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United States General Accounting Office
Washington, DC 20548

December 21, 2001

The Honorable Ernest F. Hollings
Chairman
The Honorable John McCain
Ranking Minority Member
Committee on Commerce,
Science, and Transportation
United States Senate

Subject: Proposed Alliance Between American Airlines and British Airways Raises Competition Concerns and Public Interest Issues

In August 2001, two of the world's largest airlines, American Airlines (AA) and British Airways (BA), announced their intention to form an international alliance and applied for immunity from antitrust laws in the United States and Europe. These airlines had proposed a similar alliance in 1997. However, DOT did not process the application because significant progress was not made in negotiations with the United Kingdom (U.K.) to open London's airports to new and expanded service by U.S. carriers.

Concerned about the impact that international alliances might have on aviation competition and on the fares U.S. passengers may pay and the service they may receive, you asked us to evaluate the impacts that the proposed alliance between AA and BA (AA/BA alliance) might have on aviation competition. Specifically, you asked us to determine (1) the possible consumer harms and benefits that the AA/BA alliance may create; and (2) the potential public interest issues that may arise from the proposed alliance. This letter summarizes the information we provided to Committee staff during our December 13, 2001, briefing pursuant to your request. The briefing slides, which provide more details about our analysis, are attached as enclosure I.

Background

In August 2001, AA and BA applied to the U.S. Department of Transportation (DOT) and the relevant U.K. and European regulators for antitrust immunity and for rights to code share¹ on

¹ "Code sharing" refers to the practice of airlines applying their names—and selling tickets via reservations systems—to flights operated by other carriers.

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Abstract In August 2001, two of the world's largest airlines, American Airlines (AA) and British Airways (BA), announced their intention to form an international alliance and applied for immunity from antitrust laws in the United States and Europe. These airlines has proposed a similar alliance in 1997. However, DOT did not process the application because significant progress was not made in negotiations with the United Kingdom (U.K.) to open London's airports to new and expanded service by U.S.carriers.		
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specified routes.² The AA/BA alliance has proposed to share some revenues on operations between London and nine U.S. cities: Boston, Chicago, Dallas/Fort Worth, Los Angeles, Miami, New York, Raleigh-Durham, San Francisco, and St. Louis. The alliance also proposes to code share on flights between U.S. and U.K. gateway airports³ and substantial numbers of smaller markets connecting U.S. cities with those in Europe, Africa, Asia, and the Middle East.

In the United States, DOT has the authority for approving airline alliances, for granting those alliances immunity from antitrust laws, and for negotiating agreements with foreign governments that regulate air travel between the United States and those countries. In order to approve and grant antitrust immunity for airline alliances, DOT must find that the alliance is not adverse to the public interest. DOT cannot approve an agreement that substantially reduces or eliminates competition unless the agreement is necessary to meet a serious transportation need or to achieve important public benefits that cannot be met or that cannot be achieved by reasonably available alternatives that are materially less anticompetitive. Public benefits include considerations of foreign policy concerns. When DOT reviews code-sharing alliances, it does not apply a written set of guidelines in their analysis. Instead, DOT issues orders on a case-by-case basis for each proposed alliance, establishing standards through case precedent.

In the past, DOT has refused to review applications for antitrust immunity unless the United States has an "open skies agreement" with the country where the foreign airline is located. Open skies agreements are bilateral air service agreements that remove the vast majority of restrictions on how the airlines of the two countries signing the agreement may operate between, behind, and beyond gateways in their respective territories. DOT has successfully negotiated open skies agreements with 56 governments, including many in Europe. However, U.S.-U.K. aviation is still governed by a restrictive accord, commonly known as Bermuda II. Among other things, Bermuda II, which was signed in 1977, restricts U.K. and U.S. flights serving London's Heathrow airport to two carriers from each country--AA, BA, United Airlines, and Virgin Atlantic--and provides that both countries' regulatory agencies approve airline's fares. The United Kingdom may have a limited opportunity to negotiate a new bilateral agreement with the United States because the European Union (E.U.) has challenged that authority in the courts and a decision is expected early in 2002.

