Essays on the Analysis of Dynamic Games

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Abstract

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This dissertation seeks to combine ideas from literatures in Machine Learning and the econometric analysis of games, and contributes to the analysis of dynamic competition in the context of high-dimensional covariates. Chapter 1 studies new entry and mergers in the U.S. airlines industry and explores how the incentives of legacy carriers to accommodate new entry change when they merge and whether low cost carriers are sensitive to these changes when making entry decisions. We estimate an explicitly network-wide, strategic and dynamic model of airline competition, and find evidence that Southwest was more likely to enter markets where, from Delta and Northwest's perspective, the expected value of committing aircraft capacity, relative to other markets, fell the most post-merger. Chapter 2 develops a method for deriving policy function improvements for a single agent in high-dimensional Markov dynamic games. We derive a one-step improvement policy over any given benchmark policy, and the one-step improvement policy can in turn be improved upon until a suitable stopping rule is met. Chapter 3 applies the method proposed in Chapter 2 to solve for policy function improvements in a high-dimensional entry game similar to that studied by Holmes (2011). The game has a state variable vector with an average cardinality of 10^{42}. We find that our algorithm results in a nearly 300 percent improvement in expected profits as compared to a benchmark strategy.

Chapter 1: Legacy carriers in the U.S. airline industry have a long history of vigorously defending their most important hubs from low cost carrier expansion. Since 2005, the U.S. airline industry has undergone some of the most dramatic merger activity in its history, with five mergers between major carriers reducing the number of major carriers from eight to four. This merger activity has coincided with low cost carrier expansion into some hubs previously dominated by legacy carriers. This chapter explores how the incentives of legacy carriers to accommodate new entry change when they merge, and whether low cost carriers are sensitive to these changes when making entry decisions. To do so, we estimate an explicitly network-wide, strategic, and dynamic model of airline competition. In this model, a carrier's aircraft fleet is fixed in the short term, generating network-wide tradeoffs. We use this model to simulate and estimate the value of committing aircraft capacity to particular travel markets for Delta and Northwest, both unmerged and merged, across each carrier's U.S. domestic network and compare these estimates to the entry patterns of Southwest Airlines since 2008. We find evidence that Southwest was more likely to enter markets where, from Delta and Northwest's perspective, the expected value of committing aircraft capacity, relative to other markets, fell the most post-merger.

Chapter 2: In this chapter, we propose a method for finding policy function improvements for a single agent in high-dimensional Markov dynamic optimization problems, focusing in particular on dynamic games. Our approach combines ideas from literatures in Machine Learning and the econometric analysis of games to derive a one-step improvement policy over any given benchmark policy. In order to reduce the dimensionality of the game, our method selects a parsimonious subset of state variables in a data-driven manner using a Machine Learning estimator. This one-step improvement policy can in turn be improved upon until a suitable stopping rule is met as in the classical policy function iteration approach.

Chapter 3: We consider the problem of finding policy function improvements for a single agent in high-dimensional dynamic games where the strategies are restricted to be Markovian. Conventional solution methods are not computationally feasible when the state space is high-dimensional. In this chapter, we apply a method recently proposed in Chapter 2 to solve for policy function improvements in a high-dimensional entry game similar to that studied by Holmes (2011). The game we consider has a state variable vector with an average cardinality of over 10^{42}. We use the method to find a one-step policy improvement. We find that our algorithm results in a nearly 300 percent improvement in expected profits as compared to a benchmark strategy.

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Chapter 1

NEW ENTRY AND MERGERS IN NETWORK INDUSTRIES: EVIDENCE FROM U.S. AIRLINES

1.1 Introduction

From 1994 to 2007, prior to its merger with Delta Airlines in 2008, Northwest Airlines accounted for seventy-four percent of passenger enplanements from the Minneapolis-St. Paul (MSP) airport, on average. To protect its dominant position, Northwest typically responded to new low cost carrier entrants with aggressive price drops and increases in the number of offered flights, with several of these responses generating allegations of predatory pricing and antitrust scrutiny.[1] Not surprisingly, low cost carriers maintained a relatively small presence at MSP, accounting for an average of five percent of passenger enplanements from the airport from 1995 to 2007.[2] With a small share of low cost carrier flights, fares through MSP remained relatively high, consistently ranking as some of the highest fares among major U.S. domestic airports during the same time period.[3]

In the second quarter of 2008, Northwest announced its merger with Delta. Almost immediately after this announcement, Southwest Airlines, the dominant low cost

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[1]For an extensive analysis of the predatory pricing practices of Northwest Airlines at the Minneapolis-St. Paul airport, see Dempsey (2000, 2002).

[2]The share of low cost carrier and Northwest passenger volume for MSP from 1995 to 2007 was computed using the T100 segment database, available from the U.S. Department of Transportation, Bureau of Transportation Statistics. To determine the identity of low cost carriers, we used the historical list of these carriers with IATA codes available from IACO (2014). See the Appendix for a complete list.

[3]See Dempsey (2000). In the DB1B Market database, using data from 1995 to 2007, MSP has a mean and median fare rank of seventh among the top 75 airports in the U.S. by 2002 passenger volume.

carrier in the United States, declared its intentions to offer nonstop flights from MSP to Chicago, which represented its first regular nonstop flight offerings from MSP. Southwest's entry initiated a wave of low cost carrier flight offerings, with so many new offerings that the governing authorities at MSP expanded the airport to accommodate the growing presence of low cost carriers, whose share of enplaned passengers increased to an all-time high of nineteen percent in 2014.[4]

What would drive a dominant incumbent with a history of aggressively responding to new entrants to seemingly give up this competitive position and accommodate entry after a merger? This chapter answers this question. Existing models of predatory behavior might conclude that Northwest would become *more* likely to defend MSP against new entrants after the merger. For example, "long purse/deep pockets" predation models argue that predatory pricing strategies are supported by the relatively deep financial resources of incumbents relative to new entrants, allowing them to credibly threaten or actively engage in predatory pricing long enough to make new entry unprofitable (see, e.g., Bolton and Scharfstein (1990)). This framework might suggest that the new Delta and Northwest, whose merger formed the largest carrier by passenger volume at the time, would be in an even better financial position to aggressively respond to new entrants than the unmerged Northwest, which was the fifth largest airline prior to its merger.

We answer this question by proposing and estimating a model of airline competition that captures the tradeoffs associated with committing aircraft capacity to particular markets around the U.S. Given that purchasing new aircraft takes several years, adding aircraft capacity to a market (by increasing the number of flights) in response to new entry usually requires some degree of reallocation of aircraft from another route the

[4]The Metropolitan Airports Commission at MSP voted to expand Terminal 2 in June of 2015 to accommodate this growth, see ABC (2015) and Minneapolis Post (2013). The share of enplaned passengers for low cost carriers was computed using the number of enplaned passengers flying to or from MSP in the T100 segment database (2014 data). Carriers are classified as low cost using the classification of IACO (2014). See the Appendix for the list of carriers designated as low cost.

incumbent carrier serves.[5] This increase in aircraft capacity increases competition, lowering fares for all carriers in the market, with the lower fares intended to make operating in the market unprofitable for the new entrant. The expected return for the incumbent comes from additional market power due to the loss of a competitor in subsequent periods if this increased competition successfully causes the new entrant's exit.

Keeping this characterization of airline competition in mind, the incentives of legacy carriers to accommodate entry in our model have three salient features. First, these incentives are dynamic, in that aircraft capacity increases involve a temporary investment of short-term profits for an increase in expected profits realized at a later time. Second, aircraft capacity constraints generate network-wide tradeoffs, since the cost of aircraft reallocation involves forgone profits not only from the market experiencing increased competition but also from the (possibly far away) market that provides the excess aircraft capacity. Finally, these incentives partly depend on differences in cost structures between legacy carriers and low cost carriers. Low cost carriers typically operate with lower marginal costs than legacy carriers, and an incumbent that accommodates a low cost carrier entrant can expect strong price competition. Mergers of legacy carriers change the opportunity costs of reallocating fleet capacity, thereby changing the costs of defending markets against new entrants. To the extent that these costs are too high in a given market, legacy carriers will accommodate entry.

