (1987); THOMAS K. MCCRAW, PROPHETS OF REGULATION: CHARLES FRANCIS ADAMS, LOUIS D. BRANDEIS, JAMES M. LANDIS, ALFRED E. KAHN 217–21 (1984); Michael. E. Levine, *Airline Competition in Deregulated Markets: Theory, Firm Strategy, and Public Policy*, 4 YALE J. ON REG. 393, 402 (1987).

39. Because Professor Dempsey made this comment in response to my assertion that he wanted to restore the full CAB, I may be guilty of creating a straw man in his name. However, the proposal I examine is not uncommon when industries claim they face "destructive" competition. *See* ABA ANTITRUST SECTION, MONOGRAPH NO. 24, FEDERAL STATUTORY EXEMPTIONS FROM ANTITRUST LAW 66–72 (2007).

40. JOHN J. NANCE, SPLASH OF COLORS: THE SELF-DESTRUCTION OF BRANIFF INTERNATIONAL 250–51 (1984) (noting that Braniff ascribed many costs to its high-priced service to South America; its new managers then sold those routes, thinking them to be money losers, which resulted in the same costs being borne by its remaining system).

IV. THE INITIAL DEREGULATION OF AIRLINES RESTED ON FALSE ASSUMPTIONS AND UNJUSTIFIED EXPECTATIONS

In retrospect, it is amazing how many experts misunderstood the airline business. Michael Levine and Alfred Kahn, two of the key players in deregulation, have both so acknowledged, as Professor Dempsey is delighted to point out.[41] The 1978 deregulation rested on a series of false assumptions about how unregulated airlines would compete.[42] One very substantial component was the failure to recognize the network nature of airline services.[43] They are networks that move people from point A to point B either directly or indirectly. Moreover, many travelers moving between points must change planes. There are not a sufficient number of travelers between, e.g., Madison, Wisconsin, and Houston, Texas, in a day (perhaps even a week) to justify providing point-to-point service. But, combine the travelers from a number of upper-Midwest cities at a hub and an airline can fill a plane to Houston. However, a hub-and-spoke system, like the network systems discussed in the article by James Reitzes and Diana Moss,[44] involves a much more complex economic and policy analysis. A single airline is likely to dominate a hub; therefore, for those traveling to and from that location, there will be few choices.[45] Moreover, entry into providing service to such hub from another hub can invite vigorous competition.[46]

A closely related error is that the authors of deregulation imagined that entry and exit would be nearly costless and, therefore, nearly perfect competition would exist.[47] In particular,

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41. Dempsey, *supra* note 1, at 477 ("There is no denying that the profit record of the industry since 1978 has been dismal, that deregulation bears substantial responsibility, and that the proponents of deregulation did not anticipate such financial distress—either so intense or so long-continued." (quoting Alfred E. Kahn, *Airline Deregulation—A Mixed Bag, but a Clear Success Nevertheless*, 16 TRANSP. L.J. 229, 248 (1988) (internal footnotes omitted))).

42. For fuller elaboration on these points, see Carstensen, *supra* note 7, at 120–21 (identifying the false assumptions used to justify the deregulation of rates, routes, and barriers to entry).

43. *See* Michael E. Levine, *Airline Deregulation: A Perspective*, 60 ANTITRUST L.J. 687, 689–90 (1991) (discussing the unanticipated influence of network effects on economies of scale and scope in the airline industry).

44. James Reitzes & Diana Moss, *Airline Alliances and Systems Competition*, 45 HOUS. L. REV. 293, 296–99 (2008).

45. *See* Robert M. Hardaway, *Of Cabbages and Cabotage: The Case for Opening up the U.S. Airline Industry to International Competition*, 34 TRANSP. L.J. 1, 11 (2007) (discussing the affect of "concentration" on the availability of low cost fares).

46. *See, e.g.*, Dempsey, *supra* note 1, at 455 (discussing barriers to entry faced by new airlines, particularly when an airport is dominated by an incumbent airline).