Under federal law, DOT is to give the Attorney General and Secretary of State "an opportunity to submit written comments about" a proposed alliance's application. The Department of Justice's (DOJ) role is advisory and its analysis is performed pursuant to the Sherman Antitrust Act and the Clayton Act, which set forth antitrust prohibitions against restraints of trade. To determine if a proposed alliance is likely to create or enhance market power and allow firms to maintain prices above competitive levels for a significant period of time, DOJ applies its Horizontal Merger Guidelines, which describe the analytic framework and the specific standards to be used in analyzing mergers and alliances.⁴ To analyze a

² Other airline alliances have also recently applied for antitrust immunity. In August 2001, Delta, Air France, Alitalia, and Czech Airlines applied for antitrust immunity. In September 2001, United Airlines and bmi British Midland applied for antitrust immunity for their proposed alliance with several other foreign airlines.

³ A gateway airport is a point of first arrival in and last departure from a country.

⁴ United States Department of Justice and Federal Trade Commission Revision to the Horizontal Merger Guidelines (Apr. 8, 1997).

merger, DOJ defines both the product or service and geographic market in which the merging parties compete. In the airline industry, the relevant market has been defined as scheduled airline service between a point of origin and a point of destination. This is often, but not always, defined as a city pair.⁵ Then DOJ measures the degree to which a merger or alliance will affect the concentration level in that market. A key concern is whether entry into the market by other airlines would limit or counteract a proposed merger's potential for harm. On December 17, 2001, DOJ submitted comments to DOT on the AA/BA alliance and on the similar application for antitrust immunity from United Airlines and its "Star Alliance" partners.

In the United Kingdom, the Office of Fair Trading assesses proposed transatlantic alliances under the E.U. competition rules and judges whether or not they are compatible with those rules. The European Commission also reviews proposed alliances and ensures that a consistent approach is taken on all E.U.-US alliances.

AA and BA proposed a similar alliance in 1997. DOT did not make a final ruling on the application because significant progress was not made in negotiations with the United Kingdom to open London's airports to new and expanded service by U.S. carriers. Findings by DOJ, OFT, and the E.U. advised that new entrants would need from 196 to 267 landing and take-off times (slots) to balance the anticompetitive effects of the proposal.**Observations**

Without some regulatory remedy, the AA/BA alliance could dominate markets between major U.S. cities and London, especially in those that originate or terminate at London's Heathrow airport—the preeminent airport in the United Kingdom. A number of studies, including our own, have shown that airlines can exercise market power in markets that they dominate.⁶ That is, they have the ability to raise fares and limit service. The AA/BA alliance would likely control much of the market from U.S. gateway airports to London's two major airports—Heathrow and Gatwick. Together, AA and BA account for 52 percent of the non-stop flights between the United States and London, and 61 percent of the non-stop flights between the United States and Heathrow. Between specific airports, together AA and BA control over 50 percent of the non-stop flights between London's major airports and Boston (Logan), Chicago (O'Hare), Dallas/Fort Worth, Miami, New York (JFK), Raleigh-Durham, and St. Louis airports. In 2000, over 7 million passengers traveled in these markets. Because business travelers overwhelmingly prefer nonstop travel to Heathrow over connecting travel to other London airports, the AA/BA alliance's ability to exercise market power in business travel markets to Heathrow is of particular concern.⁷

⁵ In addition, DOJ recognizes that nonstop service between cities is important because business travelers are less likely to regard connecting service as a reasonable alternative. Thus, DOJ may see a transaction as competitively problematic because of its impact on nonstop city-pair traffic. Some cities are served by more than one commercial airport. These cities include Los Angeles, San Francisco, Chicago, New York, and Washington, D.C. In these cases, the relevant market may be an airport pair.

⁶ Markets with fewer competitors, especially those dominated by a single carrier, have higher fares. See, for example, Steven A. Morrison, "New Entrants, Dominated Hubs, and Predatory Behavior," Statement before the Subcommittee on Antitrust, Business Rights, and Competition, Committee on the Judiciary, United States Senate (Apr. 1, 1998). See also *Airline Competition: Higher Fares and Less Competition Continue at Concentrated Airports* (GAO/RCED-93-171, July 15, 1993).