We use this model to study a rich and comprehensive dataset on U.S. airline prices, entry decisions, and scheduled flights, and estimate how the incentives of incumbent legacy carriers to accommodate new entry change with mergers. In particular, we focus

[5]Carriers sometimes utilize short-term plane leases to obtain additional aircraft capacity quickly. However, these leases are not always immediately available. Short-term leases run one to three years and are typically obtained from one of three sources: a manufacturer who leases a preowned aircraft traded in as part of a previous new aircraft purchase, a financial institution that leases aircraft while waiting for opportunities to sell it, or another aircraft owner or carrier with idle capacity. Even if aircraft are available from these sources, the terms of short-term leases are often more problematic to negotiate than those of long-term leases. Issues in these negotiations often revolve around which party assumes the risk of unforeseen maintenance and repairs, see Wieand (2015).

on changes in these incentives for the merged Delta and Northwest Airlines and compare these changes to the entry and expansion behavior of Southwest Airlines.[6] Since 2005, the U.S. airline industry has experienced some of the most dramatic merger activity in its history, with five mergers between major carriers including America West and US Airways in 2005, Delta and Northwest in 2008, United and Continental in 2010, Southwest and AirTran in 2011, and American Airlines and US Airways in 2013.[7] This merger activity has reduced the number of major carriers in the industry from eight to four: American, Delta, United, and Southwest. Industry consolidation coincided with an expansion by low cost carriers into several major domestic markets where low cost carrier participation was previously low.[8]

We study changes in the incentives of newly merged legacy carriers to accommodate entry by proceeding in four steps. First, we propose a dynamic, strategic model of aircraft competition which we explicitly condition on the network-wide flight offerings of carriers. Second, we develop an identification and estimation strategy that allows us to recover the opportunity cost of committing aircraft capacity to each market served by a reference legacy carrier. Third, we use these estimates to simulate the expected return of driving Southwest out of each flight segment in our sample unentered by Southwest in the first quarter of 2008, both with and without the Delta and Northwest merger (which was announced in 2008q2). Fourth, we analyze the correlation between

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[6] We are currently estimating changes in the incentives of a broader set of legacy carriers (in addition to Delta and Northwest) to accommodate the entry of a broader set of low cost carrier entrants (in addition to Southwest) in the context of the other legacy carrier mergers that have occurred since 2008. This includes the United and Continental merger and the American and US Airways merger.

[7] Table A.2 in the Appendix lists the dates for merger announcement, regulatory approval, shareholder approval, legal closing date, issuance of a single operating carrier certificate by the Federal Aviation Administration (FAA), and the creation of a single passenger reservation system. The last two events signal the effective operation of the carriers as a single carrier.

[8] For example, using enplaned passenger data from the U.S. Department of Transportation (the Airline Origin and Destination Survey, DB1B market database), three historical Delta or Northwest hubs experienced increases in the shares of enplaned passengers transported by low cost carriers (LCC's) after the merger of Delta and Northwest (comparing 2008 and 2014 LCC share, see Figure 1.1 in Section 1.2).

these estimated returns and Southwest entry patterns from 2008q2 to 2014q4.

Our estimation strategy involves two layers, an "inner" layer and an "outer" layer. The inner layer involves estimating consumer demand and product cost parameters by adapting the structural estimation procedure of Berry and Jia (2010), which is a variant of the framework proposed by Berry, Levinsohn, and Pakes (1995). In this setup, carriers offer differentiated airline products and otherwise compete over price. The model also allows low cost carriers and legacy carriers to have different marginal cost structures, which are the marginal cost structures implied by the estimated structural parameters of the model.[9] This approach is flexible in that it accommodates unobservable product and cost characteristics as well as different customer types. We use the estimated parameters to recover the product-level profits of each carrier as a function of observable market characteristics.

The outer layer uses the estimated product-level profits as primitives to estimate the value of reallocating aircraft capacity across the network of the reference legacy carrier, conditional on observable network characteristics and the strategic responses of competitors. For this layer, we use data on sequences of entry and capacity choices by all U.S. domestic carriers since 2006 to model entry and flight capacity strategies as functions of payoff relevant state variables.[10] This allows us to estimate the entry and capacity strategies of all carriers as functions of observable characteristics. We use the estimated strategy functions and forward simulation to estimate the choice-specific value of flight capacity reallocation as a function of network-wide characteristics, both with and without the merger.[11] These estimated choice-specific value functions in

[9]This reflects the well-known tendencies of low cost carriers to operate point to point networks, offer fewer amenities, and maintain homogenous aircraft fleets to lower maintenance costs. In contrast, legacy carriers operate hub and spoke networks, offer more amenities, and maintain heterogeneous aircraft fleets to accommodate a larger and richer set of flight offerings.

[10]To facilitate this analysis, we assume carriers form strategies that are Markovian. In a series of robustness checks (forthcoming), we test the Markov assumption by testing whether information realized prior to the current period significantly explains carrier strategies after conditioning on all current payoff relevant states.

[11]This approach makes the choice-specific value function the outcome variable in an econometric

turn allow us to derive legacy carrier flight capacity reallocation strategies, which designate the segments from which flight capacity should be drawn to respond to the hypothetical entry of a low cost carrier.[12] We use the reallocation strategies in a subsequent simulation to estimate the value for the legacy carrier of defending flight segments unentered by Southwest as of 2008q1 against new Southwest entry, both with and without the merger.

The primary challenge encountered when estimating the choice-specific value functions is that we explicitly condition on network-wide characteristics, which makes the set of regressors very large and increases the computational burden of simulation substantially. Competition parameters in the context of dynamic industry competition are often estimated using simulation, and it is well-known that the simulation burden of estimation in these settings increases dramatically with the number of state variables included. For example, in our primary specification, our regressors include the aggregate number of flights offered by all carriers on each flight segment formed by the top 60 composite statistical areas in the United States by 2002 passenger volume (1770 regressors), the capacity choices of the reference legacy carrier on the same flight segments (1770 regressors), and a series variables derived from carrier capacity choices (including interaction terms), for a total of 17700 regressors. This specification allows us to study network-wide capacity reallocation strategies in a rich manner. However, in a dynamic game setting, the evolution of these state variables generates an intractable number of solution paths for candidate parameters using existing methods.[13]

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model. See Pesendorfer and Schmidt-Dengler (2008) and Bajari, Hong, and Nekipelov (2013) for examples.

[12]Specifically, we derive one-step improvement reallocation strategies for the merged and unmerged legacy carrier. The one-step improvement process is similar to the first step of the well-known policy function iteration method for deriving optimal policies in dynamic optimization problems, see Bertsekas (2012) for an extensive review of policy function iteration methods. This choice maximizes the estimated choice-specific value function in a "greedy" manner, i.e. in the current period.

[13]See Bajari, Benkard, and Levin (2007) for a discussion of this issue in the context of estimating models of dynamic industry competition.

To lower this burden, we utilize a well-known technique from Machine Learning known as Component Wise Gradient Boosting (CWGB).[14] CWGB works by projecting the estimand functions of interest onto a low-dimensional set of parametric basis functions of regressors, with the regressors and basis functions chosen in a data-driven manner.[15] In our application, CWGB estimates a low-dimensional approximation to the choice-specific value function of the reference legacy carrier, which in turn reduces the simulation burden of estimating the value of defending flight segments in the next step.

To preview results, we find that expansion by Southwest in the U.S. since 2008 was most likely in flight segments that, from Delta and Northwest's perspective, became expensive to defend, relative to other flight segments in Delta and Northwest's combined U.S. domestic network. We also find that these results are driven primarily by merger-induced changes in the opportunity costs of reallocating fleet capacity across the network of the merged Delta and Northwest.

This chapter represents the first attempt to estimate the incentives of legacy carriers to accommodate new entry across the entire U.S. domestic network, as well as how these incentives change after carriers merge. This allows us to contribute to the small but growing number of empirical studies of predation, including, for example, Snider (2009), Genesove and Mullin (2006), Scott-Morton (1997), Bamberger and Carlton (2007), and Ito and Lee (2004).

A primary advantage of our approach is that we estimate the incentives of legacy carriers to accommodate entry even on flight segments unentered by Southwest. This is attractive because, in equilibrium, if Southwest perceives the legacy carrier will

[14] This technique was developed and characterized theoretically in a series of articles by Breiman (1998, 1999), Friedman *et al.* (2000), and Friedman (2001). Also see Hastie *et al.* (2009) for an introduction to the method.

[15] CWGB methods can accommodate non-linearity in the data generating process, are computationally simple, and, unlike many other non-linear estimators, are not subject to problems with convergence in practice.

respond with aggressive competition upon entry, they may choose not to enter. As a consequence, competition responses to *actual* entry may be relatively accommodative, as was found by Ito and Lee (2004). However, low cost carrier industry representatives often cite the expected competitive responses of legacy carrier incumbents as important barriers to their expansion, see GAO (2014). Our approach allows antitrust enforcers and policymakers to identify the U.S. domestic markets where low cost carriers face the greatest risk of a robust competitive response from incumbent legacy carriers and how this risk changes in response to proposed mergers. For example, this type of analysis can be used to determine whether new entry is likely to offset reductions in competition due to mergers,[16] or whether airport administrators should plan for an influx of low cost carriers after a merger. It can also be used as a supplementary tool in retrospective merger analyses to determine how past mergers made low cost carrier expansion more or less costly.

We also contribute to the nascent literature applying Machine Learning estimation techniques in economics, see, for example, Athey and Imbens (2015), Bajari, Nekipelov, Ryan, and Yang (2015), Chernozhukov, Hansen, and Spindler (2015), Kleinberg, Ludwig, Mullainathan, and Obermeyer (2015), and Manzanares, Jiang, and Bajari (2015) for recent examples. Machine Learning refers to a set of methods developed and used by computer scientists and statisticians to estimate models when both the number of observations and controls is large. See Hastie *et al.* (2009) for a survey. In particular, we utilize a model selection (regressor selection) technique from Machine Learning to overcome the curse of dimensionality inherent in solving dynamic optimization problems. Our Machine Learning estimator allows us to select a parsimonious set of state variables in a data-driven manner, reducing the computational burden of subsequent simulation steps.

