

145 334

ORIGINAL

DEPT. OF TRANSPORTATION
DOCKETS

01 DEC 17 PM 4: 54

**BEFORE THE
DEPARTMENT OF TRANSPORTATION
WASHINGTON, D.C.**

U.S.--U.K. ALLIANCE CASE: OST-2001-11029 - 40

STATEMENT OF DANIEL M. KASPER

Communications concerning this statement should be sent to:

**DANIEL M. KASPER
LECG, LLC.
350 Massachusetts Avenue
Suite 300
Cambridge, MA 02139
617-252-9994 (Ph)
671-621-8018 (Fax)**

December 17, 2001

STATEMENT OF DANIEL M. KASPER

My name is Daniel M. Kasper. I am a Director and head of the Transportation practice for LECG, LLC. ("LECG"). I also serve as Director of the firm's Cambridge, Massachusetts office. LECG is an economic consulting firm that provides expert analysis and consulting in wide range of public policy matters including competition, antitrust and regulatory policy. I personally have more than 20 years of public and private sector experience dealing with issues of regulation and competition in the airline industry. I earned my M.B.A. and J.D. degrees from the University of Chicago where I did graduate coursework in microeconomics and industrial organization with, among others, Nobel Economic Laureates Ronald Coase and George Stigler. Subsequently, I served on the faculties of the University of Southern California and the Harvard Business School, where my research and teaching dealt with economic regulation and competition policy in airline and other "regulated" industries. I have also authored a leading book on competition and regulation in international aviation markets -- *Deregulation and Globalization: Liberalizing Trade in International Air Services* (American Enterprise Institute) -- as well as a monograph examining competition in *The U.S. Regional Airline Industry* (The Economist Intelligence Unit). I have also written numerous articles, case studies, and research papers on various aspects of transportation and government policy in both domestic and international markets.

Prior to joining LECG, I consulted extensively on economic and public policy matters with clients in both the public and private sectors as a Partner and Head of the National Transportation Program at Coopers & Lybrand, L.L.P. and, before that, as Head of the Transportation Practice at Harbridge House, Inc. Before joining Harbridge House, I served at several senior level positions at the United States Civil Aeronautics Board, including more than three years as Director of International Aviation. In the latter capacity, I was responsible for formulating and implementing the Board's policies with respect to international aviation, including fares and rates, bilateral and multilateral aviation negotiations, as well as competition and regulatory policy.

In 1993, I was appointed as one of 15 voting members of the U. S. National Airline Commission, a body created by an act of Congress to evaluate and make recommendations on how to improve the performance of the U.S. airline industry. I have testified as an expert on airline and aviation industry matters before state and federal courts as well as legislative bodies, Executive Branch agencies, and international organizations.

In response to reply comments, including those filed late, I was asked by American Airlines and British Airways (both of whom I had previously advised on competition and regulatory policy aspects of their proposed alliance) if I would be willing to share with the Department of Transportation my reactions to arguments raised in opposition to the proposed alliance and why I believe that competition and international aviation policy considerations support the grant of immunity sought by the applicants. Because I am convinced that the public generally and consumers in particular would benefit from approval of the proposed alliance and the resulting adoption of an Open Skies agreement with the United Kingdom, I have agreed to do so. I therefore respectfully request the Department for leave to file this answer. Acceptance will not prejudice any party and will enable the Department to have a more complete and reliable record upon which to decide the issues raised in this matter. I have no economic or financial interest in any of the parties to this proceeding, nor do I have any economic or financial stake in the outcome of this proceeding.

* * *

For more than two decades, the United States has pursued an aviation policy designed to transform U.S. international aviation markets from highly regulated regimes that restricted competition into competitive markets that rely principally on market forces and competition to serve and protect the interests of the traveling public. This policy is based in large part on the conviction that freedom of entry and pricing -- key components of Open Skies agreements -- would result in better and more efficient air service than would continued bilateral regulation, a conviction buttressed by the substantial benefits generated by airline deregulation, the U.S. domestic version of Open Skies. Throughout this period, securing an Open Skies agreement

with the United Kingdom has been a central objective of U.S. aviation policy. Hence, I find it troubling that, just when the United States appears to be on the brink of securing the Open Skies agreement it has long (and properly) sought -- on terms virtually identical to those previously negotiated with other European countries -- opponents now seek to impose conditions for their own apparent private benefit that would scuttle a U.S.-UK Open Skies agreement and, with it, the anticipated public benefits that have heretofore been widely acknowledged to flow from such agreements.