⁷ In its comments on the proposed alliance submitted to DOT, DOJ noted that service to Heathrow is a separate market from service to Gatwick, especially for time-sensitive business passengers.

The extent to which the AA/BA alliance may be able to exert market power will depend on whether other airlines can enter these markets under an open skies agreement. Moreover, an open skies agreement, in and of itself, may not guarantee the ability of other airlines to enter these markets. Because capacity is severely constrained at Heathrow airport by a lack of available slots at times that are commercially viable for transatlantic service, the ability of U.S. airlines to initiate or increase U.S.-Heathrow operations in a timely manner under an open skies agreement is limited unless slots and facilities are made available. Officials with AA and BA state that U.S. airlines could enter Heathrow by using their alliance partners' slots. However, members of the other alliances report that these opportunities would be very limited or nonexistent. Thus, along with open skies, some regulatory remedy may be needed to promote competition between certain U.S. gateway airports and Heathrow.⁸

Some passengers may benefit from the larger network created by the AA/BA alliance. Possible beneficiaries of the alliance include travelers who would have additional service on certain routes. In particular, passengers seeking to travel between cities that do not have gateway airports might benefit from the new connecting airport-pair services that an AA/BA alliance would be able to provide. Similarly, passengers flying between smaller gateway airports may benefit if the AA/BA alliance increases flight frequencies. The level of benefits would depend on the number of competitors already operating in those markets and the potential amount of passenger traffic in those markets. Other passengers may also benefit. These include (1) all of AA and BA's customers if significant operation efficiencies are achieved through the alliance and are passed on in lower fares to passengers, (2) contract customers whose traveling costs are related to the total number of routes served by the alliance, and (3) frequent flyers whose frequent flyer miles may increase in value.

The potential benefits from the AA/BA alliance may be limited. First, the potential benefits that would theoretically accrue to passengers from increased transatlantic service between the airlines' gateway airports may be limited because of continuing constraints in slots, gates, and terminal facilities at London's Heathrow airport and because of BA's corporate strategy of reducing its overall capacity. Second, although the AA/BA alliance would add an additional competitor in most of the markets between non-hub U.S. cities and those in Europe that the AA/BA alliance plans to serve (thus providing some potential benefits to consumers), we found that several carriers are already serving many of those markets. Fewer carriers serve the markets that the AA/BA alliance plans to serve between cities in the United States and those in Africa, Asia and the Middle East. While the AA/BA alliance could provide additional service in these markets, the potential amount of passenger traffic in these markets--and thus the potential benefits from the alliance--are uncertain. Third, neither AA nor BA claim that the alliance would generate substantial operational savings that could be passed on to stockholders, employees, and customers. On the other hand, contract passengers and frequent flyers are likely to benefit, at least in the short run, by flying with alliance airlines that have more extensive networks, allowing them to access more locations.

⁸ In its comments on the proposed alliance, DOJ wrote that, without remedy, it would oppose the AA/BA alliance because it threatens a substantial loss of competition and higher prices for a large number of consumers. DOJ concluded that slots for more than nine new daily round trips would be needed to assure that existing competition in the New York and Boston markets will be preserved. DOJ also noted that entry is unlikely in markets from Chicago and Dallas to London, and recommended that DOT not grant antitrust immunity to AA/BA for certain transactions in those two markets.