[16]The U.S. Horizontal Merger Guidelines (USDOJ 2010, Section 9) explicitly consider the possibility of new entry when determining whether a proposed combination would reduce competition in a given market.

Finally, the overall approach of this chapter can be generalized to study dynamic competition in other settings and may be especially useful when studying network industries. Dynamic, strategic competition in network industries is notoriously high-dimensional and analytically and computationally challenging to study, since firms typically compete in thousands of markets simultaneously. To overcome these difficulties, researchers often analyze more stylized versions of competition and choose state variables by assumption. However, deciding which state variables should enter the model *a-priori* may be weakly justified in many empirical applications. Data-driven model selection serves as a promising alternative, since it enables researchers to s-tart with more realistic models of agent behavior, allowing the data and estimation technique to select the regressors deemed most important for analysis.[17]

The rest of the chapter proceeds as follows. Section 2 describes changes in legacy carrier and low cost carrier flight capacity in the United States since 2005, focusing in particular on Northwest Airlines and changes at its Minneapolis-St. Paul hub. Section 3 describes the model of airline competition. Section 4 details the data, whiles Section 5 describes our identification and estimation strategy. Section 6 presents and discusses our results. Section 7 concludes.

1.2 Background

Legacy carriers have historically responded to low cost carrier entry with aggressive price drops and aircraft capacity increases. Some of the most famous of these responses occurred in the 1990's and early 2000's, when low cost carriers began entering markets comprised of the primary hubs of legacy carriers, with many generating antitrust scrutiny.[18] Notwithstanding this scrutiny, allegations of predation in the U.S. airline

[17]There has been relatively little attention to model selection in econometrics until recently. See Belloni, Chernozhukov, and Hansen (2013) for a survey of some recent work.

[18]For example, in 1995 and 1996, American responded aggressively with both price decreases and capacity increases to the entry of Vanguard Airlines into the Dallas Fort Worth (DFW) to Wichita market, given the importance of American's DFW hub to its overall profitability. The aggressive

industry are frequent, and there is evidence this behavior still serves as a barrier to entry. As recently as 2014, in a study by the Government Accountability Office (GAO (2014)), low cost carrier executives and industry participants noted that predatory responses by legacy carriers still serve as barriers to entry for low cost carriers, also see U.S. Congress (1996).

Prior to its merger with Delta Airlines in 2008, Northwest Airlines was the fifth largest airline by domestic passengers traffic. Headquartered near Minneapolis-St. Paul (MSP) airport, Northwest held its major hub at MSP and added Detroit and Memphis as hubs after its acquisition of Republic Airlines in 1986. Northwest's share of passengers traveling through these airports was high, accounting for an average of 71 percent, 70 percent, and 75 percent in Detroit, Memphis, and MSP, respectively, from 1994 to 2007.

To defend its dominant position in these hubs, Northwest developed a reputation as one of the most aggressive responders to new entrants, frequently generating allegations of predation. These responses involved, primarily, price cuts and increases in capacity, which included increases in the number of flights offered, the number of low priced seats offered, and the size of planes utilized.[19] One well known example included the entry of Reno Air into MSP. Reno Air was a small low cost carrier which initiated operations in 1992 with seven jets and began offering three daily round-trip flights between Reno, Nevada and MSP in February of 1993. The Reno to MSP route had been abandoned by Northwest in 1991. Two days after Reno Air inaugurated service,

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responses resulted in Vanguard's exit from this route and also resulted in antitrust scrutiny, with the U.S. Department of Justice (DOJ) filing a formal predation case against American. See Snider (2009) for a detailed analysis of this predation event.

[19]It also involved other means, including eliminating ticket restrictions such as advanced purchases and Saturday night stays, incentivizing travel agents and biasing reservation systems to redirect customers away from the new entrant, refusing to enter joint administrative agreements (e.g. joint fare, interline service, code-sharing, ticketing, and baggage handling) with the new entrant, refusing to lease gates and other infrastructure (e.g. aircraft hangars) or share aircraft parts with the new entrant, awarding frequent flyer bonuses for travel on contested routes, and providing incentives for partner regional airlines to deny feeder route service for the new entrant. For a detailed discussion of the predatory practices used by Northwest in the late 1990's and early 2000's, see Dempsey (2000).

Northwest announced that it would offer three daily round-trip flights from MSP to Reno. It also announced that it would provide new service from Seattle, Los Angeles, and San Diego to Reno, which were three cities Reno Air served, and also that it would match Reno Air's low fares and provide frequent flyer bonus miles for travel to Reno. After this initial activity generated scrutiny from federal aviation authorities, Northwest abandoned its planned service from Seattle, Los Angeles, and San Diego, but maintained its service from MSP to Reno. Later that year, Reno Air abandoned its service to MSP. Prior to this withdrawal, Northwest's lowest nonrefundable and refundable round-trip fares were $86 and $136, respectively. After the withdrawal, they rose to $149 and $455. Reno Air filed an antitrust lawsuit in 1997, claiming that Northwest's actions were predatory.[20]

Similar episodes include Northwest's responses to the entry of Spirit (Detroit), Pro Air (Detroit), Kiwi International (MSP, Detroit), Vanguard (MSP), Sun Country (MSP, Detroit), and ValueJet (Memphis). Northwest also responded preemptively to low cost carrier expansion *near* its hubs. For example, as Western Pacific Airlines began to expand service from its base in Colorado Springs in 1996, Northwest initiated service from each of its hubs to Colorado Springs. Upon Western Pacific's liquidation in 1997, Northwest terminated service to the city from its Detroit and Memphis hubs. These and related actions induced one industry commentator to conclude "[i]n the history of U.S. commercial aviation, no airline has presented more evidence of predatory behavior than Northwest," (Dempsey 2000, p. 52).

Prior to its merger with Northwest, Delta Airlines was the third largest airline by passenger traffic and operated a primary hub in Atlanta, along with major hubs in Cincinnati and Salt Lake City. Similar to Northwest, Delta served as the dominant carrier at its hubs, accounting for an average of 73 percent, 77 percent, and 62 percent of passenger traffic through Atlanta, Cincinnati, and Salt Lake City, respectively, from

[20] It abandoned this lawsuit after it was acquired by American Airlines.

1994 to 2007. Initially, Delta's responses to low cost carrier intrusion into in its primary Atlanta hub were mild, famously accommodating the expansion of ValuJet in the early 1990's.[21] Within a few years, however, Delta's responses to low cost carrier entry began resembling those of Northwest, resulting in allegations of predation by ValuJet, AccessAir, and AirTran.

In the second quarter of 2008, Delta and Northwest announced their intentions to merge, forming the largest airline by passenger traffic at the time. The merger coincided with dramatic changes in market structure both nationally as well as in the hubs of both carriers. Nationally, all legacy carriers, including the "new Delta", reduced the aggregate number of flights offered in response to rising fuel prices and uncertain demand conditions induced by the Global Financial Crisis of late 2007 and Great Recession of 2008-2009. In particular, the new Delta reduced the total number of domestic flights it offered significantly, from nearly 40,000 in 2005 offered by either Delta or Northwest to 16,000 offered by the new Delta at the end of 2014.[22]

The merger also coincided with changes in the share of low cost carrier passengers traveling through the hubs of Delta and Northwest, which is illustrated in Figure 1.1.[23] The figure shows the timing of these changes relative to the legal closing date of the merger at the end of 2008, as well as the issuance of a single operating certificate for the merged airline in 2009.[24] The largest change in low cost carrier share occurred

[21]ValuJet began service in 1993 from Atlanta to three tourist destinations served by Delta, including Jacksonville, Orlando, and Tampa. Although Delta responded to these offerings by matching ValuJet's fares on some tickets, it retained ticket restrictions absent from ValuJet's tickets, including advanced purchase, round-trip travel, and Saturday night stay requirements. Additionally, Delta refrained from flooding the market with additional capacity and maintained its existing stock of higher fare business class tickets. See Allvine et al. (2007), p.92, for a discussion of the entry of ValuJet into Atlanta. Within one year, ValuJet had expanded to offer nonstop service to seventeen cities. ValuJet eventually merged with AirTran in 1997 and maintained a strong presence in Atlanta, which continued after the merger of AirTran and Southwest in 2011.

[22]This series was constructed using a comprehensive OAG sample on scheduled flights for all U.S. domestic carriers from 2005 to 2014. See the Data section for details on sample selection.

[23]The share of low cost carrier enplaned passengers was computed using data from the T100 segment database. See the Data section for details on this dataset.