47. Carstensen, *supra* note 7, at 120.

a hub airline would not raise prices because entry would occur and drive prices back down. In fact, there is a great deal of entry-specific investment (sunk costs),[48] and so competition is imperfect. The failure to appreciate this fact led to the failure to consider other assumptions, including the expectation that with easy entry and exit no local market could be effectively monopolized and exploited.[49]

There is a striking disagreement between Professor Dempsey and Michael Levine on the importance of hubs. Professor Dempsey portrays them as inefficient and undesirable.[50] He urges that more point-to-point service would be the better form of transportation.[51] He asserts that there are continuing economies of scale in airplanes; so a larger plane used for infrequent point-to-point service would be more efficient than frequent service to a hub at which passengers would be redirected to their various destinations.[52] In contrast, Levine's position is that there are few economies of scale after airplanes provide 125 or so seats. Moreover, he stresses that for many travelers, there is insufficient demand to support a 125-seat level of service on a point-to-point basis, even if only once a day. But, the twenty or thirty travelers who do seek to go between those two points can be pooled through the hub system to provide sufficient numbers to offer efficient, relatively frequent service. On the other hand, Levine also recognizes that some discount airlines specialize in point-to-point service where they can collect enough passengers from a region to justify the flight.[53] Such airlines aim to serve leisure travelers who are more flexible in their travel times but who may face high monopoly prices where

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48. Dempsey, *supra* note 1, at 468–69 (describing several sources of sunk costs required for an airline's entry into a market, including the training of employees, securing aircrafts, and establishing offices).

49. *See* Carstensen, *supra* note 7, at 127 (concluding that once the assumption of contestability is invalidated, "both exclusionary and exploitative pricing are feasible").

50. Dempsey, *supra* note 1, at 436 ("[H]ubbing . . . appears to have reduced efficiency and productivity as measured by labor and equipment utilization, and fuel consumption.").

51. *Id.* at 436–38 (discussing the shortcomings of hub service and the success and benefits of the point-to-point service).

52. *Id.* at 457–58 (noting the economic inefficiency of small-plane hub networks, as compared to Southwest's model).

53. *See* Michael E. Levine, *Airline Alliances and Systems Competition: Antitrust Policy Toward Airlines and the Department of Justice Guidelines*, 45 HOUS. L. REV. 333, 337–38 (2008) ("Production indivisibilities are overcome by aggregating passengers, readily willing to adjust their purchase patterns for relatively small amounts of money . . . [or] adjust their day and time of travel, and perhaps even their choice of leisure destination, to get low fares . . . .").

there is limited competition among conventional carriers.[54] My views more closely align with those of Levine. There are a number of potential point-to-point services,[55] but the limited frequency that would occur in linking many city pairs means that hub systems are, and will remain, the dominant form of linkage.

A second kind of error arose from assumptions about how markets for air travel would work in a deregulated world. One of the most important of those errors was the assumption that seats on airlines would be commodities and priced like other commodities—at a relatively uniform price.[56] In fact, as both Professor Dempsey and Michael Levine have pointed out in their papers, the airlines have a great deal of capacity to vary prices and thereby differentiate among travelers depending on the traveler's demand elasticity.[57] One important implication of this economic fact is that competing airlines in the deregulatory world have very strong incentives to maximize this price differentiation. As Professor Dempsey argues, this results in many tickets being deeply discounted and producing revenue below average total cost while a small group of travelers pay supercompetitive prices from which the airlines must obtain a profit.[58]

Another assumption that proved false was that antitrust law would continue to provide robust and critical oversight of

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54. *Id.* at 337 (noting leisure passengers' willingness to sacrifice convenience for cost savings). An example would be service from eastern South Dakota to Florida. Travelers may have very few options from major airlines, and those airlines providing any service to the region may focus primarily on business travelers and, therefore, offer few discounts. For leisure travelers in this situation, it is rational for them to travel some distance by car to a location from which the traveler can get a discounted, direct service. However, if such services divert too many travelers, the major airlines can engage in a variety of exclusionary tactics to drive out the low-price entrant. *See, e.g.*, Spirit Airlines, Inc. v. Nw. Airlines, Inc., 431 F.3d 917, 921 (6th Cir. 2005) (finding potential predatory pricing in a leisure market between Detroit–Philadelphia and Detroit–Boston); United States v. AMR Corp., 335 F.3d 1109, 1111–12 (10th Cir. 2003) (finding no violation when a major airline expanded service, increased the size of its planes, and reduced fares until new entrants left the market).

55. It appears that there is an increasing amount of point-to-point service using small, commuter planes. Based on the views of both Dempsey and Levine, this seems to be inefficient in terms of costs, although the fares tend to be similar to those involving travel through a hub. Are major airlines introducing these services in order to deter entry by other airlines?

