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COMMENTARY

READERS RESPOND

More Airlines Will Crash If Mergers Are Blocked

By Jagdish N. Sheth and Rajendra S. Sisodia. Mr. Sheth is a professor of marketing at Emory University in Atlanta. Mr. Sisodia is a professor of marketing at Bentley College in Waltham, Mass.

The plan by United Airlines to acquire US Airways is dead. American consumers are left to contend with another weak and wounded carrier attempting to stay airborne -- for how long, no one knows.

The merger died because the Justice Department managed to stonewall it for 14 months, despite the blessing of the nation's largest airline passenger consumer group. Members of Congress, moreover, become personally irate when it comes to the airline industry; they depend on it so heavily to manage their hectic schedules. Like all frequent travelers, they can cite examples where they have felt personally let down, even betrayed, by an airline. Many suggested that allowing these two airlines to merge would have created unhealthy levels of concentration and further exacerbated service problems.

But this is a double standard. Most major industries have a far greater degree of concentration than the airline industry. Worse, it's bad economics. If Congress and the Justice Department are interested in promoting a healthy and efficient airline industry that can satisfy customers, shareholders and employees, they should approve this merger, and a few more like it.

The U.S. airline industry is divided into three groups of carriers:

- *The big three.* American, United and Delta own about 54% of the market, each with approximately 18%. These carriers serve multiple markets (though none can be said to be truly national in scope) with a full range of services, including feeder, short-haul, long-haul, international and freight.

- *The specialists.* Profitable niche players such as Southwest (a "product specialist" focusing on short-haul flights), Jet Blue and Midwest Express (both "market specialists" focusing on the New York City and Milwaukee markets, respectively), and others.

- *The ditch dwellers.* These are airlines that are stuck in a no-man's land between the big generalists and the focused specialists. They are too large

> and diversified in terms of markets and services to be viable as focused specialists, but too small to compete across the board with the big three. Those in the ditch (typically, companies with between 5% and 10% market share) include US Airways, Northwest, Continental and, until its recent purchase by American (justified, ironically, by United's announced plans to acquire US Airways), TWA.

In exhibiting this big-three structure, the airline industry represents the rule rather than the exception, but with two critical differences: The big three in the airline industry are not nearly as dominant as they are in a typical industry, and the number of companies in the ditch is far greater.

The problem is that the ditch companies have no long-term future, and serve only to drag down the industry's financial performance as well as its ability to serve customers efficiently and with reasonable service standards. Ditch companies incur costs that are comparable to those incurred by the big three. In the airline industry, these costs include operating multiple hubs with numerous gates, maintaining a fleet that includes several different types of aircraft, offering three classes of service, establishing expensive clubs at major airports, running national marketing campaigns, and sustaining hybrid distribution systems that include travel agents, corporate sales, Internet sales, and consolidators. But ditch companies lack the market share over which to spread those costs; US Airways's cost per passenger mile is 40% higher than that of the big three.

Ditch companies thus operate with very low or negative margins. The first strategy of desperate CEOs in these circumstances is to cut costs. The brunt of this cost-cutting is felt by consumers, who soon respond by deserting the airline, leading to further deterioration in financial performance. This downward spiral leads inevitably to one destination -- Chapter 11. Indeed, ditch companies in the airline industry have sought bankruptcy protection numerous times over the past two decades.

The airline industry needs to evolve from one that includes a number of sub-monopolies -- markets (such as Denver) in which a single airline (in Denver's case, United) controls the lion's share of traffic -- to one that features true head-to-head competition between major carriers in all major markets. In other words, the thrust of regulatory efforts should be to promote vigorous market-by-market competition, rather than set arbitrary limits on overall industry concentration. The best way to accomplish this is to enable the emergence of three truly national players, and ensure that they compete directly as often as possible.

We have studied hundreds of industries as part of the research for our forthcoming book, "The Rule of Three." We found that in industries allowed to evolve through competitive market forces, the three biggest companies collectively control 70%-90% of the market, with the balance comprised of product or market specialists. We further found that this structure provides the highest level of operating efficiency along with a reasonable amount of choice for customers.

The airline industry needs to move as rapidly as possible toward this structure by allowing the big three to merge with ditch players, as American has done with TWA. This becomes especially imperative as the airline industry globalizes over the next several years; carriers that have consolidated their position in their domestic markets will be far better positioned to emerge as leaders.

In most industries, ditch companies soon exit that uncomfortable domain, usually by merging with one of the larger companies. In the airline industry, unfortunately, this exit route has been effectively sealed off. The only alternative for ditch airlines will be to shrink into specialty markets. US Airways will likely be forced to retreat to its roots as an "Eastern seaboard" specialist. This will keep the airline industry in its present unsatisfactory state -- too many sub-monopolies, not enough head-to-head competition.

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