

Monthly Article

on

Undercutting of Fares in the Aviation Industry

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INTRODUCTION

The price of an air ticket largely comprises of

- The Base Fare,
- Taxes and Airport Fees and
- Fuel Surcharge

Firstly, the airlines determine what type of plane they will be using for a flight. This helps in determining the number of seats in each travel class. While a Travel Class indicates the quality of the class, for example, First Class, Business, Economy, etc, a Booking Class, also known as Fare Class or Fare Bucket, indicates the type of ticket. Each Booking Class has different rules and restrictions and hence a different price. The reason behind having various Booking Classes is to maximize profit by targeting the two main types of travelers: Leisure Travelers and Business Travelers.¹

The Leisure Traveler is flexible with dates as compared to Business Travelers and hence they buy up the cheaper booking class while Business Travelers are willing to pay more for a ticket due to the spontaneous and urgent nature of their trips.

Generally, when cheaper tickets aren't completely sold out, the airline comes up with a discounted booking class to cover the cost of the flight.²

HOW IS AIRFARE DETERMINED

Before 1978, in the USA, the government determined whether a new airline could fly to a given destination or charge a certain price, or be in operation. This resulted in limited competition;

¹ Schlick, Chris. "How Do Airlines Set Prices." September 1, 2013. Accessed April 4, 2015. <https://flightfox.com/tradecraft/how-do-airlines-set-prices>.

² Ibid.

airlines were guaranteed a profit as the tickets were expensive. The vast majority of Americans couldn't afford to fly, at all.³ Prior to 1978, there were 10 big carriers known as trunk lines which controlled almost 90 percent of the American market alongside 8 smaller regional carriers. The Civil Aeronautics Board-the controlling authority for airlines guaranteed the airlines a 12 % return on flights which were 55 % occupied.⁴

The prices skyrocketed during the energy crisis of the 1970s, and a team of senators and economists decided to withdraw government control over the airlines. Once deregulation was effected, the ticket prices fell drastically as barrier to entry was lowered drastically. As a result, the aviation industry saw a 30% increase in the number of passengers from 1965 to 2000 and between 1970s and 2011, the number of passengers tripled. The main rationale behind deregularisation resulting in lower prices was that since flying is not a life necessity therefore, it is a price sensitive product and when there is intense competition for a price sensitive product, it always leads to falling prices.⁵

Subsequently, the aviation industry was deregulated all over the world.

In India, the Directorate General of Civil Aviation (DGCA) sets a lower ceiling on the airfares for all airlines. If the airlines charge lower fares than that, the matter is referred to Competition Council.

Internationally, the International Air Transport Association was formed in 1945 and subsequently, in 1947, it was given the responsibility of setting a coherent fare structure in order to eliminate cut-throat competition and secure the interest of the consumers.

³ Thompson, Derek. "How Airline Ticket Prices Fell 50% in 30 Years." *The Atlantic*, February 28, 2013. Accessed April 5, 2015. <http://www.theatlantic.com/business/archive/2013/02/how-airline-ticket-prices-fell-50-in-30-years-and-why-nobody-noticed/273506/>.

⁴ Maynard, Michelin. "Did Ending Regulation Help Fliers." *The New York Times*, April 17, 2008. Accessed April 5, 2015. http://www.nytimes.com/2008/04/17/business/17air.html?pagewanted=all&_r=1&.

⁵ Thompson, Derek. "How Airline Ticket Prices Fell 50% in 30 Years." *The Atlantic*, February 28, 2013. Accessed April 5, 2015. <http://www.theatlantic.com/business/archive/2013/02/how-airline-ticket-prices-fell-50-in-30-years-and-why-nobody-noticed/273506/>.