56. Carstensen, *supra* note 7, at 125.

57. *See* Dempsey, *supra* note 1, at 453–55 (describing segmentation within the air transportation services market and identifying different price elasticities of demand in these segments); Levine, *supra* note 53, at 337–39 (arguing that through price discrimination, airline networks create value both for customers willing to pay extra for frequent service and for price-sensitive customers willing to adjust their travel plans for lower fairs).

58. Dempsey, *supra* note 1, at 460–61, 465–66.

mergers. In fact, merger authority remained with the Department of Transportation for a period of years during which several major anticompetitive mergers were authorized.[59] Since then, the Antitrust Division of the Department of Justice has come to provide the basic merger review, but in some ways this is too late.[60] Moreover, the Division has shown neither an excessive willingness to challenge mergers generally nor an appreciation of the competitive issues arising from the newest form of collaboration among airlines, as discussed by James Reitzes and Diana Moss.[61]

V. THE COMPLEX ECONOMIC CHARACTER OF CURRENT AIRLINE OPERATIONS

Airlines, as they have evolved following deregulation, are complex economic entities. They are a form of network organization that have substantial sunk costs and that gain significantly from having a larger network.[62] Given the current legal definitions of the rights of the airline to restrict the buyer's use of a ticket, the airline can impose a great deal of price differentiation on potential customers because each has unique characteristics. As Professor Dempsey has pointed out, in a competitive world, this means that individual airlines facing discounting by other airlines are forced to respond, resulting in a

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59. Carstensen, *supra* note 7, at 136–37.

60. Peter C. Carstensen, *Airline Mergers–Second Best Results in a Changed Environment*, *in* COMPETITION POLICY AND MERGER ANALYSIS IN DEREGULATED AND NEWLY COMPETITIVE INDUSTRIES (forthcoming Dec. 2008) (noting that, in 1989, antitrust review of airline industry mergers was removed from the authority of the Secretary of Transportation).

61. Reitzes & Moss, *supra* note 44, at 306–309 (examining governmental response to potential anticompetitive issues raised by recent airline alliances). One very interesting fact is that domestic airline alliances seem to provide very little true codeshared service (i.e., where the traveler moves between two airlines). It appears that less than one-half of 1% of all tickets involve such service. Harumi Ito & Darin Lee, *Domestic Code Sharing, Alliances, and Airfares in the U.S. Airline Industry*, 50 J.L. & ECON. 355, 369 (2007) (showing that traditional codesharing accounted for only 0.20% of tickets in the third quarter of 2003 (citing U.S. DEPARTMENT OF TRANSPORTATION, OD1B DOMESTIC DATABASE (2003)). Even more curious is the fact that a more frequent type of alliance travel, commonly known as virtual codesharing, is done entirely by an airline other than the one that issued the ticket. *Id.* Moreover, the issuing airline collects practically no revenue from this transaction. *Id.* at 359 (calling the revenue "nominal"). Overall, however, the total of alliance type travel appears to be very small indeed. *Id.* at 368–69 (noting that over 98% of passengers do not use codesharing).

62. *See* Bradley H. Weidenhammer, *Compatibility and Interconnection Pricing in the Airline Industry: A Proposal for Reform*, 114 YALE L.J. 405, 421–27 (2004) (explaining the effects of deregulation on the U.S. airline industry and the development of the prevailing hub-and-spoke system of network organization for the airlines); *see also* Dempsey, *supra* note 1, at 468–69 (discussing the "sunk costs" of the airline industry).

potential downward spiral of discounts and price differences that can result in long-term failure of the airline.[63]

A second level of complexity arises from the development of airline managerial systems and corporate tactics. Except for Southwest Airlines, airline managers in the United States have relied heavily on leasing and debt to finance their operations.[64] This imposes a high cash flow requirement on the business that, in turn, drives the need to extract revenue throughout the year, regardless of demand. The culture of debt is a product of managerial decisions and choices made by takeover specialists rather than something imposed by competition among the airlines.