This opposition is even more troubling when one considers that, even in the absence of an Open Skies agreement, AA/BA's combined share of slots (and flights) at LHR -- approximately 39% -- is not only well below that typically required to raise serious antitrust concerns but also well below the shares held individually by KL and AF (whose alliance partners have opposed the AA/BA application), as well as LH, at their respective hubs. Likewise, the increase from 37% to 39% that results from combining the slot holdings of AA and BA is well below that which has raised -- or should raise -- antitrust concerns. And like Professor Kahn, I am not aware of any prior airline alliance or merger where such a small share increase was deemed "worthy of antitrust concern, let alone condemnation,"¹ particularly when the pre-merger share was as low as 37%.

Following a U.S.-UK Open Skies deal, moreover, both U.S.-LHR and U.S.-London markets would have competitive structures equal to or better than other U.S.-European airline hub markets. In addition to existing non-stop competition from UA and VS and CO (which offers blocked space code share service on Virgin Atlantic's flights between the U.S. and London, including flights to LHR), AA/BA are certain to face new non-stop competition from British Midland. And, as discussed below, additional new services will in all likelihood be offered by other U.S. carriers between their hubs and LHR following an Open Skies agreement. In addition, Open Skies will for the first time allow airlines to serve London from any U.S. city, further enhancing competition. Thus, it is difficult to see how (or why) U.S.-London markets would be less competitive following the grant of immunity to AA/BA than they are today or why they would be less competitive than are the markets between the U.S. and other European hubs --

¹ Statement of Alfred Kahn, p. 6.

including FRA, AMS and CDG -- where competing alliances already enjoy the antitrust immunity.

Nonetheless, several opposing carriers have claimed that, notwithstanding the elimination of the existing bilateral's restrictions on the number of U.S. carriers permitted to serve LHR, they would be precluded from using LHR because they would be unable to obtain slots. For a variety of reasons, such statements are simply not credible.² Since new entrants are given preference to available slots in the LHR slot pool, additional U.S. carriers seeking access to LHR would have preferential access to slots at LHR. In addition, under existing rules, all new U.S. carrier entrants at LHR would be able to acquire and then swap slots with other airlines serving LHR. Since a significant number of LHR slots now appear to be used for less economically valuable services than the transatlantic services proposed by the U.S. carriers,³ it is reasonable to expect that, if the proposed new U.S.-LHR services are as valuable as their proponents claim, they will be able to acquire additional slots in the existing slot market from these less valuable uses/users.⁴ This expectation is supported by the U.S. experience following domestic deregulation, when major airlines were generally able to obtain slots even at the most severely slot constrained U.S. airports (DCA, LGA, ORD).

Even if they were unable to obtain sufficient slots from the slot pool, most of the carriers opposing AA/BA could obtain slots from their partners under alliances previously granted antitrust immunity by the Department. It is my understanding that such transfers occur with some regularity,⁵ and that VS and the European alliance partners of U.S. airlines opposing AA/BA also

² Even at congested airports like LHR, new slots are periodically created and existing slots returned to the slot pool. Since under existing rules, new entrants are given preference to such slots, they have been able to acquire slots at LHR which, in some cases, have been swapped to obtain slots at different times. See, Joint Reply of American Airlines and British Airways ("AA/BA Joint Reply"), p. 80.

³ See, for example, AA/BA Joint Reply, pp. 84-86 and Exhibit JA-R-8.

⁴ As first demonstrated in an analysis by Nobel Economic Laureate Ronald Coase, an existing holder of property rights (here, a slot) has strong economic incentives to consider not only how valuable that slot is when he uses it but also how much other potential users would be willing to pay for that slot (i.e., the "opportunity costs"). If other prospective users believe they can use the slot more effectively, they have strong incentives to offer a price for the slot that exceeds the value the existing holder can obtain from continuing to use (rather than sell) the slot. In short, there is little reason to conclude that new U.S. carrier entrants at LHR would be unable to acquire slots for their proposed services via the existing slot market.