The AA/BA alliance raises a number of important public interest issues. First, because our analysis suggests that a grant of antitrust immunity could provide an opportunity for the alliance to enhance its market power on some routes, a full review of the competitive effects of this and other alliances is important. For example, while DOT has established standards through public orders on different alliances, it does not apply a set of written guidelines to its analysis of a proposed alliance's possible effects on competition. DOT's standards are set through orders on a case-by-case basis, which establishes case precedent. If challenged, DOT decisions are also subject to judicial review. In 1999, the Transportation Research Board recommended a two-part process for the review of international airline alliances seeking antitrust immunity in which DOJ would consider competitive effects and forward to DOT only those applications acceptable on competitive considerations.⁹ Second, the United States and United Kingdom may have differing interests in expediting a bilateral open skies agreement and a decision on the alliance. On the one hand, the United Kingdom may benefit from expediting these matters because, depending on the outcome of a case now before the European Court of Justice that is anticipated to be announced early in 2002, the E.U. may take over negotiations for such agreements. If that were to happen, the E.U. would be negotiating on behalf of all of its European members, not just those of the United Kingdom.¹⁰ On the other hand, the interests of the United States in having these decisions expedited are less clear. U.S. consumers could potentially benefit from an expedited open skies agreement. However, the time in which the negotiations are concluded may be less important to U.S. consumers than the outcome of the negotiations—effectively providing for sufficient new and expanded service by U.S. entrant airlines at Heathrow to mitigate potential harm from the reduction in competition that could occur with any alliance seeking antitrust immunity.

Scope and Methodology

To address these issues, we used commercial databases to determine the proportion of U.S.-London air traffic (i.e., flights and passengers) the AA/BA alliance would have controlled assuming that they operated the flights they had planned to fly in September 2001.¹¹ We also computed the impact that the AA/BA alliance would have had on routes connecting other non-hub cities in the United States and Europe for which the AA/BA application requests the right to code share. In addition, we reviewed the literature on the impact of international alliances and interviewed airline officials and other industry experts (e.g., academic researchers) to determine the potential impact of alliances on service and competition. Finally we reviewed documents filed with DOT to obtain the views of various parties and to help determine whether U.S. airlines that are not now permitted to fly into London's Heathrow airport would be able to get commercially viable access to that airport.

⁹ *Special Report 255 Entry and Competition in the U.S. Airline Industry: Issues and Opportunities*, Transportation Research Board, July 1999.

¹⁰ An official of the United Kingdom indicated that if the E.U. obtains the legal right to negotiate open skies agreements for its members, it could be up to 5 years before an agreement with the United States that covers the United Kingdom is reached. The expected delay is based on the perception of the E.U.'s need to study existing agreements, renegotiate some of these agreements to standardize them across countries, and determine what a new E.U.-U.S. agreement should cover.

¹¹ We used the schedules announced by the airlines prior to the terrorist attacks of September 11, 2001 to examine the share of capacity each airline would operate, under the assumption that the airlines would attempt over time to rebuild their post-September 11 operations to previous levels.

As arranged with your offices, we plan no further distribution of this report until 30 days after the date of this letter. At that time, we will provide copies to the Honorable Norman Mineta, Secretary of Transportation; major U.S. airlines; and other interested parties. We are sending copies of this letter to interested congressional committees. We will also send copies to others upon request.

We provided drafts of the briefing slides to DOT and DOJ for their review. DOT officials noted that the department could not provide substantive formal comments on our draft because the matter is still subject to a pending proceeding. DOJ did not offer any comments. We also provided AA and BA officials and representatives of the E.U. with excerpts of the draft for comment, and they provided technical clarifying suggestions that we incorporated. We conducted our review between August and December 2001 in accordance with generally accepted government auditing standards.

We are sending copies of this letter to interested congressional committees. The letter is also available on GAO's homepage at <http://www.gao.gov>. If you have any questions about this letter, please contact me at 202-512-8984. Key contributors to this assignment are listed in enclosure II.

A handwritten signature in black ink, reading "JayEtta Z. Hecker". The signature is fluid and cursive, with the first name "JayEtta" written in a larger, more prominent script than the last name "Hecker".