PREDATORY PRICING IN AVIATION INDUSTRY

Predatory pricing is defined as pricing a commodity below an appropriate measure of cost with the intention and purpose of eliminating a competitor⁶. Essentially, in cases of predatory pricing, the predator forgoes his present revenues by lowering the prices of the commodity supplied by him in order to drive a competitor out of the market. He recovers the revenue that is lost by making higher profits after he has succeeded in driving away the competitor and making the market less competitive.⁷

For predatory pricing to succeed, the predator must ensure that

- Below cost production must not continue for an indefinite period.⁸
- It must take place in a concentrated market where the predator has some sort of monopoly power.⁹
- There must be a reasonably high barrier on market entry so that the predator gets a certain stable period of monopoly returns.

In the aviation industry, the allegations of predatory pricing arise when a major airline, while operating from its hub airport, in response to the entry of a low-fare carrier, lowers its price aggressively and also adds capacity. Such targeted response of major airlines usually forces the exit of the low-cost airlines from the market. Anti-trust law requires to prove that the predator priced the fares below its costs and selectively accepts losses in the market and later cushions such losses by imposing high fare and hub traffic in a comparatively lesser competitive market.

In the airline industry, the classical understanding of predatory pricing involves standby fare. Standby fare means that an airline that has unsold seats may offer a deeply discounted fare to passengers in order to make comparatively higher profits than it would if they left those seats empty. This is wrongly understood as predatory pricing because such fares are not predatory as they are not intended to and neither do they have the effect of monopolizing the passenger market of a certain airlines or displacing it from the market. By offering standby fare, the airlines

⁶ Camp-All Corp v Cast Iron Soil Pipe Inst., 851 F.2d 478.

⁷ Kelco Disposal, Inc. v. Browning-Ferris Indus. of Vt., Inc., 845 F.2d 404

⁸ Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 588 (1986).

⁹ Am. Acad. Suppliers v. Beckley-Cardy, Inc., 922 F.2d 1317, 1319 (7th Cir. 1991).

simply try to maximize its revenue and utilize the excess capacity of seats at its disposal.¹⁰ Setting a standby fare is therefore a harmless practice. However, there is an alternative form of predatory pricing that occurs in low-fare airline market, known as “Targeted Response to Entry”. It happens when an airline responds to the entry of a low-fare airline by aggressively lowering its prices and adding capacity.¹¹

Although, the claims of predatory pricing are usually tenuous under the current anti-trust laws because the major airlines can limit price-matching to the price-sensitive markets where they face competition, while remaining profitable by combining passengers from various routes and cushioning losses with hub traffic not subject to the new price competition. Thus, the major airlines can avoid censure under the antitrust laws by pricing above-cost on the route as a whole, while at the same time pricing low enough on certain passenger markets to force the exit of a low-fare entrant.¹²

A plaintiff seeking to establish competitive injury resulting from a rival’s low prices “must prove that the prices complained of are below an appropriate measure of its rival’s costs.”¹³

The standby fare is largely considered the reason behind why below-cost prices don’t seem predatory. The standby fares are exempt from any antitrust liability because the purpose of such fares is to cover the incremental passenger variable cost.¹⁴ Once an airline commits to flying a certain route and sinks the bulk of its major flight variable costs which includes the cost of the plane, its fuel, and crew, the cost of serving one additional passenger becomes negligible.¹⁵

The prerequisite in such conditions is that the standby fare must only cover the passenger variable cost of the airlines, which includes processing the ticket, in-flight meals, incremental fuel, etc. The rationale behind this is that the seat is going out anyway, either full or empty, and any price above the cost of serving the additional passenger will make the additional sale

¹⁰ Robenalt, James L. "Predatory Pricing in the Low-Fare Airline Market: Targeted, Discriminatory, and Achieved with Impunity." *Ohio State Law Journal* 68:64.

¹¹ *Ibid.*

¹² *Ibid.*

¹³ *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574

¹⁴ Robenalt, James L. "Predatory Pricing in the Low-Fare Airline Market: Targeted, Discriminatory, and Achieved with Impunity." *Ohio State Law Journal* 68:64.