Another managerial decision was to abandon interlining—the easy process of switching among airlines in the course of travel.[65] Instead, each major airline has tried to develop its own network to provide connections among thousands of points of arrival and departure.[66] The possibility of flying to a hub on a regional carrier and transferring to another airline for the next leg of the trip, a common experience before deregulation, is no longer feasible. Each major airline has created its own feeder system, making it very costly to take a flight on one airline and switch to another for the next leg, unless the two airlines have an express codesharing system.[67] For example, both United Airlines and American Airlines compete with links to Chicago's O'Hare Airport by use of small planes that are inefficient. If a third party operated that service, it could use larger, more efficient planes and provide the same frequency of service. The trunk lines would have to find a way to purchase tickets on such a carrier to ensure that it had sufficient revenue to justify its operation. Of course, all other carriers serving Chicago could also book passengers

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63. *See* Dempsey, *supra* note 1, at 441–42 (describing the destructively competitive practices of the airlines).

64. *See id.* at 441–43 (examining the debt financing and debt-to-capital ratios of the major airlines and asserting that leases account for most off-balance sheet debt); *see also* MORRELL, *supra* note 17, at 169–70 (summarizing the sources of airline finance).

65. Ken Hendricks et al., *Entry and Exit in Hub-Spoke Networks*, 28 RAND J. ECON. 291, 291 (1997) (noting that the emergence of hub-spoke networks has led to a decline in interlining).

66. *Id.* (reporting that as airlines "transform their networks into hub and spoke networks . . . interlining traffic as a share of connecting traffic fell from 38.8% in 1979 to 4.5% in 1989").

67. *Id.* (discussing network externalities associated with hub-and-spoke networks, such as coordination costs). For some low-volume airports, it appears that carriers still engage in shared use of regional service. I have personally observed this on travel to and from Santa Barbara, California, where American Airlines and Northwest Airlines use the same local service under the American Eagle brand.

onto that connecting line. Eliminating connecting services of this sort protects the dominant carriers from competition. Thus, the major carriers accept operating inefficiency in order to entrench their market position.

The introduction of round-trip tickets that required the passenger to fly all segments of the trip both frustrated the use of interlining and facilitated price differentiation.[68] For example, a traveler flying from Madison, Wisconsin, to Detroit, Michigan, might pay $600 for the round-trip ticket, while the passenger next to her, traveling through Detroit to Washington, D.C., might pay only $250 for a round-trip ticket. But the Detroit traveler cannot buy the D.C. ticket and get off the plane in Detroit without being subject to a major penalty, as well as being barred from flying home again on the return portion of the ticket.[69]

The limits imposed on travelers by the airlines with respect to the use of their tickets are not a consequence of competition. Instead, such limits are a consequence of the definitions that the legal system has provided for these transactions. Prior to deregulation, the CAB set the rules that governed the use of tickets.[70] When Congress deregulated the airlines, it assumed the same general policy of uniform prices would continue because that is how commodity prices work.[71] As a result, Congress failed to write any limits into the law concerning the airlines' right to define the terms and conditions for the sale of their tickets.[72]

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68. *Cf. Antitrust Issues in the Airline Industry: Hearing Before the S. Comm. on Commerce, Science, & Transportation*, 106th Cong. 37–38 (2003) (statement of Sen. Byron L. Dorgan) (discussing the impact of consolidation in the industry on interlining).

69. *See* Chase v. Nw. Airlines Corp., 49 F. Supp. 2d 553, 557–58 (E.D. Mich. 1999). This practice was subject to an antitrust challenge that survived the initial motions to dismiss on the pleadings. *Id.* at 568–69. Because of Northwest's bankruptcy, however, the case was abandoned without even obtaining injunctive relief preventing this monopolistic practice. Northwest Airlines Corp., Annual Report (Form 10-K), at 18 (Mar. 16, 2007).

70. *See* Am. Airlines, Inc. v. Wolens, 513 U.S. 219, 232 (1995) (noting that, prior to deregulation, CAB governed rates, routes, and service among the airlines); *see also* Richard H. K. Vietor, *Contrived Competition: Airline Regulation and Deregulation, 1925–1988*, 64 BUS. HIST. REV. 61, 67–68 (1990) (explaining that the CAB had broad authority over the airline industry, including setting prices and controlling competition).