JayEtta Z. Hecker
Director, Physical Infrastructure Issues

Enclosures

Proposed American Airlines/ British Airways Alliance

Potential Reductions in Competition Raise Public Interest Issues

Briefing to the Senate Commerce Committee
December 13, 2001

Overview

- Objectives
- Background
 - Overview of current American Airlines/British Airways (AA/BA) operation
 - Governmental review process
 - Alliances create potential harms and benefits for travelers
 - London is a significant market and Heathrow is unique
- Possible harm from alliance
 - AA/BA will likely dominate certain markets
 - US airlines may not have adequate access to Heathrow
- Possible benefits from alliance
 - General benefits from alliances
 - Benefits from this alliance may be limited
- In summary
- Public interest issues
- Scope and methodology

December 13, 2001

2

Objectives

Concerned about the impact that international alliances might have on aviation competition, you asked us to determine

- The possible consumer harms and benefits that the proposed alliance between AA and BA may create
- What potential public interest questions may arise from the proposed alliance

December 13, 2001

3

Background: AA/BA Application

- AA/BA, members of the oneworld international alliance, have applied to the U.S. Department of Transportation (DOT) and the relevant United Kingdom (UK) and European authorities to form an alliance with antitrust immunity and code sharing authority on specified routes
- AA/BA has proposed to share revenues on operations between London and nine US cities including New York, Chicago, San Francisco, and Miami
- AA/BA has also applied for authority to share codes on routes between another 31 cities in the US and 61 cities in Europe, Africa, Asia, and the Middle East
 - Examples of US cities include Austin, Albuquerque, Ft. Myers, and Syracuse
 - Examples of cities abroad include Aberdeen, Nice, Dar es Salaam, and Dubai

December 13, 2001

4

Background: Overview of Governmental Review Process

- US-UK air travel is governed by a restrictive bilateral treaty (“Bermuda II”), which limits each countries’ airlines access to the other countries’ airports including those in London
- DOT is considering the proposed alliance’s effect on the public interest
 - By law, DOT can only approve an agreement that substantially reduces competition if it provides public benefits that cannot be met in a substantially less anticompetitive way
 - Policy states that DOT will not grant antitrust immunity unless the US has an open skies agreement with the UK
 - DOT issues decisions after considering issues raised by interested parties, but does not have written guidelines for reviewing alliance applications
 - DOT is also considering the effects of alliances proposed by members of the Star and SkyTeam alliances

December 13, 2001

5

Background: Overview of Governmental Review Process

- In its advisory role, the Department of Justice (DOJ) may submit comments on the alliance's competitive effects after performing an analysis based on its merger guidelines
- UK may have limited time to negotiate open skies agreement; may lose authority to European Union (EU) early in 2002 due to EU legal challenge

December 13, 2001

6

Background: Governmental Review of Prior AA/BA Application

- AA/BA applied for approval of a similar alliance in 1997
- DOT did not make a final ruling on the application because significant progress was not made in negotiations with the UK to open London's airports to new and expanded service by US carriers
- Findings by DOJ and relevant UK and European competition authorities advised that new entrants would need from 196 up to 267 landing and take-off times (slots) to balance the anticompetitive effects of the proposal

December 13, 2001

7

Background: Alliances Present Potential Harms and Benefits

- Overview of Potential Harms
 - Loss of independent competitors in markets creates possible abuse of market power, leading to less capacity and higher airfares
 - Operating barriers--such as capacity constraints at key airports--limit entry by new competitors

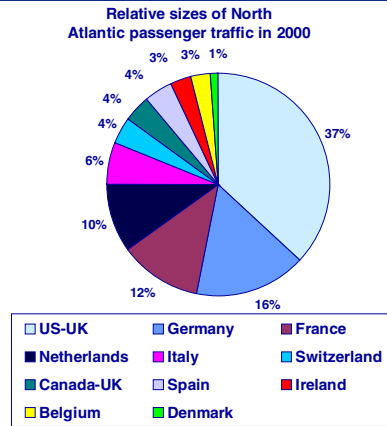
- Overview of Potential Benefits
 - Alliances between non-overlapping networks may improve service
 - Provide more online service between non-hub cities
 - Increase frequency of non-stops from smaller gateway airports
 - Passengers may benefit from operational efficiencies
 - Contract customers may reduce travel costs by purchasing services from larger airline networks
 - Frequent flyers may benefit from expanded network

December 13, 2001

8

Background: US-UK has largest share of North Atlantic passengers

- US-UK is the largest component of the North Atlantic air passenger traffic
- US-UK component is more than twice as large as the next largest, North Atlantic-Germany, and more than three times as large as the third largest, North Atlantic-France