¹⁵ *Ibid.*

profitable.¹⁶ The standby fare is considered non-predatory because it is generally priced above short-run marginal cost. This standby fare only covers the marginal costs of serving one additional person therefore; the standby fare is legal despite the fact that it is typically priced below average variable cost (AVC).¹⁷

A major airline that engages in a targeted response to entry does not use a yield management policy to use up excess capacity or to charge each individual passenger as close as possible to the maximum they are willing to pay. Rather, it engages in a deliberate campaign to divert passengers away from a low-fare entrant by making more seats available at lower prices. Such targeted response can only be described as “discriminatory sharp-shooting”.¹⁸ Predation means deep, pinpointed, discriminatory price cuts by big companies aimed at driving price cutters out of the market, in order then to be able to raise prices back to their previous levels. An increase in capacity to divert low-fare passengers away from an entrant is crucial to an airline’s predatory campaign. Without increasing capacity and providing more low-fare seats, a major airline may not be able to accommodate a sufficient number of low-fare passengers to force the entrant from the market.¹⁹

Although major airlines do selectively accept the losses in the market in which they compete with a low-fare entrant, they can do so with impunity under the law because they cushion such losses with high fares that are not subject to competition.²⁰ Most courts that evaluate predatory pricing in the airline industry adopt an Average Variable Cost (AVC) benchmark and determine whether the total number of passengers on a route, on average, is flying at prices above or below AVC.²¹ Therefore, even though the airline is not engaged in maximizing its profit by increasing both its capacity and proportion of low-fare passenger revenue, the airline can still reap profits by utilizing the high-fare passenger revenue. Despite the fact that most passengers will gravitate toward the airline’s lower fares during the predatory campaign, the airline can still price above costs by using its economies of scale and combining passengers from various routes.²²

¹⁶ Ibid.

¹⁷ Ibid.

¹⁸ Ibid.

¹⁹ Ibid.

²⁰ Ibid.

²¹ Ibid.

²² Ibid.

COMPETITIVE PRICING IN IMMEDIATE-RESPONSE OLIGOPOLY MARKETS

In a market where a small number of firms sell a homogeneous good and can monitor each other's prices and respond to the price changes almost immediately, the likely outcome is collusive pricing. Collusive Pricing can result even without any sort of explicit communication among the firms. Acting unilaterally, each firm recognizes that price cuts will be matched immediately, so cutting price makes sense only if the firm would prefer an equilibrium in which all firms charged the new lower price. This greatly reduces the incentive to compete on price.²³

Robert H. Gertner, in his work titled, 'Communication among Competitors: Game Theory and Antitrust' explored the outcome in such a market when firms have different costs and capacity constraints. According to him, the outcome in immediate-response markets will still be close to the collusive outcome and the price will be dictated by the firm that prefers the lowest price. This occurs because higher cost firms have nothing to offer a low cost firm in return for it agreeing to a price above its own profit-maximizing levels. Of course, if which firm prefers the lowest price differs across markets, then there may well be room for trades in which each firm agrees to a higher price than it would like in one market in return for increasing price closer to its preferred level in another market.²⁴

If the competing firms differ sufficiently in costs or other attributes, one firm may be able to sustain a lower price than others with none wanting to change its price given the prices charged by others. Such an outcome relies on the lower cost firm having a capacity constraint. In such a case, the higher cost firms are better off allowing the low-cost firm to fill its capacity and then selling to the remaining demand than matching the price of the lower cost firm and gaining a higher market share.²⁵ Thus, even though the airlines differed in costs and other attributes, the ability to monitor one another's prices closely and respond very quickly could still result in prices well above the competitive level.²⁶ This, however, affects anti-trust in different ways. On

²³ Borenstein, Severin. "Rapid Communication and Price Fixing: The Airline Tariff Publishing Company Case." Accessed April 9, 2015. <http://faculty.haas.berkeley.edu/borenste/download/atpcase1.pdf>.

²⁴ Carlton, Dennis W., Robert H. Gertner, and Andrew M. Rosenfield. "Communication Among Competitors: Game Theory and Antitrust," *George Mason Law Review*, 5 (Spring 1997): 423-440.