71. Carstensen, *supra* note 7, 125–27 (examining the mistaken assumptions underlying deregulation).

72. *See* H.R. REP. NO. 95-1211, at 30 (1978), *reprinted in* 1978 U.S.C.C.A.N. 3737, 3766 (noting that the committee believed the law would "not cause prices for air service to rise to a greater degree than they would if no legislation was passed"); *see also* John. W. Freeman, *State Regulation of Airlines and the Airline Deregulation Act of 1978*, 44 J. AIR L. & COM. 747, 748 (1979) (suggesting that Congress believed that the "rigors of the marketplace" would produce a more efficient industry); Michael E. Levine, *Revisionism Revised? Airline Deregulation and the Public Interest*, 44 LAW & CONTEMP. PROBS. 179, 181–82 (1981) (discussing the motivations of Congress in deregulating the airlines).

The interaction of the network characteristics of commercial air travel with the nearly unconstrained capacity of airlines to charge different prices in the context of competition contributes greatly to the problems facing the industry today. Because airlines must respond to each other's competitive moves and because costs are a function of the entire network, the downward spiral that concerns Professor Dempsey can occur.[73] The central analytic point is that the spiral is a function of two things: (1) the broad right of airlines to define the scope and nature of the travel they confer on the traveler, which creates the context for price differentiation, and (2) a series of management decisions about how to organize the capital invested in the airline in ways that result in excessive fixed-payment obligations.[74]

Vertical integration in both operating feeder systems and leasing or owning airport gates contributes to further fixed costs.[75] Again, these costs are incurred because the industry's managers have chosen to configure organizations that way. The primary competitive consequence is to exclude competition by making entry more costly and difficult. In fact, this kind of sunk cost investment makes other exclusionary practices rational because of their deterrent implications.

None of the factors listed above are inherent in competition. Instead, these factors are artifacts of the way the legal system authorizes airlines to compete and the responses of airline management to those opportunities. Indeed, Professor Dempsey is correct when he states that the resulting behavior is "individually rational, but collectively irrational."[76] The source of the problem, however, is not in competition itself, but instead in the legal structure that governs the competition of airlines.

VI. THE BETTER RESPONSE: MARKET FACILITATION BY FIXING THE ANTICOMPETITIVE BATHWATER BY REDESIGNING THE LEGAL TUB TO HELP THE COMPETITIVE AIRLINE BABIES

The most important implication of Professor Dempsey's article is that it is long past the time to revise and reform the legal regime in which airlines operate. For the reasons discussed earlier, it would be a bad idea to try to return to direct command-

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73. *See* Dempsey, *supra* note 1, at 429–32.

74. *See id.* at 437–42 (discussing the "[c]auses of [u]nsatisfactory [f]inancial [p]erformance").

75. *See* ALFRED E. KAHN, LESSONS FROM DEREGULATION: TELECOMMUNICATIONS AND AIRLINES AFTER THE CRUNCH 5–6 (2004) (noting the "huge fixed costs" associated with hub-and-spoke operations).

76. Dempsey, *supra* note 1, 461.

and-control regulation, and an even worse idea to authorize airlines to collude together without direct regulatory oversight. Instead, I would suggest that there should be a serious review and revision of the legal framework within which airlines compete. The first goal of this revision is to reduce the capacity to engage in excessive price discrimination among travelers so pricing more generally reflects the average cost of service and exclusionary conduct is made more costly. Second, the goal should be to reduce barriers to entry and, therefore, increase consumer choice. This will offset some of the potential for price increases that would come from a reduction in the ability to differentiate prices and would also indirectly deter exclusionary conduct by making it an ineffective strategy even in the eyes of myopic airline managers.

Although each ticket is to some substantial degree a unique product, it consists of more generic components. Hence, two changes in the rights of airlines to restrict the use of tickets would make a great difference in the potential conduct of those businesses. First, the buyer of a ticket could have the right to transfer the entire ticket—or parts of it—to third parties as well as the right to use only those segments that the traveler desires. Such rights are the usual attributes of buyers of commodities.[77] The airline should have no complaint. It asked a price for a set of segments, and having received the price it asked, the airline should not be allowed to interfere with the buyer's decision about where and how to use those segments.[78]

The recognition that the traveler owns the right to the seat—and can make as much or as little use of it as the traveler chooses—should have significant impact on the pricing of airline tickets. The gains from the various types of traveler-specific discrimination would be severely limited. Airlines would have to price their inventory of tickets in way that was much closer to the average cost of providing service. Some price differences would still be practical, but the range of differences would necessarily be reduced, given the capacity of passengers to buy the low-cost set of seats and speculators to purchase seats to resell on eBay or in some other internet outlet. This would also make exclusionary price discrimination less practical whenever

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77. *See* YORAM BARZEL, ECONOMIC ANALYSIS OF PROPERTY RIGHTS 3 (2d ed. 1997) (defining an individual's right in a commodity to include his or her ability to consume the good directly through use or indirectly through exchange).