⁵ AA/BA Joint Reply, at 82. In addition, LHR slot transfers between Star Alliance member carriers followed rapidly the grant of immunity to that alliance.

have significant slot holdings at LHR.⁶ It is clear that not all of these carriers' existing LHR slots are currently being used on routes with significant network value. KL, for example, operates a total of 2 daily round trips between LHR and Eindhoven and 4 daily round trips LHR-Rotterdam. These services do not connect to a Wings alliance hub and hence carry predominantly local traffic. As a result, they have relatively little network value, particularly in comparison to LHR-DTW/MSP, routes that NW will be permitted to serve, once Open Skies is instituted. Likewise, AF has 6 daily round trips (3 each from LHR to Lyon and Toulouse) that have little network value. Once existing bilateral regulatory restrictions are lifted following Open Skies, some or all of these slots could readily be converted to transatlantic service. AF/DL, for example, could use these slots to institute service on routes such as LHR-JFK and LHR-ATL. In addition, AF and KL could also make modest frequency reductions between their hubs and LHR – offset by using larger aircraft on their remaining LHR flights and/or by adding service from LGW or other London airports.⁷ KL, for example, already holds a significant share of the slots at London City Airport where it enjoys even better access than at LHR to central London business travelers. Both AF/DL and NW/KL presumably formed their respective alliances in order to earn greater profits. And both clearly have profit sharing elements at the core of their alliances. So I fail to understand why they should be rewarded – and AA/BA penalized – for their own threatened failures to re-deploy their existing LHR slot holdings in an economically rational manner, once the restrictions of Bermuda II are lifted.

Likewise, carriers with code sharing agreements can effectively share slots, which provides yet another means for carriers to obtain access to LHR. CO, for example, already provides code-share service to LHR under its agreement with VS and recently received approval from the Department to engage in an extensive code-sharing arrangement with KL.⁸ As discussed previously, alliance partners have clear and strong incentives to utilize slot transfers and/or code shares to serve LHR when such arrangements will generate greater profits for their respective

⁶ See, for example, AA/BA Joint Reply, Exhibit JA-R-4, pp. 2-6.

⁷ This type of scheduling is common in major U.S. cities with multiple airports, one of which is capacity constrained. Examples include service between major hubs and: DCA, IAD, and BWI; LGA, EWR, and JFK; and ORD-MDW.

⁸ Even if an immunized alliance might provide CO with better access to alliance partner' LHR slots, the lack of such an alliance is the result of strategic business choices made by CO. If CO were to deepen further its relationship with KL/NW. It is not apparent under such circumstances, why CO should be rewarded, or AA/BA should be penalized, for CO's own strategic decisions, including its decision to delay joining Wings.

alliances. Hence, assertions by opponents that their alliance partners will not make LHR slots available to them should be viewed with considerable skepticism.⁹

In any event, the Department has long recognized that alliances and alliance-building have become increasingly important aspects of competition among airlines and that one of the most significant competitive features of alliances is that they provide carriers with access to markets and airports that would otherwise be more difficult for them to serve. But the Department has thus far wisely resisted the urgings by some that it rewrite the rules to protect some competitors at the expense of others. Finally, in the unlikely event that there is little entry and expansion of transatlantic air services at LHR following Open Skies, LHR's competitive structure would still be superior to that of other European and U.S. hubs since it would have extensive direct competition between two major hub competitors (Star and oneworld alliances) plus substantial service by VS and additional service by several 3rd party carriers.

Still other comments have invoked the concept of the competitive parity or "ubiquity" of airline networks to justify their pleas for massive slot divestitures or, in the alternative, denial of immunity to AA/BA.¹⁰ But upon examination, this "rationale" is likely to create more problems than it resolves. For example, it would permit carriers that do not currently compete on any AA/BA overlap routes to receive slots for service to their hubs even though many such services would be unlikely to add any significant incremental one-stop competition on the overlap routes. Although it is clear that such an approach would transfer scarcity rents (an issue that is discussed below) from AA/BA to their competitors, it would do so by eviscerating BA/AA's London route network. Simply stated, it is far from clear how a "remedy" that effectively dismantles one major network would strengthen overall network competition or otherwise benefit consumers (as opposed to competitors).

In addition, the key premises upon which the "network ubiquity" justification depends are highly suspect. As previously discussed, for example, its assumptions that new entrants would be unable

⁹ See, for example, Delta, p. 28; Northwest, p. 23. Even if true, moreover, there would be no reason for the Department to penalize AA/BA or reward other alliances for engaging in such economically inefficient behavior.

