## Bloomberg Businessweek

### Magazine



### United and Continental Reach for the Sky

Posted on May 05, 2010
http://www.businessweek.com/magazine/content/10_20/b4178019955335.htm

The future chief executive officer of what's likely to become the world's biggest airline surprised his old boss one night on a Houston highway by pulling alongside in his Infiniti as they were each clocking about 130 miles per hour.

"The passenger window goes down, and there's Jeff, a big grin on his face," former Continental Airlines (CAL) CEO Gordon Bethune, 68, says in recalling the late-1990s episode involving Jeff Smisek, then the carrier's general counsel. "He waves at me and takes off. Who else would do that?"

Obviously, Smisek likes taking risks, whether it's racing on a darkened highway or piloting a combined Continental and UAL's (UAUA) United Airlines after their $2.9 billion merger. Yet the 55-year-old Harvard Law School graduate, who has been at Continental's controls only since January, is trying to rewrite the rules of an industry that has humbled plenty of other CEOs before him. "We fully expect that Smisek and his team will be successful in combining the best of each organization," said Douglas Runte, managing director of Piper Jaffray (PJC). "But the immensity of the challenges should not be underestimated. U.S. aviation history is littered with the debris of airline mergers."

How's this for a to-do list: Smisek will have to figure out a way to generate profits at the combined carrier after annual losses at UAL and Continental in each of the past two years; navigate a tough U.S. antitrust review; and work with restive unions that had demanded the ouster of United CEO Glenn Tilton, who is staying on as nonexecutive chairman of the combined carrier.

## Merger's Challenges

Key to Smisek's success will be his ability to realize $1.2 billion in combined cost savings and new revenue, while funneling additional traffic from the expanded United-Continental domestic network into its more lucrative international routes.

Just managing the sheer logistics of the combined airlines will be a huge undertaking. The main jet fleets of the two carriers total 700 aircraft. Continental flies only Boeing (BA) planes; United uses jets from both Boeing and Airbus. Flying planes from different makers requires separate maintenance procedures, staff training, and spare parts.

The combined airlines, which will operate under the United name but sport Continental's colors and globe logo, now employ more than 88,000 workers. Other than some white-collar consolidation, management so far says it isn't planning big staff cuts. Yet it still could face tough negotiations with its airline unions, often a major impediment to a successful merger.

Traditionally the key task has been harmonizing work rules and consolidating union seniority lists into a single worker roster. Since seniority determines which pilots get higher-paying aircraft assignments and better working hours, it's usually a traumatic process. US Airways (LCC), for instance, still has not been able to get workers to agree to unified contracts—five years after its merger with America West. Maintaining two sets of work rules has kept US Airways from realizing some of the planned savings behind that tie-up.

Frequent flyers shouldn't encounter any hassles. Continental's OnePass and United's Mileage Plus rewards programs will not be merged until after the deal is completed, which could be as soon as late 2010. Then, account balances from the two programs would be combined. The Continental and United reward programs already are linked through the Star Alliance of international carriers, so there will not be a big increase in reward destinations due to the merger.

## Antitrust Review

Things won't go nearly so smoothly for Smisek, who must convince regulators that the Continental-United marriage would not significantly reduce competition. Currently, United is the third-biggest American carrier by traffic (Continental is No. 4) behind Delta Air Lines (DAL) and American Airlines (AMR). The combined airline would leap to the front of the tarmac, raising fears that it could amass too much pricing power—especially on high-fare international routes frequented by business travelers.

A United-Continental combination would surpass Delta as the top U.S. carrier on routes across the Atlantic with a 40 percent share of passenger traffic. The duo would handle 53 percent of all traffic on Pacific routes (United is the leader now), based on data compiled by Bloomberg. In the U.S., the two airlines have overlapping nonstop flights in 13 markets.

True, U.S. antitrust authorities have allowed lots of industry consolidation in recent years. Washington approved the 2008 merger of Delta and Northwest and US Airways Group's merger with America West Holdings in 2005. That was during the Bush Administration. The Obama Administration Justice Dept.'s antitrust division led by Christine Varney is another matter. She's expected to scrutinize the Continental-United tie-up closely. Varney has already raised questions about the competitive impact of existing international airline alliances that share some flights but stop short of mergers. Last June, DOJ called for

limits on Continental's earlier request to coordinate flights overseas with United, saying the plan was "unprecedented in scope and breadth, sanctioning collusion."

## Downplaying the Worries

The department "signaled quite strongly, in my view, that it would be very skeptical of a complete merger between United and Continental," said Mark Popofsky, co-head of antitrust at Ropes & Gray in Washington and a senior counsel in President Bill Clinton's Justice Dept.

United and Continental downplay worries about air pricing, noting discount carriers now command more than a quarter of domestic traffic. "This is a brutally competitive industry," Smisek said after the deal was announced. "We couldn't set airfares before this, we can't set airfares after this. We are responsive to demand."

Still, some industry insiders believe regulators may force route divestitures or the sale of some of United and Continental's takeoff and landing slots at coveted airports in the New York and Washington areas. Says James Burnley, a partner at Venable in Washington and U.S. transportation secretary under President Ronald Reagan: "It's by no means going to get automatic approval."

***The bottom line*** *A merged United-Continental must assuage competition regulators without losing scale advantages that make their marriage attractive.*