[24]The issuance of a single operating certificate by the U.S. Federal Aviation Administration rep-

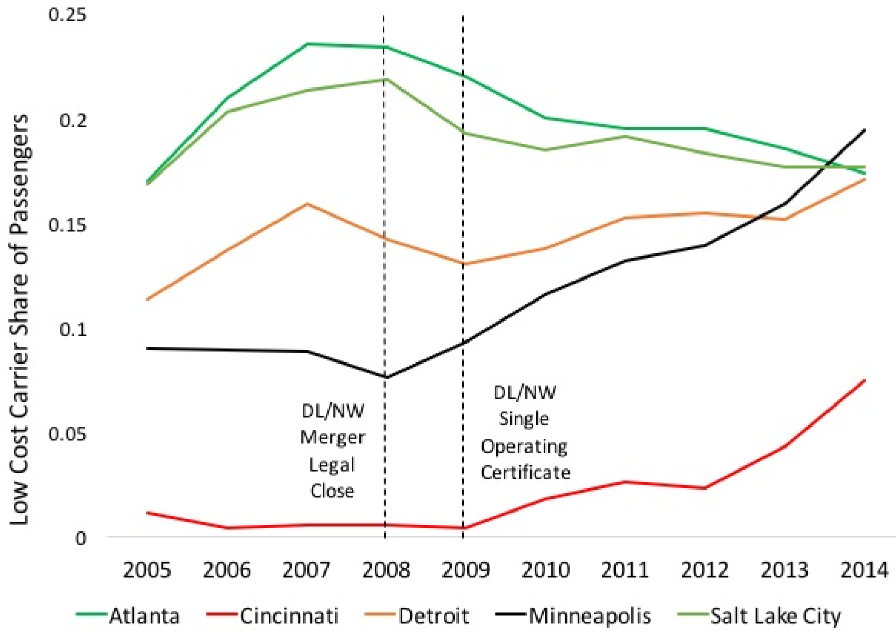

Figure 1.1: Low Cost Carrier Share of Passengers, Delta and Northwest Hubs

at the Minneapolis-St. Paul airport. In the fourth quarter of 2008, coinciding with the legal close of the merger, Southwest announced that it would provide eight daily flights from Minneapolis, St. Paul to Chicago's Midway airport, which began in March of 2009. This represented Southwest's first new airport entry since its re-entry into San Francisco in August of 2007.[25] This announcement was followed by a wave of new low cost carrier flight offerings and new entry, increasing the share of passengers traveling on low cost carriers from 7.6 percent in 2008 to 19.5 percent in 2014. This low cost carrier influx induced the expansion of Terminal 2 at MSP in June of 2015.[26] The consummation of the merger also saw a reduction in the share of passengers transported by Delta or Northwest through MSP, dropping from 66 percent in 2008 to 55 percent

resents the legal recognition of the carriers as a single carrier and is issued only after a rigorous demonstration of aligned operating procedures.

[25]See Dallas Morning News (2008) and NewsCut (2008).

[26]See Minneapolis Post (2013) and ABC (2015).

as of 2014.

The shares of low cost carrier passengers also experienced post-merger changes at the other hubs of Delta and Northwest. In Cincinnati, this share rose from 0.6 percent in 2008 to 7.5 percent in 2014. This coincided with a decrease in the new Delta's share of passengers from 42 percent in 2008 to 32 percent in 2014.[27] The low cost carrier share rose slightly in Detroit from 14 percent in 2008 to 17 percent in 2014. This share increase also accompanied a reduction in the share transported by the new Delta, which decreased from 64 percent in 2008 to 55 percent in 2014. This overall pattern was reversed in Atlanta and Salt Lake City, which experienced passenger share drops by low cost carriers and increases by the new Delta. As illustrated in Figure 1.1, the low cost carrier share dropped from 23 percent (2008) to 17 percent (2014) in Atlanta and from 22 percent (2008) to 18 percent (2014) in Salt Lake City. In contrast, the share of passengers for the new Delta increased from 62 percent (2008) to 76 percent (2014) in Atlanta and from 47 percent (2008) to 53 percent (2014) in Salt Lake City.

Other recent mergers also resulted in significant changes in the share of low cost carrier traffic. After the merger of Delta and Northwest, six of the remaining major carriers participated in mergers, including United and Continental in 2010, Southwest and AirTran in 2011, and American and US Airways in 2013. This consolidation has left four major domestic carriers including three legacy carriers: Delta, United-Continental, and American, as well as Southwest. Although Southwest is classified as a low cost carrier, it was the nation's fourth largest airline in terms of enplaned passengers as of 2015.

Table 1.1 shows the proportion of U.S. domestic markets that experienced legacy carrier and low cost carrier increases or decreases in the number of scheduled flights surrounding recent legacy carrier mergers.[28] As shown in Table 1.1, 41 percent, 14 percent,

[27]This represented a continuation of a general reduction of capacity by Delta since 2005.

[28]The total number of markets considered is 3540, which includes all markets formed by flights between the top 60 composite statistical areas in the United States by 2002 total passenger volume. See the Data section for details on sample selection.

and 20 percent of markets experienced both legacy carrier flight capacity decreases and low cost carrier flight capacity increases surrounding the Delta and Northwest, United and Continental, and American and US Airways mergers, respectively.

Legacy Carrier Capacity Change by Market (Pre to Post Merger)	Low Cost Carrier Capacity Change by Market (Pre to Post Merger)	Delta and Northwest Merger (Percent of Markets)*	United and Continental Merger (Percent of Markets)*	American and US Airways Merger (Percent of Markets)*
Increase	Decrease	5%	47%	20%
Increase	Increase	1%	4%	58%
Decrease	Decrease	52%	34%	2%
Decrease	Increase	**41%**	**14%**	**20%**

* Percent of 3540 markets created by the top 60 composite statistical areas in the United States by 2002 passenger volume. Computed using OAG data.

Table 1.1: Legacy Carrier and Low Cost Carrier Flight Capacity Increases and Decreases by Merger, Proportion of Markets

In the next sections, we explore the role of merger-induced changes in the incentives of Delta and Northwest to accommodate new entrants as determinants of Southwest Airline's expansion patterns.

1.3 Model

In this section, we characterize our model of airline competition, which involves a game between carriers played in two layers. The outer layer focuses on a capacity game between all U.S. carriers, where in each time period, carriers make simultaneous entry and capacity decisions in all U.S. domestic flight segments. A capacity allocation by the reference legacy carrier is constrained in the current period, since we assume its airline fleet remains fixed. This makes the legacy carrier's capacity responses to new entry a constrained reallocation of its currently available fleet across its U.S. domestic flight network. The inner layer assumes that carriers offer differentiated airline products in each market and compete by choosing prices. An important feature of this price competition is that it is conditional on the entry decisions and capacity allocations of all competitors in the market made in the outer layer, since the number of entrants and capacity allocations affect the price elasticity of demand for consumers in the market. This feature provides the mechanism for increasing competition on a flight segment, since an injection of capacity into a market typically lowers prices for all competitors. We first define some notation and concepts common to both stages and then describe the network-wide dynamic capacity game followed by the market-level pricing games.

1.3.1 Preliminaries

We establish some common terminology and notation used throughout the remainder of the chapter. As in Berry and Jia (2010), we define an airline market by a unidirectional origin and destination pair. For example, Cleveland to Denver represents a different market than Denver to Cleveland, which allows characteristics of the origin city to affect demand. Following Berry and Jia (2010), Berry, Carnall, and Spiller (BCS) (2007), and Berry, Levinsohn, and Pakes (1995) we assume each carrier offers a set of differentiated airline products, including nonstop and onestop flights.[29] We define each airline product by the following tuple: origin, destination, stop, and carrier.[30] This accommodates the introduction of many products by the carrier, including both onestop and nonstop flights, in a single market. Finally, we refer to a flight segment

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[29]Following Berry and Jia (2010), we exclude the possibility of more than one stop since the percentage of flights with these itineraries on our data is small. In the DB1B market database from 2005q4 to 2014q3, the average percentage of nonstop flights, onestop flights, and flights with more than one stop are: 42%, 53%, and 5%, respectively.

[30]Our product definition differs slightly from that of Berry and Jia (2010) in that we eliminate fare bins as an additional classifier of products. We do this primarily to avoid the potentially arbitrary choice of fare bins.

or segment as a bidirectional origin and destination pair. For instance, Cleveland to Denver represents the same segment as Denver to Cleveland. We make the distinction between markets and segments primarily to facilitate different choice variables between consumers and carriers.

We define a discrete but infinitive number of time periods, denoted as $t = 1, ..., \infty$, and a discrete and finite number of carriers, i.e. $f \in \mathcal{F} \equiv \{1, ..., F\}$ where $\mathcal{F}$ is the set of all carriers and F is the total number of carriers. The set of carriers not including a reference carrier f is denoted as $-f$, where $-f \equiv \{\neg (f \cap \mathcal{F})\}$, airline products are indexed by $j \in \{1, ..., J_{mt}\}$ where J_{mt} is the total number of products offered by all carriers in market m at time t, and each consumer is indexed by i. Markets are indexed by $m \in \{1, ..., M\}$, and bidirectional segments are indexed by $c \in \{1, ..., C\}$. Finally, we employ a simulation and estimation procedure in Section 1.5.3, which involves the generation of simulated data. We index each observation of simulated data by l.

1.3.2 Network-Wide Capacity Game

Game Overview

In the outer layer, we focus on the value of investing aircraft capacity around the U.S. domestic network of a reference legacy carrier f, given the competitive capacity and pricing responses of opponent carriers. For practicality, we use the number of flights as our unit of aircraft capacity. A legacy carrier's defense of a particular flight segment involves an increase in the number of flights it offers on the flight segment in the current period, followed by a return to its baseline strategy in subsequent time periods. To facilitate the increase in capacity, we assume the legacy carrier borrows aircraft (flights) utilized on other flight segments that it serves.[31] Opponent carriers react strategically

[31] An increase in capacity on a flight segment increases capacity in all markets the flight segment serves. For example, we assume an increase on the Chicago to MSP bidirectional flight segment increases capacity on nonstop flights from Chicago to MSP and MSP to Chicago, as well as all onestop flights with Chicago to MSP or MSP to Chicago as a connecting leg (such as Chicago to MSP to Seattle). See the online Appendix for details (available soon).

to both of these actions, and we assume the game is Markov in that only information contained in the current state matters. We describe this game formally in what follows.