²⁵ *Ibid.*

²⁶ *Ibid.*

the one hand, low-cost monitoring and quick response raises concern that prices will end up at supra competitive levels and will harm consumers. On the other hand, this may happen without any further facilitating circumstances, that is, without any actions that are clearly in violation of antitrust laws.²⁷ It is not an antitrust violation for a firm unilaterally to charge high prices. Not only does such a circumstance present a dilemma for the prosecution of an antitrust case, it also makes it difficult to devise a remedy to the situation. Neither “charge lower prices” nor “stop responding to the actions of other firms” are realistic remedies under the antitrust law.²⁸

THE AIRLINE TARIFF PUBLISHING COMPANY CASE

On December 21, 1992, the U.S. Department of Justice filed antitrust charges against ATPCO and eight major airlines.²⁹ The complaint charged that the airlines, through ATPCO, had colluded to raise price and restrict competition in the airline industry. The Justice Department argued that the airlines had carried on detailed conversations and negotiations over prices through ATPCO. It pointed to numerous instances in which one carrier on a route had announced a fare increase to take effect a number of weeks in the future. Other carriers had then announced increases on the same route, though possibly to a different fare level. In many cases cited, the airlines had interacted back and forth until they reached a point where they were announcing the same fare increase to take effect on the same date.³⁰ In cases where one airline did not announce that it would post the same fare increase as the others, the increase generally did not take place. In such situations it was common for carriers to “roll” their fare increases -- that is, to move the effective date further into the future, in order to give the carrier that had not announced a matching fare increase more time to do so.³¹

²⁷ Borenstein, Severin. "Rapid Communication and Price Fixing: The Airline Tariff Publishing Company Case." Accessed April 9, 2015. <http://faculty.haas.berkeley.edu/borenste/download/atpcase1.pdf>.

²⁸ Ibid.

²⁹ *United States v. Airline Tariff Publishing Company*, Civil Action No. 92-2854, filed December 21, 1992).

³⁰ Borenstein, Severin. "Rapid Communication and Price Fixing: The Airline Tariff Publishing Company Case." Accessed April 9, 2015. <http://faculty.haas.berkeley.edu/borenste/download/atpcase1.pdf>.

³¹ Ibid.

The DOJ's case also was based on patterns of multimarket coordination that it claimed to have identified. The complaint argued that the carriers were using fare basis codes and footnote designators to communicate to other airlines linkages between fares on different routes.³²

For example, let's assume that airline A1 has a hub at city C1 from which it serves a route to city C3 with nonstop flights, as illustrated in Figure 1. Airline A2 has a hub at C2, which is between C1 and C3. Airline A2 is offering a relatively low fare in the C1-C3 market with service that requires a plane change at C2. This low fare is siphoning off customers from the nonstop service that A1 offers on the route. A1 would like A2 to raise its fare on the C1-C3 route. If that were the whole story, however, A1 would not have much ability to bribe or coerce A2. However, A2 serves C2-C4 with nonstop service, and A1 offers change-of-plane service on that route over its hub at C1 -- exactly the reverse of the previous situation. A1 could strike a deal with A2 in which each carrier agrees not to undercut the other's nonstop service with its own fares that require a plane change at its own hub.³³

The DOJ argued that in such situations the ATPCO system of fare basis codes and footnote designators offered the sort of sophisticated communication necessary to spell out and agree upon such a deal. DOJ expressed that it would work in the following manner:

A1 would institute a new fare on C2-C4 that undercut A2's fare on that route, and A1 would give this new fare the same or a similar fare basis code as A2 was using for the fare A1 was unhappy with on C1-C3, thus signal A2 the connection between the two fares. A1 would then put a short last-ticket date on this new fare, indicating that it would be available for only, say, two weeks. It would also put in a fare on the C2-C4 route that matched A2's current fare and would give that fare a first-ticket date that was the same as its last-ticket date for the cheaper fare. A1 would then wait to see if A2 got the message. If it did, A2 would put a last ticket date on its fare on C1-C3 that was the same as the last ticket date A1 had put on its cheap C2-C4 fare and would add a new fare that matched A1's fare on C1-C3 and had the same date for its first ticket date. If that happened, then two weeks hence each carrier, without further action, would raise its fare on the other's nonstop route so that it was no longer undercutting the nonstop route with change-of-plane service. If A2 did not get the message or respond in the way that A1 wished, A1 could roll

³² Ibid.