78. If one orders a Big Mac meal at McDonalds, nothing requires the buyer to eat everything. The same logic applies to airline travel once one regards the right to the seat as "property" of the buyer.

the traveler could use the lower priced segments in ways that did not directly impact the target.[79] However, in many contexts, airlines would retain the capacity to engage in exclusionary pricing similar to that seen in *AMR* and *Spirit* where the entrant airlines were offering travel between the hub and a particular destination.[80]

A second change in the sale of tickets would be to require that all tickets be sold on a one-way basis. This would facilitate the restoration of interlining travel depending on the prices and convenience of different segments of the trip. Such a reform would also increase the pressure on airlines to price segments based on the average cost of providing the service rather than on strategic considerations. Such a requirement could be implemented by requiring airlines to refund to travelers the price associated with the unused return portion of their ticket. This would induce airlines to offer one-way fares that are consistent with round-trip fares.[81] Because of the losses that would result if seats were unoccupied, airlines could be allowed to require notice in advance of departure if a traveler is not going to use their ticket. The airline would then have the right to impose a "re-stocking fee" to cover the costs of returning the seat to inventory.

The foregoing proposals reflect simply a redefinition of the rights of the buyer and seller in the commodity sold: the right to the seat on the plane. While such interventions might be disparaged as regulation, they are in fact the common role of law in defining the commodity market. They are rules that define the market and the transactions in the market, but leave the buyers and sellers free to transact within that legally defined context.

Stronger interventions might also be considered. First, as in banking and other industries, the law might impose a capital adequacy requirement on commercial airlines.[82] Such a

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79. If Northwest Airlines offers low-priced seats from Madison to Las Vegas through Minneapolis in order to compete with a competitor's direct service between Madison and Las Vegas, travelers to Minneapolis could buy such tickets and get off in Minneapolis. Hence, in order to compete on the spokes of its network, the airline would have to limit its exploitation of travelers to its hub.

80. *See supra* note 54 and accompanying text (citing these cases to show that where an entrant airline's service attracts too many travelers, the major airlines competing on that route can engage in variety of exclusionary tactics to drive out the entrant).

81. The logic of this rule is that airlines could not charge much higher prices for one-way tickets in comparison to round-trip tickets because a traveler wanting to use two different carriers could, under this proposal, buy two round-trips, use part of each, and get a refund for the unused half on the basis that each half counted 50% of the total price. This would induce airlines to offer one-way tickets for approximately half of a round-trip fare, less any discount on the refund.

82. Heath Price Tarbert, *Are International Capital Adequacy Rules Adequate? The*

requirement could: (1) demand that airlines have at least 30% or more of their capital in equity investments, and (2) require that the value of leased and owned equipment be treated as the capital of the airline. Such a requirement would mean that airlines would have greater flexibility to avoid cash flow problems during periods of slow demand. As Professor Dempsey has shown, there are regular cycles of high and low usage as well as variance contingent on exogenous economic factors.[83] By requiring more equity relative to both debt and lease payments, the law would limit the discretion of managers to take financial risks in order to pursue strategic goals unrelated to the operation of the airline itself.

A second possible intervention would be to require divestiture of certain operations related to airports. Currently, airlines lease specific gates and have exclusive rights to use those gates.[84] Airlines also provide most ground services including check-in and luggage handling. If an independent airport operator could provide some—or all—of these services, it would lower the sunk costs of the airlines and create greater flexibility in the use of scarce gate facilities at those airports with access constraints.[85]

Finally, regulators might consider imposing pricing requirements on airlines that preclude unduly high or low prices relative to some standard. The European Union has experimented with this idea by settling merger cases that resulted in monopolistic dominance of particular city pairs by linking the price of such a pair to a competitive pair of rough

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Basle Accord and Beyond, 148 U. PA. L. REV. 1771, 1772, 1778 (2000) (noting that governments attempt to reduce banking industry risk through capital adequacy regulation).