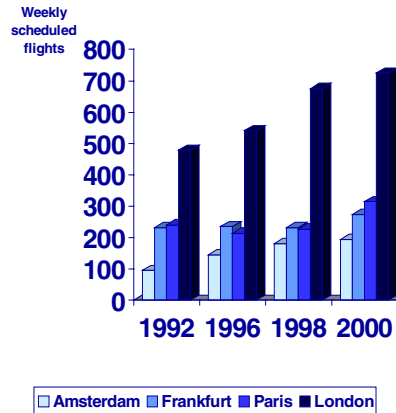


December 13, 2001

Source: BA-AA The Landscape: Access to London Heathrow Remains the Key
Merrill Lynch 9

Background: US-London operations are large relative to other European cities

- In 2000, scheduled flights from London were almost as great as that of the other three major cities combined
- London's scheduled traffic grew 51 percent from 1992 to 2000
- During the same time period, Amsterdam's scheduled traffic grew 104 percent, but is still only a little over one-fourth as large as London's



December 13, 2001

Source: UK House of Commons, Environment, Transport and Regional Affairs, Appendices to the Minutes of Evidence, Memorandum by Cranfield University 10

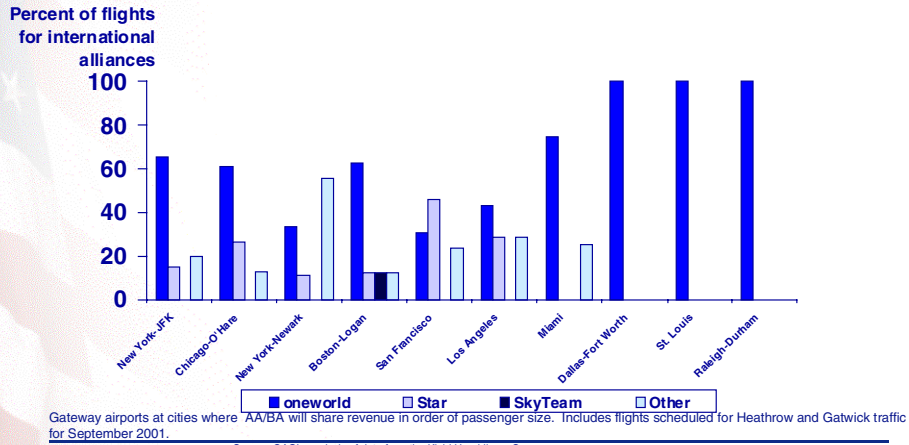
Background: Access to Heathrow's airport provides unique opportunities

- Carriers can earn fare premiums on service to Heathrow
 - Full fares for business class seats to Heathrow from New York are 47 percent higher than corresponding fares to Frankfurt
 - Three times as many of London's high-yield business passengers used Heathrow as compared to Gatwick in 1998
- According to Merrill Lynch, Heathrow is "overwhelmingly superior" to Europe's other airports in terms of convenience for high-yield local business traffic
- Terminal, parking, and slot capacity is severely constrained at Heathrow
- The proportion of lower-yield connecting traffic at Heathrow is smaller than at other European airports

December 13, 2001

11

Potential Harm: AA/BA's oneworld will likely dominate certain major markets



December 13, 2001

12

Potential Harm: Dominated Markets Affect Significant Passenger Traffic

- AA/BA will dominate routes with significant passenger traffic
- If Heathrow is a separate market from Gatwick, oneworld will have a larger share of most non-stop routes: 83% of Boston, 100% of Miami
- AA/BA's strategies focus on high-yield business passengers, so they may have a larger share of this market
- In markets where a stop is reasonable, AA/BA may have a smaller share of the market

Passengers in London markets

To and from US airport	Passengers in 2000
New York-JFK	2,975,310
Chicago-O'Hare	1,466,647
Boston-Logan	1,108,497
Miami	838,768
Dallas-Ft. Worth	404,840
St. Louis	131,028
Raleigh-Durham	97,059
Total	7,022,149