³³ Ibid.

forward its last-ticket date on its cheap C2-C4 route. By re-filing the fare with a different last ticket date, A1 could also make sure that this fare again showed up on A2's daily list of new fares, just in case A2 overlooked it the previous time. The DOJ argued that the combination of future first ticket dates and fare basis codes or footnote designators that allowed an airline to highlight a link between two fares on different routes made it much easier than it would otherwise be for two airlines to "negotiate" over fares on different routes. With these facilitating devices, the Department asserted, the airlines could make clear the "trades" they were offering: raising price on one route in return for a rival raising price on another route.³⁴

Along with filing the case, the Justice Department also announced a settlement with United Airlines and USAir. Under the settlement, the airlines did not admit guilt on any of the charges, but they agreed to abide by the DOJ's proposed remedies. In particular, United and USAir agreed to stop announcing most price increases in advance of the date on which they took effect. Instead, most price increases would have to take effect at the time they were announced. The other six airlines agreed to nearly the same restrictions as had United Airlines and USAir³⁵

THE SPIRIT CASE³⁶

Spirit filed its complaint against Northwest under Section 2 of the Sherman Antitrust Act and alleged that Northwest targeted certain of the routes on which it and Spirit competed and substantially increased capacity and began pricing below Northwest's average variable cost. Northwest's conduct follows a classic pattern of predatory pricing. The pattern of successful predation is well known: a "single firm, having a dominant share of the relevant market, cuts its prices in order to force competitors out of the market or perhaps to deter potential entrants from coming in".³⁷

³⁴ Ibid.

³⁵ Ibid.

³⁶ *Spirit Airlines v. Northwest Airlines*, 431 F.3d 917 (6th Cir., 2005).

³⁷ Robenalt, James L. "Predatory Pricing in the Low-Fare Airline Market: Targeted, Discriminatory, and Achieved with Impunity." *Ohio State Law Journal* 68:64.

In this case, the magnitude and scope of Northwest's response is rather stark. On the Boston route, Northwest was the only carrier prior to Spirit that provided non-stop service. Northwest held an 89% market share on this route and offered an average of 8.5 flights per day with a lowest unrestricted fare of \$411. In response to Spirit's entry, however, Northwest sharply reduced its fares and added capacity to accommodate more low-fare passengers. Northwest dropped its lowest fare to \$69, increased its daily nonstop flights on the route from 8.5 to 10.5, and added a 289-seat DC-10 airplane that had triple Spirit's entire daily capacity.³⁸

As a consequence, Spirit's load factors plummeted and it was eventually forced to exit the market. On the Detroit to Philadelphia route, Northwest's only competitor on this route prior to Spirit was United Airways, which was described as a "compliant" competitor. Northwest held a 72% market share on this route and its lowest unrestricted fare was \$355. But once Spirit entered and began achieving high load factors, Northwest dramatically reduced fares and increased capacity. Northwest reduced its lowest unrestricted fares from \$355 to \$49 on all flights for this route. In addition, it added another flight to the route and dramatically increased its number of low-fare passenger seats.³⁹ Spirit soon left the market, and in response, Northwest increased its lowest unrestricted fare from \$49 to \$271 and later to \$461. Yet despite the predatory pattern in this case, Spirit's claim of predatory pricing is difficult to prove under the current legal framework. Spirit must show that Northwest priced below its cost on these routes with the expectation of later recouping its losses with monopoly profits. The law governing claims of predatory pricing entails a two-part test set out by the *United States Supreme Court in Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*⁴⁰

Under this test, a plaintiff must prove that

1. The prices complained of are below an appropriate measure of its rival's costs," and
2. The defendant had a dangerous probability of recouping its investment in below-cost prices.

³⁸ Ibid.

³⁹ Ibid.

⁴⁰ 509 U.S. 209, 222–24 (1993).