States

The state vector, denoted as $\mathbf{s}_t$, is comprised of the total number of flights offered by all carriers in period t for each segment in the $C = 1770$ U.S. domestic segments considered,[32] i.e.

$$\mathbf{s}_t \equiv (s_{1t}, ..., s_{Ct}) \in \mathcal{S}_t \subseteq \mathbb{N}^C$$

where $s_{1t}, ..., s_{Ct}$ represents the total number of flights for each of the C segments at time t, $\mathcal{S}_t$ represents the support of $\mathbf{s}_t$, and $\mathbb{N}^C$ represents the C-ary Cartesian product over C sets of natural numbers $\mathbb{N}$. At time t, the state at time $t+1$ is random and is denoted as $\mathbf{S}_{t+1}$ with realization $\mathbf{S}_{t+1} = \mathbf{s}_{t+1}$.

We also define the dimension-reduced state vector that remains as a result of the Component-Wise Gradient Boosting (CWGB) estimation process described in Section 1.5.3. Define this state vector, denoted as $\widetilde{\mathbf{s}}_t$ for all t, as

$$\widetilde{\mathbf{s}}_t \equiv (s_{1t}, ..., s_{C_{CWGB}t}) \in \widetilde{\mathcal{S}}_t \subseteq \mathbb{N}^{C_{CWGB}}$$

where C_{CWGB} represents the number of state variables that remain after CWGB, such that $C_{CWGB} \leq C$. In practice, it is often the case that the dimension of $\widetilde{\mathbf{s}}_t$ is much smaller than the dimension of the original state vector $\mathbf{s}_t$, i.e. C_{CWGB} is much smaller than C, making the cardinality of $\widetilde{\mathcal{S}}_t$ much smaller than the cardinality of $\mathcal{S}_t$. This cardinality reduction plays an important role in reducing the computational burden of the counterfactual simulation detailed in Section 1.5.3.

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[32]See Section 1.4.2 for details on our sample selection process.

Actions

Define the number of flights offered by carrier f in period $t-1$ in each of the C segments as $\underline{\mathbf{a}}_{ft-1} \equiv \left(\underline{a}_{ft-11}, ..., \underline{a}_{ft-1C}\right) \in \underline{A}_{t-1} \equiv \mathbb{N}^C$. An action for carrier f at time t, denoted as $\Delta\mathbf{a}_{ft}$, is a vector of changes in the number of flights the carrier offers in each of the C segments considered, where negative changes cannot exceed the number of flights offered by the carrier in the previous period, i.e.

$$\Delta\mathbf{a}_{ft} \equiv (\Delta a_{f1t}, ..., \Delta a_{fCt}) \in \Delta\mathcal{A}_{ft} \equiv \mathbb{Z}^C$$

such that $\Delta a_{fct} + \underline{a}_{fct-1} \geq 0$ for all segments c. Similarly, actions for the competitors of the reference legacy carrier at time t represent the vector of changes in the number of nonstop flights offered by each carrier in each segment, where negative changes cannot exceed the number of flights offered by the carrier in the previous period, i.e.

$$\Delta\mathbf{a}_{-ft} \in \Delta\mathcal{A}_{-ft} \equiv \mathbb{Z}^{C*(F-1)}$$

such that $\Delta a_{fct} + \underline{a}_{fct-1} \geq 0$ for all c and $f \in -f$.

As with the state vector, we also define the dimension-reduced action vector for carrier f that remains as a result of the CWGB estimation process described in Section 1.5.3. Define this action vector, denoted as $\Delta\widetilde{\mathbf{a}}_{ft}$ for all t, as

$$\Delta\widetilde{\mathbf{a}}_{ft} \equiv (\Delta a_{f1t}, ..., \Delta a_{fC_{CWGB}t}) \in \Delta\widetilde{\mathcal{A}}_{ft} \subseteq \Delta\mathcal{A}_{ft}$$

such that $\Delta a_{fct} + \underline{a}_{fct-1} \geq 0$ for all segments c represented in the dimension-reduced vector. The action vector $\Delta\widetilde{\mathbf{a}}_{ft}$ often has many fewer action variables than the full vector $\Delta\mathbf{a}_{ft}$.

Period Return

In each period t, each carrier's segment-level operating profits are given by the function:

$$\pi_{fct}\left(s_{ct}, \Delta a_{fct}, \Delta a_{-fct}, \mathbf{z}_{ct}\right) + \mu_{fct}$$

where μ_{fct} is an unobserved random segment and airline-specific profit shifter which is independent across segments, and $\mathbf{z}_{ct}$ represents a set of observable segment-level characteristics with the collection of these characteristics across segments denoted as $\mathbf{z}_t = (\mathbf{z}_{1t}, ..., \mathbf{z}_{Ct})$. We abuse notation by suppressing the dependence of profits on a set of parameters. The vector $\mathbf{z}_{ct}$ and profit parameters are further described in Section 1.3.3. Denote the vector of profit shifters across all markets as $\mu_{ft} \equiv (\mu_{f1t}, ..., \mu_{fCt}) \in \Theta \subseteq \mathbb{R}^C$, where Θ is it's support. Operating profits are a function of the current capacity levels for all carriers in segment c and period t. We assume $\pi_{fct}(.) = 0$ for all segments where the carrier offers zero flights and specify $\pi_{fct}(.)$ in more detail in Section 1.3.3.

We assume that total national operating profits for carrier f in time t are additively separable functions of states, actions, segment characteristics, and profit shifters across markets such that:

$$\pi_f\left(\ \mathbf{s}_t, \Delta\mathbf{a}_{ft}, \Delta\mathbf{a}_{-ft}, \mathbf{z}_t, \mu_{ft}\right) = \sum_{c=1}^{C} \pi_{fct}\left(\ s_{ct}, \Delta a_{fct}, \Delta a_{-fct}, \mathbf{z}_{ct}\right) + \mu_{fct}$$

These are a function of the total number of flights for all carriers in each market, the changes in the number of flights chosen by all carriers, observable segment-level characteristics across all segments, the unobserved profit shifters, and the set of parameters.

Strategies

We assume that carriers choose capacity levels simultaneously at each time t. A nationwide strategy for carrier f is a vector-valued function $\Delta\mathbf{a}_{ft} = \delta_f\left(\mathbf{s}_t, \mathbf{z}_t, \mu_{ft}\right)$, which maps current capacity levels, segment characteristics, and profit shifters in all segments at time t to carrier f's time t action vector $\Delta\mathbf{a}_{ft}$. From the perspective of all other carriers $-f$, carrier f's policy function as a function of the state is random. We define the conditional probability mass function corresponding to the strategy function of carrier f as:

$$\sigma_f\left(\Delta\mathbf{A}_{ft} = \Delta\mathbf{a}_{ft}|\mathbf{s}_t, \mathbf{z}_t\right) \equiv \int \mathbb{I}\left\{\delta_f\left(\mathbf{s}_t, \mathbf{z}_t, \mu_{ft}\right) = \Delta\mathbf{a}_{ft}\right\} dF\left(\mu_{ft}\right) \tag{1.1}$$

where $dF\left(\mu_{ft}\right) = f\left(\mu_{ft}\right) d\mu_{ft}$, $F\left(\mu_{ft}\right)$ and $f\left(\mu_{ft}\right)$ represent the joint cdf and pdf of μ_{ft}, respectively, and $\Delta\mathbf{A}_{ft}$ is a random variable with support $\Delta\mathcal{A}_t$ and realization $\Delta\mathbf{a}_{ft}$. Further, we denote the joint conditional probability mass function for the strategy functions of all carriers $-f$ at time t as $\sigma_{-f}\left(\Delta\mathbf{A}_{-ft} = \Delta\mathbf{a}_{-ft}|\mathbf{s}_t, \mathbf{z}_t\right)$, where $\Delta\mathbf{A}_{-ft}$ is a random vector with support $\Delta\mathcal{A}_{-ft}$ with realization $\Delta\mathbf{a}_{-ft}$. Abusing notation, we often abbreviate $\sigma_f\left(\Delta\mathbf{A}_{ft} = \Delta\mathbf{a}_{ft}|\mathbf{s}_t, \mathbf{z}_t\right)$ as σ_f and $\sigma_{-f}\left(\Delta\mathbf{A}_{-ft} = \Delta\mathbf{a}_{-ft}|\mathbf{s}_t, \mathbf{z}_t\right)$ as $\sigma_{-f}\left(\Delta\mathbf{a}_{-ft}|\mathbf{s}_t, \mathbf{z}_t\right)$.