December 13, 2001

Source: DOT

13

Potential harm: US airlines may not have adequate access to Heathrow

- Open skies will not permit US airlines to enter Heathrow unless slots are available
 - The slot administrator at Heathrow—Airport Coordination, Ltd.— says that opportunities to accommodate new entrant US carriers in the first two seasons are extremely limited.
 - When slots are available, they are often not at times suitable for competitive transatlantic service
- Some US carriers may get slots from their alliance partners, but those carriers claim that this is unlikely

December 13, 2001

14

Potential benefits: Gains from new connecting service may be limited

- DOT reports that gains from alliances come mostly from connecting US cities to cities in Africa, Middle East, and Asia
- AA/BA will serve many more non-hub cities in US-Europe than in US-Africa, Asia, or the Middle East
- Markets including cities in Africa, Asia, and the Middle East are small relative to those including cities in Europe
- Five or more airlines had scheduled flights on over 70 percent of the routes between non-hub cities in the US and Europe
- Benefits may also be limited due to Heathrow constraints and BA's pursuing a strategy to reduce overall capacity

Number of markets where AA/BA will provide new connecting service

Size of market by number of monthly flights	US-Europe	US-Africa, Asia, or the Middle East
Large (more than 250)	857	37
Small (250 or less)	441	407
Total	1298	444

December 13, 2001

Source: GAO's analysis of data from the Kiehl Hendrickson Group

15

Potential benefits: Other gains are uncertain

- Gains from operational efficiency may be limited
 - Gains will likely be small as AA and BA are not integrating organizations substantially
 - Gains will be shared by passengers, stockholders, and employees so no one group will see substantial benefits
- If Heathrow gives the alliance market power, other benefits may be short-lived
 - According to some experts, control over international markets may limit domestic competition
 - If AA/BA enhance their market power, gains for corporate contractors and frequent flyers may disappear

December 13, 2001

16

In summary

- Without some regulatory remedy, AA/BA would likely exercise considerable control over routes between major US cities and London, especially those routes that originate or terminate at London's Heathrow airport—the preeminent airport in the United Kingdom
 - Because capacity is severely constrained at Heathrow airport, the ability of US airlines to increase US-Heathrow operations in a timely manner under an open skies agreement is limited
 - Gains from the alliance and from negotiating an open skies agreement with the UK may not offset the harms from reduced competition
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December 13, 2001

17

Public interest issues

- How can it be assured that the competitive effects of international alliances are fully reviewed?
 - DOJ has guidelines to follow; DOT has established standards through public orders on different alliances,
 - DOJ has filed statements on competitive effects in other alliance applications
 - The Transportation Research Board has called for a two-part process where DOJ would consider competitive effects and forward to DOT only those applications acceptable on competitive considerations
- What are the various interests in expediting an open skies agreement with the UK?
 - It may be the UK's last chance to negotiate a bilateral agreement before the EU takes responsibility for these negotiations
 - Time may be less important to U.S. consumers than the outcome of the negotiations; for U.S. consumers will benefit only if the outcome includes sufficient new and expanded service by U.S. entrant airlines at Heathrow to mitigate potential competitive harm

December 13, 2001

18

Scope and Methodology

To analyze the impact of the proposed AA/BA alliance, we

- Used commercial databases to determine the proportion of US-London traffic (flights and passengers) AA/BA would have controlled assuming that they flew the flights they had planned to fly in September 2001
- Computed the impact AA/BA would have had (given their September 2001 schedules) on routes connecting other non-hub cities in the US with cities in Europe, Africa, and the Middle East for which AA/BA have requested the right to code share
- Reviewed the literature on the impact of international alliances and interviewed airline officials and other industry experts (e.g., academic researchers) to determine the potential impact of alliances on service and competition
- Examined documents filed with DOT to obtain the views of various parties and to help determine whether U.S. airlines that are not now permitted to fly into London's Heathrow airport would be able to obtain commercially viable access to that airport

December 13, 2001

19

GAO Contacts and Staff Acknowledgments

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