¹⁰ I note, for example, that the total number of slots demanded by opposing carriers exceeds the total number of slots held by AA & BA. See also, the late-filed Answer of Michael E. Levine.

to obtain slots at LHR is unconvincing on both theoretical and historical grounds. And even if these assumptions were valid (which I do not believe to be the case), it is undisputed that both airlines and passengers would still have an extraordinary range of airport choices at London when compared to other European or even U.S. hubs. Unlike the typical hub situation (DTW, ATL, FRA, or AMS, for example), London travelers and the airlines serving them have a range of convenient airports from which to choose. Both Gatwick¹¹ and Stansted are well-established international aerodromes, while London City Airport provides competing alliances with convenient access for business travelers to/from London's central business/ financial/legal centers for connections via their European hubs as well as point-to-point traffic in competition with BA's services from LHR.¹²

While it may be the case that some passengers prefer LHR to other London airports, that fact cannot justify the draconian "divest or deny" relief sought by those opposing the pending agreement. That is particularly true where, as discussed above, there is an ample supply of airport capacity in the immediate London area. By removing existing bilateral restrictions on routing and pricing (i.e., deregulating), moreover, a U.S.-U.K. Open Skies agreement will make it easier for airlines to develop these "secondary" airports into even stronger competitive alternatives to LHR -- as happened with U.S. airports -- including BWI, IAD, EWR, MDW, HOU and OAK, among others-- following U.S. deregulation . Thus, although it used to be argued that there were no effective substitutes for LGA, today EWR with its CO hub clearly serves as a highly effective competitor/substitute for LGA, and CO carries more traffic than any other airline serving the New York City area.¹³ Likewise, the rapid growth in traffic enjoyed by low-fare European airlines from London airports other than LHR casts further doubt on the proposition that access to LHR is indispensable. Thus, both U.S. and recent U.K. experience suggests that it would be a mistake to assume -- as opponents here seem to argue -- that, in a deregulated marketplace, these relatively unconstrained secondary airports cannot provide an effective alternative to established gateways, including LHR. In short, unless the Department is

¹¹ I note in this regard BA's recent announcement that it is eliminating a substantial number of operations at LGW which will make several hundred slots available there for other airline(s) and increase both actual and potential competition for BA's flights from LHR.

¹² In addition, Luton Airport has additional unused capacity which could be utilized by airlines that voluntarily relinquish their existing LHR slots (in the slots market) following Open Skies.

willing to assume that consumers are simply sheep who will continue bleating a path to LHR forever and without regard to alternatives, concerns about “network ubiquity” neither justify nor require the relief sought by those carriers objecting to the proposed transaction.

Finally, the fact that average fares at LHR exceed those at other London airports is largely irrelevant to the issues in this proceeding because, as Professor Kahn has pointed out, it simply reflects the existence of scarcity rents caused by the absolute limits on the number of flights permitted at LHR, not monopoly profits. As a result, these scarcity rents “would persist even if operations at Heathrow were markedly less concentrated.”¹⁴ The important difference between scarcity rents and monopoly profits, noted by Professor Kahn and many others, highlights another reason for skepticism regarding the demand of oneworld’s competitors for substantial slot divestitures on “network parity” grounds: It is effectively a claim that competitive network parity requires a redistribution of scarcity rents at LHR.¹⁵ I am aware of no competition policy precedent or justification for such a claim. Moreover, implementing such a redistribution policy would inevitably force the Department to engage in highly subjective, legislative decisions regarding the distribution of wealth.

¹³ Following the introduction of services at JFK by new entrant JetBlue, traffic using JFK has also eclipsed traffic using LGA to a number of common destinations.

¹⁴ Statement of Alfred Kahn, p. 6. For similar reasons, average fares at U.S. slot constrained airports DCA, LGA and ORD typically exceed average fares at adjacent facilities that are not slot constrained.

¹⁵ The risk of rent seeking behavior is exacerbated here by the EU’s economically confused slots policy, which appears to suggest that airlines that are required to divest slots may not be entitled to sell or otherwise receive compensation for the divested assets.