Our data lacks the degrees of freedom necessary for reliably estimating nation-wide strategy functions, as described in Section 1.5. This is because nation-wide strategy functions are a function of capacity levels in all segments, and to estimate these we are left using only variation by time, which leaves us with only forty observations (forty quarters) to estimate a function with more than 1770 regressors. We therefore define "local" carrier strategy functions, which are local to each particular segment. Aguirregabiria and Ho (2012) and Benkard, Bodoh-Creed, and Lazarev (2010) follow similar strategies when confronting the degrees of freedom shortage inherent in commonly used airline data. [33]

[33] In particular, the U.S. Department of Transportation, Bureau of Transportation Statistics, provides rich and commonly used datasets, including the T100 and DB1B databases, which we make use of in this chapter. The T100 databases provide either segment-level or market-level domestic data on all passenger enplanements in the U.S. since 1993 for reporting carriers. Reporting carriers include all carriers with gross revenues greater than $20 million. The DB1B databases provides data on fares and other characteristics for a 10 percent sample of all tickets sold in the U.S. since 1993 for reporting carriers, which represents all major carriers in the U.S. Although these datasets are large and comprehensive, the degrees of freedom shortage arises when attempting to propose and estimate explicitly network-wide models of airline competition. This is because each provides data at the monthly frequency (T100) or the quarterly frequency (DB1B). For example, from 1993 to 2014, the T100 database provides monthly data for at most 264 monthly samples, while the DB1B database provides quarterly data for at most 88 quarterly samples. Without using cross-sectional differences among different segments and markets in each carrier's network, each time period provides, at the extreme, one observation of each carrier's network choice. Since these networks are often made up of thousands of segments and markets, researchers have made use of cross-sectional differentiation by estimating "local" carrier strategy functions. Overall, we utilize local strategy

Define the conditional probability mass function for the local strategy function for carrier f, denoted as $\sigma_f \left(\Delta A_{fct} = \Delta a_{fct} | s_{ct}, \mathbf{z}_{ct}\right)$, such that:

$$\sigma_f \left(\Delta A_{fct} = \Delta a_{fct} | s_{ct}, \mathbf{z}_{ct}\right) = \int \mathbb{I} \left\{\delta_f \left(s_{ct}, \mathbf{z}_{ct}, \mu_{fct}\right) = \Delta a_{fct}\right\} dF\left(\mu_{fct}\right) \tag{1.2}$$

where $dF\left(\mu_{fct}\right) = f\left(\mu_{fct}\right) d\mu_{fct},\ F\left(\mu_{fct}\right)$ and $f\left(\mu_{fct}\right)$ represent the cdf and pdf of μ_{fct}, respectively, and ΔA_{fct} is a random variable with a support of the set of integers $\mathbb{Z}$.

Finally, for estimation purposes, we define two specifications for local carrier strategies, one for flight capacity choice and another for entry. For the first specification, we assume local flight capacities are an additively separable linear functions of the profit-shifter μ_{fct}, i.e.

$$\Delta a_{fct} = \left(s_{ct}, \mathbf{z}_{ct}\right) \vartheta_f^{cap} + \mu_{fct} \tag{1.3}$$

where ϑ_f^{cap} is a vector of parameters to be estimated and we assume μ_{fct} is iid across segments and time.

We assume local entry strategies take the familiar probit model form:

$$\Pr\left(\mathbb{I}\left(\Delta a_{fct} + \underline{a}_{fct-1} > 0\right) = 1 | s_{ct}, \mathbf{z}_{ct}\right) = \Phi\left(\left(s_{ct}, \mathbf{z}_{ct}\right) \vartheta_f^{entry}\right)$$

where $\Pr\left(.\right)$ represents the probability of positive capacity in segment c, conditional on $s_{ct}, \mathbf{z}_{ct},\ \vartheta_f^{entry}$ is a vector of parameters to be estimated, and Φ represents the cumulative distribution function for the standard normal distribution.

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functions but overcome the degrees of freedom shortage when estimating the value of network-wide capacity reallocation through extensive simulation and data-driven state variable selection. See the Estimation section for details.

Value Function and Choice-Specific Value Function

Value Function. Let β be a common discount factor. We define the following *ex ante* value function for carrier f at time t,

$$V_f\left(\mathbf{s}_t, \mathbf{z}_t\right) \equiv$$
$$\int \max_{\Delta \mathbf{a}_{ft} \in \Delta \mathcal{A}_{ft}} \left\{ \sum_{\Delta \mathbf{a}_{-ft} \in \Delta \mathcal{A}_{-ft}} \begin{pmatrix} \pi_f\left(\mathbf{s}_t, \Delta \mathbf{a}_{ft}, \Delta \mathbf{a}_{-ft}, \mathbf{z}_t, \mu_{ft}\right) + \\ \beta \mathbb{E}_{\mathbf{s}_{t+1}, \mu_{ft+1}} \left[V_f(\mathbf{s}_{t+1}, \mathbf{z}_{t+1}, \mu_{ft+1}) | \mathbf{s}_t, \mathbf{z}_t, \Delta \mathbf{a}_{-ft} \right] \end{pmatrix} \atop * \sigma_{-f}\left(\Delta \mathbf{a}_{-ft} | \mathbf{s}_t, \mathbf{z}_t\right) \right\} dF\left(\mu_{ft}\right) \tag{1.4}$$

where it is assumed carrier f makes the maximizing choice $\Delta \mathbf{a}_{ft}$ in each period and that the value function is implicitly indexed by the profile of policy functions for all carriers. The expectation $\mathbb{E}_{\mathbf{s}_{t+1}, \mu_{ft+1}}$ is taken over all realizations of the states and unobserved private shocks for carrier f in all time periods beyond time period t.

Choice-Specific Value Function: We define the following *ex ante* choice-specific value function for carrier f as:

$$V_f\left(\mathbf{s}_t, \mathbf{z}_t, \Delta \mathbf{a}_{ft}\right) \equiv$$
$$\int \left\{ \sum_{\Delta \mathbf{a}_{-ft} \in \Delta \mathcal{A}_{-ft}} \begin{pmatrix} \pi_f\left(\mathbf{s}_t, \Delta \mathbf{a}_{ft}, \Delta \mathbf{a}_{-ft}, \mathbf{z}_t, \mu_{ft}\right) + \\ \beta \mathbb{E}_{\mathbf{s}_{t+1}} \left[V_f(\mathbf{s}_{t+1}, \mathbf{z}_{t+1}, \mu_{ft+1}) | \mathbf{s}_t, \mathbf{z}_t, \Delta \mathbf{a}_{ft}, \Delta \mathbf{a}_{-ft} \right] \end{pmatrix} \atop * \sigma_{-f}\left(\Delta \mathbf{a}_{-ft} | \mathbf{s}_t, \mathbf{z}_t\right) \right\} dF\left(\mu_{ft}\right)$$

The choice-specific value function for carrier f represents the expected total national profits of choosing a particular vector of capacity changes, conditional on the vector of current capacity levels, the vector of capacity choices for competitors $-f$.

1.3.3 Price Competition

Unless otherwise noted, we follow the structural consumer demand and product supply model of Berry and Jia (2010) closely. For completeness, we restate their model and follow their notation as closely as possible to facilitate transparency.

Demand

The demand model is a version of the random coefficients model, employed by Berry and Jia (2010) and Berry, Carnall, and Spiller (BCS) (2007), in the spirit of McFadden (1981) and Berry, Levinsohn, and Pakes (1995). In this model, we assume there are two types of customers, denoted by r, which are classified as business and leisure travelers, respectively.

The utility function for consumer i, who is of type r, of consuming product j in market m and time t is given by:

$$u_{ijt} = x_{jmt}\kappa_{rt} - \alpha_{rt}p_{jmt} + \xi_{jmt} + \nu_{imt}(\lambda_t) + \lambda_t\epsilon_{ijmt} \tag{1.5}$$

Here, x_{jmt} is a vector of product characteristics. The first is the number of connections for a round-trip flight, i.e. zero for a nonstop flight or two for a onestop flight. In general, it is well-documented that consumers prefer nonstop to onestop flights, all else equal. The second characteristic is the number of cities served by the carrier at the destination city, which is intended to capture differences in the value of loyalty programs and the convenience of gate access. For example, a carrier serving more cities from the destination is likely to offer a more extensive and valuable frequent flyer program and more convenient gate access. The third characteristic is the average number of departures corresponding to the product during the quarter, which is intended to capture preferences over flight frequency. The fourth and fifth characteristics are the distance between the origin and destination as well as the distance squared, since air travel demand is usually U-shaped in distance. Flights with shorter distances compete with ground transportation, lowering demand. As distance increases, ground transportation becomes less viable as an alternative, increasing demand, although at longer distances flights become more inconvenient and demand weakens. The sixth and seventh characteristics include whether the origin or destination represents an area frequented by tourists (Florida or Las Vegas), since these areas tend to have unique demand patterns, and whether either the origin or destination city includes a slot controlled airport. We also add carrier dummies for nine carriers and an "other" category.[34]