83. *See* Dempsey, *supra* note 1, at 432–34, 450–55 (outlining the cycles of airline industry use and profitability and the factors that influence them).

84. HARRY LAWRENCE, AVIATION AND THE ROLE OF GOVERNMENT 249 (2004) ("Exclusive-use gates remain the predominant arrangement at large hub airports.").

85. There are important issues related to pricing such ground services. In any given airport, the service provider is likely to be a monopolist and have an incentive to charge monopoly prices. Two responses are possible. First, it is arguable that the charges for such services could be regulated in one form or another. This is a common response to monopolistic infrastructure such as gas pipelines and electric transmission grids. Peter C. Carstensen, *Creating Workably Competitive Wholesale Markets in Energy: Necessary Conditions, Structure and Conduct*, 1 ENVTL. & ENERGY L. & POL'Y J. 85, 86 (2005). Second, cooperative ownership of ground services by all significant airlines might create appropriate incentives to have efficient and sufficient services. *See* Peter C. Carstensen, *The Content of the Hollow Core of Antitrust: The* Chicago Board of Trade *Case and the Meaning of the "Rule of Reason" in Restraint of Trade Analysis*, 15 RES. IN L. & ECON. 1, 29 (1992) (observing that farmer-owned grain elevators were more efficient and had larger capacity than other grain buying systems because of the joint interest of all farmers in having sufficient and efficient capacity to handle their crops).

comparability and requiring that prices in the two pairs be equated.[86] Thus, to exploit the monopoly route, the airline must also raise prices on the competitive route. Similarly, to engage in vigorous price competition in the competitive route, the airline will have to sacrifice profits on the monopoly route. Fundamentally, this has an effect similar to revising the rights to tickets by compelling the airline to balance costs and revenues over a large number of transactions. This reduces the airline's ability to engage in focused pricing. The result, once again, is to move prices toward an average cost basis while retaining a great deal of discretion in the airline to set its prices without regulation.

VII. CONCLUSION

Professor Dempsey's article is a strong reminder of the false assumptions that underlay the decision to deregulate airlines in 1978.[87] The problem, however, was not that competition itself is undesirable, but rather the airline business involved a more economically complex set of relationships, which even the most sophisticated analysts of that time failed to recognize. As a result, the deregulation did not provide an appropriate constituting of the market for air travel in ways that would direct competition to a workable and stable market.[88] The problem is not, as Professor Dempsey would have us believe, with competition in general. Instead, the problem is with the unstructured competition resulting from the failure to impose rules and regulations, which would have constituted that competition in more efficient and desirable ways. After thirty years, it is long past time to engage in an active and focused review of the ways in which the air travel market is constituted and adopt reforms that will facilitate better practices.[89]

Unfortunately, it is easier to frustrate than to facilitate legislative action. Moreover, various parties develop strong

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86. *See generally* EUROPEAN COMPETITION AUTHORITIES, REPORT OF THE ECA AIR TRAFFIC WORKING GROUP: MERGERS AND ALLIANCES IN CIVIL AVIATION 35 (2002), *available at* http://europa.eu.int/comm/competition/publications/eca/report_air_traffic.pdf (describing the European Union's "prince reduction mechanism").

87. *See* Carstensen, *supra* note 7, at 120–21 (outlining the false assumptions relied on in the deregulation decision).

88. *See* Dempsey, *supra* note 1, at 475 (noting that the "consensus among economists today is that the airline industry does not reflect theoretical notions of perfect competition").

89. Some of these reforms were suggested nearly twenty years ago. *See* Carstensen, *supra* note 7, at 147–50.

interests to protect the status quo.[90] Repeatedly, it is crisis that induces legislative action. If Professor Dempsey is correct, the country is close to such a crisis in airline finances.[91] If that crisis occurs, Congress will have a choice. It can follow Professor Dempsey's lead and return airlines to the failed regulatory systems of the past, or it can modify the conditions under which airlines compete to create a more efficient, sustainable set of legal conditions within which airlines can successfully compete.

90. *See* Russell Korobkin, *The Endowment Effect and Legal Analysis*, 97 NW. U. L. REV. 1227, 1266–67 (2003) (explaining how the "endowment effect" creates motivation for legislation to maintain the status quo).

91. Dempsey, *supra* note 1, at 421–23.