Statement of Daniel M. Kasper

If these requests for redistribution were nonetheless to be accepted by the Department, logic and fairness would require that any redistribution "tax" be imposed not only on AA/BA but proportionally on all LHR slot holders (since all benefit from the scarcity rents), including United, British Midlands, and Virgin Atlantic. Overall, I can see no need or justification for the Department to contemplate, let alone to undertake, such a significant departure from its established standards.¹⁶

Respectfully submitted,



Daniel M. Kasper

¹⁶ It is noteworthy in this context that following an agreement with Japan permitting additional U.S. carriers to serve Tokyo's Narita -- an airport cited in opposing comments as being comparable to LHR in importance and for which there is no alternative for services from the United States -- the Department did not require, nor apparently even consider requiring, the divestiture of slots by the dominant incumbents, including NWA, in order to guarantee "network ubiquity." Rather, new entrants had to acquire NRT slots from existing operators and/or new slots as they became available.

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document by hand delivery or first-class mail on all persons named on the attached service list.



CARL B. NELSON, JR.

December 17, 2001

R. Bruce Keiner
Crowell & Moring LLP
1001 Pennsylvania Ave., N.W.
Washington, D.C. 20004

M. Rush O'Keefe, Jr.
Vice President, Regulatory
Affairs
Federal Express Corporation
1980 Nonconnah Blvd.
Memphis, TN 38132

Robert E. Cohn
Alexander Van der Bellen
Shaw Pittman LLP
2300 N Street, N.W.
Washington, D.C. 20037

Burton J. Rubin
Paul M. Ruden
American Society of Travel
Agents, Inc.
110 King Street
Alexandria, VA 22314

Megan Rae Rosia
Associate General Counsel
Northwest Airlines, Inc.
901 15th Street, N.W.
Suite 310
Washington, D.C. 20005

Robert D. Papkin
Squire, Sanders & Dempsey,
LLP
1201 Pennsylvania Ave., N.W.
Suite 500
Washington, D.C. 20004

Jeffrey A. Manley
Wilmer, Cutler & Pickering
2445 M Street, N.W.
Washington, D.C. 20037

Rebecca L. Taylor
Leftwich & Douglas, PLLC
1401 New York Ave., N.W.
Washington, D.C. 20005

David S. Stempler
Air Travelers Association
5335 Wisconsin Ave., N.W.
Suite 440
Washington, D.C. 20015

Michael F. Goldman
Silverberg, Goldman &
Bikoff, LLP
1101 30th Street, N.W.
Suite 120
Washington, D.C. 20007

Roger W. Fones
Antitrust Division
Department of Justice
325 7th Street, N.W.
Washington, D.C. 20520

Donald T. Bliss
O'Melveny & Myers LLP
555 13th Street, N.W.
Suite 500 West
Washington, D.C. 20004

Richard P. Taylor
Steptoe & Johnson LLP
1330 Connecticut Ave., N.W.
Washington, D.C. 20036

Kevin P. Mitchell
Chairman
Business Travel Coalition
214 Grouse Lane
Suite 210
Radnor, PA 19087

Office of Aviation
Negotiations
Department of State
2201 C Street, N.W.
Room 5531
Washington, D.C. 20520

Barry K. Humphreys
Director, External Affairs
& Route Development
Virgin Atlantic Airways Ltd.
The Office, Manor Royal
Crawley RH 203 NU
United Kingdom

Edgar N. James
Marie Chopra
James & Hoffman, P.C.
1101 17th Street, N.W.
Suite 510
Washington, D.C. 20036

Edward P. Faberman
Michelle M. Faust
Air Carrier Association of
America
1500 K Street, N.W.
Suite 250
Washington, D.C. 20005

U.S. Transcom/TCJ5
Attention: Air Mobility
Analysis
508 Scott Drive
Scott AFB, IL 62225

First Secretary (Transport)
British Embassy
3100 Massachusetts Ave. N.W.
Washington, D.C. 20008

Jan K. Brueckner
Department of Economics
University of Illinois
at Champaign-Urbana
1206 South Sixth St.
Champaign, IL 61820

Janusz A. Ordover
131 Hemlock Hill Road
New Canaan, CT 06840

Milena Novy-Marx
Senior Economist
AES Consulting, LLC
1388 Sutter Street
Suite 650
San Francisco, CA 94109

Director of Flight Standards
Federal Aviation Administration
800 Independence Ave., S.W.
Washington, D.C. 20591