AIRLINE INDUSTRY

Potential Mergers and Acquisitions Driven by Financial and Competitive Pressures

What GAO Found

The U.S. passenger airline industry was profitable in 2006 and 2007 for the first time since 2000, but this recovery appears short-lived because of rapidly increasing fuel costs. Legacy airlines (airlines that predate deregulation in 1978) generally returned to modest profitability in 2006 and 2007 by reducing domestic capacity, focusing on more profitable markets, and reducing long-term debt. Low-cost airlines (airlines that entered after deregulation), meanwhile, continued to be profitable. Airlines, particularly legacy airlines, were also able to reduce costs, especially through bankruptcy- and near-bankruptcy-related employee contract, pay, and pension plan changes. Recent industry forecasts indicate that the industry is likely to incur substantial losses in 2008 owing to high fuel prices.

Competition within the U.S. domestic airline industry increased from 1998 through 2006, as reflected by an increase in the number of competitors in city-to-city (city-pair) markets, the presence of low-cost airlines in more of those markets, lower air fares, fewer dominated markets, and a shrinking dominance by a single airline at some of the nation’s largest airports. The average number of competitors in the largest 5,000 city-pair markets rose to 3.3 in 2006 from 2.9 in 1998. This growth is attributable to the increased presence of low-cost airlines, which increased nearly 60 percent. In addition, the number of largest 5,000 markets dominated by a single airline declined by 15 percent.

Airlines seek to merge with or acquire other airlines with the intention of increasing their profitability and financial sustainability, but must weigh these potential benefits against operational and regulatory costs and challenges. The principal benefits airlines consider are cost reductions—by combining complementary assets, eliminating duplicate activities, and reducing capacity—and increased revenues from higher fares in existing markets and increased demand for more seamless travel to more destinations. Balanced against these potential benefits are operational costs of integrating workforces, aircraft fleets, and systems. In addition, because most airline mergers and acquisitions are reviewed by DOJ, the relevant antitrust enforcement agency, airlines must consider the risks of DOJ opposition.

Both DOJ and DOT play a role in reviewing airline mergers and acquisitions, but DOJ’s determination as to whether a proposed merger is likely substantially to lessen competition is key. DOJ uses an integrated analytical framework set forth in the Horizontal Merger Guidelines to make its determination. Under that process, DOJ assesses the extent of likely anticompetitive effects in the relevant markets, in this case, airline city-pair markets. DOJ further considers the likelihood that airlines entering these markets would counteract any anticompetitive effects. It also considers any efficiencies that a merger or acquisition could bring—for example, consumer benefits from an expanded route network. Our analysis of changes in the airline industry, such as increased competition and the growth of low-cost airlines, indicates that airline entry may be more likely now than in the past provided recent increases in fuel costs do not reverse these conditions. Additionally, the Horizontal Merger Guidelines have evolved to provide clarity as to the consideration of efficiencies, an important factor in airline mergers.

Why GAO Did This Study

The airline industry is vital to the U.S. economy, generating operating revenues of nearly $172 billion in 2007, amounting to over 1 percent of the U.S. gross domestic product. It serves as an important engine for economic growth and a critical link in the nation’s transportation infrastructure, carrying more than 700 million passengers in 2007. Airline deregulation in 1978, led, at least in part, to increasingly volatile airline profitability, resulting in periods of significant losses and bankruptcies. In response, some airlines have proposed or are considering merging with or acquiring another airline.

GAO was asked to help prepare Congress for possible airline mergers or acquisitions. This report describes (1) the financial condition of the U.S. passenger airline industry, (2) whether the industry is becoming more or less competitive, (3) why airlines seek to merge with or acquire other airlines, and (4) the role of federal authorities in reviewing proposed airline mergers and acquisitions. To answer these objectives, we analyzed Department of Transportation (DOT) financial and operating data; interviewed agency officials, airline managers, and industry experts; and reviewed Horizontal Merger Guidelines and spoke with antitrust experts.

DOT and the Department of Justice (DOJ) provided technical comments, which were incorporated as appropriate.