Additional components of the utility function specified in 1.5 include: κ_{rt}, which represents a vector of "tastes for characteristics" for consumers of type r at time t, α_{rt} which represents the marginal disutility of a price increase for consumers of type r at time t, and p_{jmt}, which represents is the product price. The parameter ξ_{jmt} represents the average effect of characteristics of product j unobserved to the econometrician and is specific to market m and time t. This parameter is important in the airline context, since it helps account for unobserved characteristics such as ticket restrictions, the date and time of ticket purchase and departure (at a frequency higher than quarterly), and service quality. Berry and Jia (2010), and Berry, Carnall, and Spiller (2007) highlight the importance of accounting for these characteristics when estimating demand parameters associated with observable characteristics. The parameter ν_{imt} is a nested logit random taste that is constant across airline products within a market m and time t and differentiates airline products from the outside good. The parameter λ_t is the nested logit parameter that varies between 0 and 1 and captures the degree of product substitutability, where $\lambda_t = 0$ means that all products in capacity bin c and time period t are perfect substitutes and $\lambda_{ct} = 1$ makes the nested logit a simple multinomial logit. The parameter ϵ_{ijmt} is a logit error which we assume is identically and independently distributed across products, consumers, markets, and time. The utility of the outside good is given by $u_{iot} = \epsilon_{i0mt}$, where ϵ_{i0mt} is another logit error. We assume that the error structure $\nu_{imt}(\lambda_t) + \lambda_t \epsilon_{ijmt}$ follows the distributional assumptions necessary to generate the purchase probability of the nested logit for consumers of type r, where the nests consist of airline products and the outside good. Finally, as in the primary

[34] These include American, Alaska, JetBlue, Continental, Delta, Northwest, US Airways, United, Southwest, and Other.

specification of Berry and Jia (2010), we define two types of consumers within the nested logit specification: business travelers and tourists.

This model implies that for a market of size D_m, where D_m is the total number of passengers purchasing products in market m, the market share demand function for product j in market m at time t takes the form:

$$ms_{jmt}\left(\mathbf{x}_{mt}, \mathbf{p}_{mt}, \xi_{mt}; \theta^d_{rt}\right) \equiv$$
$$\sum_r \gamma_{rt} \frac{e^{(x_{jmt}\kappa_{rt} - \alpha_{rt} p_{jmt} + \xi_{jmt})/\lambda_t}}{\left(\sum_{k=1}^{J_{mt}} e^{(x_{kmt}\kappa_{rt} - \alpha_{rt} p_{kmt} + \xi_{kmt})/\lambda_t}\right)} \left(\frac{\left(\sum_{k=1}^{J_{mt}} e^{(x_{kmt}\kappa_{rt} - \alpha_{rt} p_{kmt} + \xi_{kmt})/\lambda_t}\right)^{\lambda_t}}{1 + \left(\sum_{k=1}^{J_{mt}} e^{(x_{kmt}\kappa_{rt} - \alpha_{rt} p_{kmt} + \xi_{kmt})/\lambda_t}\right)^{\lambda_t}} \right)$$

where $\theta^d_{rt} \equiv (\kappa_{rt}, \alpha_{rt}, \lambda_t, \gamma_{rt})$ is the vector of demand parameters to be estimated specific to time period t, and γ_{rt} is the proportion of consumer-type r at time period t. The vectors $\mathbf{x}_{mt} \equiv (x_{1mt}, ..., x_{J_{mt}mt})$, $\mathbf{p}_{mt} \equiv (p_{1mt}, ..., p_{J_{mt}mt})$, and $\xi_{mt} \equiv (\xi_{1mt}, ..., \xi_{J_{mt}mt})$ collect all product-level characteristics, prices, and unobserved attributes within each market m at time t.

Marginal Costs

We follow Berry and Jia (2010) and propose a linear specification for the marginal costs associated with product j and market m at time t:

$$mc_{jt} = w_{jmt}\theta^{mc}_{rt} + \omega_{jmt} \tag{1.6}$$

where w_{jmt} is a vector of observed cost shifters in time period t, θ^{mc}_{rt} is a vector of cost parameters specific to time t (to be estimated), and ω_{jmt} is an unobserved cost shock.

As in Berry and Jia (2010), the vector of observed cost shifters w_{jmt} contains a set of carrier dummies, a constant, the distance between the origin and destination, and the number of connections (zero for nonstop flights and two for onestop flights), which are defined separately for short haul (shorter than 1500 miles) and long haul flights (with the exception of the carrier dummies). We distinguish short haul and long haul flight parameters to accommodate differences in cost structures between them. For example, short haul flights often utilize smaller planes and provide fewer amenities. The number of connections variable is added to detect differences in costs between onestop and nonstop flights. As documented by Berry and Jia (2010), hub carriers often use onestop flights to generate cost economies per passenger by channeling passengers from a wide variety of origins to a wide variety of destinations through their hub and spoke network. The effect of stops on marginal costs is ambiguous *a priori*, however, since planes consume a large fraction of fuel during takeoffs and landings, and these costs may offset any economies achieved through hub and spoke routing. For instance, Berry and Jia (2010) found that the effect of connections on marginal costs changed sign from 1999 to 2006 (from negative to positive), which they speculated was due to increased fuel costs in 2006.

Product-Market Equilibrium

We assume each carrier offers one or more airline products in each of the markets it serves. We make the following additional assumptions.

Assumption 1 (Timing). At a given time t, carriers make capacity decisions prior to choosing prices.

Assumption 2 (Market-Level Profits). Market-level profits take the following form:

$$\pi_{fmt} = \sum_{j \in \mathcal{T}_{fm}} (p_{jmt} - mc_{jmt}) ms_{jmt} \left(\mathbf{x}_{mt}, \mathbf{p}_{mt}, \xi_{mt}; \theta^{d}_{rt} \right) D_m \tag{1.7}$$

where $\mathcal{T}_{fm}$ is the set of products produced by carrier f in market m and mc_{jmt} is the marginal cost associated with providing airline product j in market m and time t.

Assumption 3 (Bertrand-Nash Equilibrium). Conditional on the number of flights chosen by the carrier in the first stage, each carrier maximizes market-level profits by choosing prices. Prices in each market m and time t are generated by a separate Nash equilibrium among carriers offering multiple products.

Assumptions 1 and 3 ensure that, conditional on capacity levels chosen by the carriers in the outer layer, carriers solve for profit-maximizing prices by market in the inner layer. These choices can be made separately from capacity allocations made in the outer layer. Assumption 3 implies that, for each market m and time t, carriers choose prices for the products offered in market m that solve the system of equations created by the following J_{mt} first order conditions:

$$\mathbf{P}\begin{bmatrix} p_{1mt} - mc_{1mt} \\ ... \\ p_{J_{mt}mt} - mc_{J_{mt}mt} \end{bmatrix} = \begin{bmatrix} 0 \\ ... \\ 0 \end{bmatrix} \tag{1.8}$$

where,

$$\mathbf{P} \equiv \begin{bmatrix} 1 & ms_{1mt}\left(\mathbf{x}_{mt}, \mathbf{p}_{mt}, \xi_{mt}; \theta^d_{rt}\right) & \frac{\partial ms_{1mt}\left(\mathbf{x}_{mt}, \mathbf{p}_{mt}, \xi_{mt}; \theta^d_{rt}\right)}{\partial p_{1mt}} & ... & \frac{\partial ms_{J_{mt}mt}\left(\mathbf{x}_{mt}, \mathbf{p}_{mt}, \xi_{mt}; \theta^d_{rt}\right)}{\partial p_{1mt}} \\ ... & & & & \\ 1 & ms_{J_{mt}mt}\left(\mathbf{x}_{mt}, \mathbf{p}_{mt}, \xi_{mt}; \theta^d_{rt}\right) & \frac{\partial ms_{1mt}\left(\mathbf{x}_{mt}, \mathbf{p}_{mt}, \xi_{mt}; \theta^d_{rt}\right)}{\partial p_{J_{mt}mt}} & ... & \frac{\partial ms_{J_{mt}mt}\left(\mathbf{x}_{mt}, \mathbf{p}_{mt}, \xi_{mt}; \theta^d_{rt}\right)}{\partial p_{J_{mt}mt}} \end{bmatrix}$$

We use the system of equations represented by 1.8 to solve for marginal costs, as described in Section 1.5.2.

1.4 Data

1.4.1 Sources

We utilize data on unidirectional fares paid for airline tickets (along with other ticket characteristics), scheduled flights, and overall passenger travel statistics on the U.S. domestic network.

For data on unidirectional fares and other airline ticket characteristics, we use publicly available data from the Airline Origin and Destination Survey, Market Database (DB1B market database) provided by the United States Department of Transportation, Bureau of Transportation Statistics (BTS). The DB1B market database provides a quarterly ten percent random sample of all domestic origin and destination itineraries (origin, destination, and stop) purchased from reporting carriers in the United States and is available electronically for data spanning 1993 to the present period. The data contains, *inter alia*, information on flight fares, the number sampled passengers traveling under the itinerary at the given fare, and the ticketing and operating carriers for each flight segment.

For scheduled flights, we use proprietary data from OAG, the industry leading provider of airline schedule data. This database contains information on all scheduled commercial flights in the U.S. domestic market since 2005, including the scheduled flight date and time, the type of aircraft used, and characteristics of the aircraft including the maximum allowed weight capacity and aircraft range.