The first part of the Brooke Group test—below-cost pricing—is the only disputed issue in the Spirit case because it is clear that Northwest had a dangerous probability of recouping its investment in predatory pricing.⁴¹

Northwest had substantial market power in a highly concentrated market in which there were high entry barriers. Northwest had a monopoly position on the two geographic routes with little to no competition. Northwest also had a virtual stranglehold on access to gates at the Detroit Airport, controlling sixty-four of Detroit’s seventy-eight gates under a long term lease. Due to its monopoly power in the market and high barriers to entry, Northwest had ample time to recoup its investment: upon Spirit’s exit, Northwest enjoyed nineteen months of monopoly pricing before another entrant arrived. Therefore, because Northwest had a reasonable prospect of recouping its losses, the critical question is whether Northwest engaged in below-cost pricing.⁴²

The issues raised in the Spirit case provide a helpful insight into the nature of predatory pricing in the low-fare airline market. The two central issues raised in the Spirit case are:

1. Whether it is appropriate to separate out a distinct low-fare market on Northwest’s flights, and
2. How to allocate common costs to this segmented product market, if it does exist.⁴³

Spirit’s price-cost comparison reveals the difficulty in assessing predatory pricing claims against multi-product firms. If Northwest had separated its “multiple products” that is, multifare passengers, into separate planes, it would be relatively simple to conduct a price-cost comparison. For instance, if Northwest had created a separate line of flights for low-fare passengers exclusively, a fact-finder could simply measure the low-fare revenue against the cost of operating these flights.⁴⁴

Yet despite the cost allocation problems rooted in predatory pricing claims against multi-product firms, it is an economic reality that most firms sell multiple products in the same facility with shared common costs. Indeed, most major airlines sell tickets at different fares for the same

⁴¹ Robenalt, James L. "Predatory Pricing in the Low-Fare Airline Market: Targeted, Discriminatory, and Achieved with Impunity." *Ohio State Law Journal* 68:64.

⁴² *Ibid.*

⁴³ *Ibid.*

⁴⁴ *Ibid.*

flight. An airline's multi-layered fare structure typically promotes greater competition among the airlines for different segments of the passenger market. Thus, combining multi-fare passengers on the same flight is not considered to be a predatory tactic. However, as the next section points out, a major airline's campaign to divert low-fare passengers away from an entrant may require a different set of economic assumptions.⁴⁵

CONCLUSION

These major airlines are pricing above costs on routes as a whole, but they are sacrificing profits and pricing low enough to drive out entrants. If the law fails to recognize these low prices as predatory because they are above cost, consumers become the unambiguous losers. Although consumers benefit in the short run as a major airline and low-fare entrant engage in a price war, the consumer ultimately suffers once the entrant is forced from the market and the major airline resumes monopoly pricing. The difficulty in punishing unfair conduct in the airlines industry has caused a great deal of criticism. There are many commentators who have called for a reexamination of the predatory pricing doctrine.⁴⁶ They argue that the antitrust laws, as currently administered and interpreted, do permit major airlines to engage in unfair tactics without sanction. The next section discusses proposed alternatives to a below-cost rule.⁴⁷

A below-cost test has been criticized for providing too strict a standard for distinguishing the exceedingly thin line between vigorous price competition and predatory pricing.⁴⁸

To remedy this concern, the circuit courts in the USA and commentators have proposed alternative tests for evaluating predatory pricing claims. These proposals include qualitative assessments of a major airline's predatory intent, as well as a mandated price freeze to prevent drastic price cuts in response to entry. Both proposals seek to promote consumer welfare by deterring major airlines from engaging in unfair pricing tactics in response to entry. Most flights

⁴⁵ Ibid.

⁴⁶ Ibid.

⁴⁷ Ibid.

⁴⁸ *United States v. AMR Corp.*, 335 F.3d 1109, 1121.

carry a range of passenger fares, and it will not be easy to distinguish incremental from non-incremental revenue. However, capacity increase plays a key role in targeted response to entry , and a cost-standard that evaluates investment in capacity increment may help to promote competition in airline market.

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