Illustration 16.3
When is Price "Signaling" Really Price Fixing?

As we noted in the text, price fixing is illegal in the United States. Nevertheless, numerous cases of innovative methods of secretly fixing prices are discovered each year by the Justice Department. *The Wall Street Journal* reported in October 1990 that the Justice Department was conducting several investigations into possible price fixing by airlines.

At the heart of these investigations is the alleged practice by airlines of "signaling." Signals apparently take place in the thousands of fare changes that are submitted each day to the computer network that manages airfare information. An example of price signaling was provided by Steven B. Elkins, a senior director of marketing at Northwest Airlines, during courtroom testimony in the Justice Department's investigations into possible price fixing. According to Elkins, when Northwest lowered price on certain night flights out of Minneapolis, Continental responded by cutting fares in important Northwest markets. The Continental fares, however, were scheduled to expire one or two days after they were introduced.

Elkins interpreted Continental's extraordinarily brief fare reduction as "(telling) us that they weren't serious about wanting to sell those fares…We felt what they were doing was trying to send us a message that they didn't want us reducing night coach fares in these markets." Northwest apparently didn't feel like retracting its night-fare reductions in Minneapolis and signaled this to Continental by offering new cheap fares from Houston to California, *again using short expiration dates.* Houston is an essential market for Continental, and they got the message.

While some economists and antitrust attorneys view this type of back-and-forth exchange by airlines as a routine competitive business practice, critics believe signaling may, in fact, be just another innovative way of fixing prices. The most controversial aspect of price signaling is its use in disciplining airlines that cut fares. In an internal pricing memo at Northwest Airlines that surfaced in Elkin's testimony, Northwest clearly revealed that it wished to avoid price competition in the worst way:

When you get right down to it pricing is really a very poor competitive weapon in our marketing arsenal. It suffers the same limitations as the atomic bomb. Its potential is so dangerous that none of us can permit our competitors to wield it unchallenged. Attempts to use price to improve market share will be countered immediately and rendered ineffective. Price signaling, legal or not, is clearly a mechanism by which airlines attempt to coordinate pricing decisions in a way that will be less damaging to their oligopoly profits that outright price competition would be.

We now want to pass on to you some good advice, based on a more recent article in *The Wall Street Journal* (July 30, 1993) on airline signaling: Think twice before buying airline tickets on a weekend. According to the *WSJ*, "Many carriers these days test fare increases by raising prices on Friday nights, Saturdays, and Sundays, when few tickets are sold. If their competitors don't go along with the increases, the fares come down on Monday."

Airlines had previously signaled planned fare increases in computer reservation systems, then waited to see whether all other airlines followed. A single defector could scuttle an increase because the other airlines would not take the risk of losing customers to a rival that didn't increase prices. But a consent decree by the Justice Department prohibited carriers from signaling price actions. As the *Journal* reported, "The weekend fare rates are a way to accomplish the same purpose with limited risk: Even if competitors don't match the increase, the higher-priced carriers won't lose much business over a weekend and can back down on Monday morning."

The results: Airlines raised fares on one weekend, and these fares stuck. The following weekend saw full coach fares rise 5 percent; those fares also stuck. But the next weekend many carriers again raised advance-purchase prices 5 percent, but pulled back on Monday because some airlines didn't follow. Fliers who bought tickets on Saturday of Sunday paid 5 percent more than if they had bought the same tickets on the Friday before or the Monday after. In addition, many airlines increased the fee to reissue a ticket at a cheaper fare. A year before, cut-rate tickets had been refundable.

The *Journal* noted that weekend price increases could become routine, because airlines need to raise prices to improve their balance sheets. Full coach fares, used by businesses, were expected to rise. One airline executive said that the higher weekend fares were fairly widespread, but most denied any type of collusion. Other airlines blamed the "phantom" fares on the Justice Department. The weekend increases were simply the "industry's way of operating under the constraints of a consent decree."

So what is the moral? Well, when signaling practices used to avoid getting trapped in the "wrong" box of the prisoners' dilemma are restricted, managers will find other methods of signaling.

In an interview in *Forbes* magazine, Barry Nalebuff, a professor of Organization and Management at Yale, pointed out another way airlines try to signal and reduce unwanted price competition. The interviewer at *Forbes* asked Professor Nalebuff, who teaches a managerial decision-making course that focuses to some extent on how to avoid the prisoner's dilemma, "I…understand my payoffs, but my competitors don't. They start a price war. What do I do now?" Professor Nalebuff suggested doing what TWA was trying to do—change the competitive playing field. TWA was ripping out seats in its planes to offer more legroom for passengers. Instead of competing only on price, TWA was offering quality as well. As Nalebuff pointed out, "If competitors decide to match TWA, all passengers will be more comfortable and the industry will have less capacity. Cutting the excess capacity will help restore price stability and improve the profits of all airlines. TWA is trying to change the game from zero-sum to 'positive-sum' competition—everyone benefits."

We rather doubt that this will work out very well, but Professor Nalebuff also offers other examples of signaling or (legal) methods of getting out of the "bad box." We aren't going to make any recommendations. We do suggest you might want to read the article (or take Nalebuff's course). But we believe that as long as interdependence, uncertainty, and restrictions against collusion exist, astute managers will develop ways to cooperate (legally or otherwise) rather than resort to intense price competition, or, for that matter, advertising or other types of competition. We also believe that, as long as these conditions exist,

oligopolists will end up competing intensely and earning less profit than would be possible with cooperation. This may be good for consumers but is bad for the oligopolists. It is not because managers are stupid or ignorant about what they are doing. Far from it. We simply believe that the rules of the game and the constraints determine the way the game is played.

Sources: Asra Q Nomani, “Fare Warning: How Airlines Trade Price Plans,” *The Wall Street Journal*, October 9,1990.
James Hirsch, “Fliers Discover They Don’t Fare Well on The Weekends,” *The Wall Street Journal*, July 30, 1993. Rita Koselka, “Businessman’s Dilemma,” *Forbes*, October 11,1993.