Finally, we add data on segment passengers obtained from the publicly available Air Carrier Statistics database (for segment traffic), also known as the T100 segment database, also available from the BTS. This database contains monthly data on enplaned passengers for each route segment flown by all reporting U.S. carriers.[35]

1.4.2 Sample Selection

Fares and Ticket Characteristics. From the DB1B Market database, we collect quarterly data from 2005q1 to 2014q4, for two reasons. First, since we seek to estimate entry and capacity strategy functions for carriers relevant to time periods near the most recent wave of mergers (primarily, 2008 to 2013), we follow Benkard, Bodoh-Creed, and Lazarev (2010) and view data from 2000 to 2003 as unrepresentative for estimating

[35] Reporting U.S. carriers include those with greater than $20 million in gross revenue.

current carrier strategies. This is due to the eccentricities of the demand and regulatory climate immediately following the collapse of the dot-com bubble and terrorist attacks of September, 11, 2001. We view data prior to 2000 in a similar light. Second, our dataset on airline schedules (described next), which we rely upon to estimate and simulate capacity reallocations, is unavailable prior to 2005q1. Although more recent data likely captures carrier strategies more reliably, a consequence of beginning in 2005q1 is that we have only one quarter of data (2005q1) to estimate the strategy functions of carriers prior to the America West and US Airways merger, which was announced in 2005q2, and which we view as insufficient. We therefore consider only the changes in predatory incentives due to the legacy carrier merger: Delta and Northwest (2008).

We filter the sample in various ways. First, we follow Benkard, Bodoh-Creed, and Lazarev (2010) and aggregate airports by Composite Statistical Areas (CSA's) where possible and Metropolitan Statistical Areas (MSA's) otherwise. For example, Dallas-Fort Worth international airport and Dallas Love Field airport are grouped into the Dallas-Ft. Worth CSA.[36] This aggregation abstracts from carrier competition between airports within a given CSA, since consumers likely view flights to or from nearby airports within a CSA as substitutes. Further, we keep only itineraries including an origin, destination, and stop airport from the top seventy-five airports by 2002 enplaned passenger traffic.[37] These top seventy-five airports aggregate to sixty CSA's, which generate $60 * 59 = 3540$ markets and 1770 bidirectional segments. We focus on these markets and segments in our estimation and simulation exercises.

As introduced in Section 1.3.1, we define an airline product as an origin, stop, destination, and carrier tuple. For example, a onestop American Airlines flight from

[36]See the Appendix, Table A.1, for a table of the CSA's and airports used.

[37]We obtained the top 75 airports by 2002 enplaned passenger traffic from the T100 Market database, limiting the sample to purely domestic flights, and aggregating passenger volume by origin city. The top 60 CSA's in this ranking correspond to the top 75 airports listed in Appendix Table A.5. This table lists the cities and airports studied in our sample.

Atlanta to Austin through Nashville is a different product than an American Airlines flight from Atlanta to Austin through Dallas. This results in roughly 700 thousand products per quarter. We eliminate all itineraries with fares smaller than $50, since these fares are likely to correspond to itineraries purchased by redeemed frequent flyer miles. We identify nine legacy and low-cost carriers within our sample and group all others into a tenth group labeled "Other." This results in ten carriers including: American, Alaska, JetBlue, Continental, Delta, Northwest, United, US Airways, Southwest, and Other.

Scheduled Flights. Our OAG sample includes, for the second Thursday of each month (with exceptions) from January of 2005 to December of 2014, every scheduled flight with a U.S. origin or destination. We use Thursdays because they typically represent unremarkable travel days along with Tuesdays and Wednesdays, with weekly travel typically rising on Fridays, Saturdays, and Sundays. For Thursdays that fall on holidays or other remarkable events, we sample either the first or third Thursday of the month. Appendix # includes the full list of days included in the sample. As with the DB1B data, we keep only scheduled flights between the top sixty CSA's based on 2002 enplaned passengers.

Segment and Market Passengers. From the T-100 segment and market databases we retain the number of enplaned passengers per quarter and operating carrier from 2005q1 to 2014q4 for the top seventy-five airports (top sixty CSA's) as chosen by enplaned passenger traffic in 2002.

1.4.3 Data Summary

The raw DB1B market dataset from 2005q1 to 2014q4, where each observation represents a unique itinerary and fare pair, consists of roughly 3.3 million observation per quarter or 128.1 million total observations. This dataset is aggregated to the product level, i.e. to unique origin, stop, destination, carrier and year/quarter tuples, and sampled as described in the previous section. The resulting dataset consists of roughly 230 thousand observations per quarter, or 9.1 million observations total. Finally, for the simulation, we create a template dataset of all *possible* products created by the top 60 CSA's, resulting in 12.6 million observations per quarter, or 492.1 million observations over all time periods. We populate this template dataset with actual data from the aggregated DB1B market database as well as flight capacity and aircraft data from OAG. The raw OAG data consists of nearly 196 thousand observations per quarter for a total of 7.7 million observations over all time periods, where each observation represents a scheduled flight. We aggregate this data to the origin, destination, and carrier level, resulting in between 2000 and 3540 observations per quarter and carrier, depending on the size of each carrier's network.

From these initial aggregated datasets we create several variables to carry out both the price competition and capacity game parameter estimation processes. Table 1.2 lists descriptive statistics for the variables used in our price competition estimation exercise. The average product share in each market is small at 4.9 percent, with an average of 22 products per market. Average fares per product are $228.44 with a standard deviation of $149.47. The flights served in our sample have an average distance between the origin and destination of 1776 miles and serve origins and destinations with average populations of 3.7 million people. Thirty-five percent of our sample consists of nonstop flights, with the remainder consisting of onestop flights. Table 1.2 also presents averages, standard deviations, and min and max values for a variety of other variables in our sample.[38]

[38]This includes the average number of round-trip connections for each flight (Num. of Connections), the number of cities served by nonstop flights provided by any carrier from the origin or destination, the number of routes (origin, destination, and connection) within each market, on average (Num. of Routes in a Market), the average number of carriers in each market (Num. Carriers by Market), and the average number of low cost carriers by market (Num. Low Cost Carriers by Market). It presents the number of departures by product (Num. Departures), the average population for each origin and destination pair (Population by Market), the average population for the origin and destination separately (Origin, Destination Population), the average number of passengers flying to or from the destination or origin in a given year and quarter (Origin, Destination Passengers), the average share of passengers transported by any carrier from the origin or destination (Carrier's Share of Origin, Destination Passengers), the percentage of flights with up to 15 and 30 minute

Statistic	Mean	St. Dev.	Min	Max
Product Share	0.05	0.12	0.00	1.00
Fare	228.44	149.47	1.11	3625.07
Distance	1775.67	926.51	73.70	7424.45
Num. of Connections	1.87	0.50	0.00	2.00
Num. of Cities with Non-Stop Flight from Dest.	20.30	15.82	0.00	57.00
Num. of Cities with Non-Stop Flight from Origin	22.15	16.67	0.00	57.00
Num. of Routes in a Market	26.03	17.51	0.00	130.00
Num. of Carriers in a Market	6.54	1.44	0.00	9.00
Num. of Low Cost Carriers in a Market	0.86	0.67	0.00	2.00
Num. of Departures	44.56	210.47	0.01	12002.49
Num. of Seats	114.25	40.63	0.00	328.11
Population by Market (millions)	3.75	2.74	0.26	15.87
Origin Population (millions)	3.83	3.94	0.14	18.97
Destination Population (millions)	3.69	3.86	0.14	18.97
Origin Passengers (millions)	0.18	0.15	0.01	0.53
Destination Passengers (millions)	0.18	0.15	0.01	0.53
Carrier's Share of Origin Passengers	0.17	0.17	0.00	0.78
Carrier's Share of Destination Passengers	0.16	0.16	0.00	0.77
Share of Flights with up to 15-minute Delays	0.15	0.16	0.00	1.00
Share of Flights with up to 30-minute Delays	0.21	0.19	0.00	1.00
Share of Flights Operated by Commuter Airlines	0.32	0.39	0.00	1.00
Share of Non-Stop Flights	0.35	0.32	0.00	1.00
Share of Flights Originating from Hubs	0.13	0.19	0.00	0.98
Share of Flights Arriving in Hubs	0.15	0.22	0.00	0.99
Origin Hub Dummy	0.14	0.35	0.00	1.00
Connecting Hub Dummy	0.39	0.49	0.00	1.00
Destination Hub Dummy	0.10	0.30	0.00	1.00
Low Cost Carriers Dummy	0.16	0.37	0.00	1.00
FL or Las Vegas Dummy	0.23	0.42	0.00	1.00
Slot-Controlled Airport Dummy	0.21	0.43	0.00	2.00

Table 1.2: Price Competition Variables Summary

We present descriptive statistics for variables used in the entry and capacity specifications of the capacity game estimation process in Table 1.3. Many of these variables

delays, the percentage of flights operated by commuter airlines, the percentage of nonstop flights, and the percentage of flights that originate or arrive at hubs. It also shows averages for a variety of dummies.

describe characteristics of segments similar to those in the price competition specification, including characteristics of the origin and destination, characteristics related to flight distance, and competition characteristics at the segment level.[39]

Statistic	Mean	St. Dev.	Min	Max
Origin Pop * Destination Pop (trillion)	7.43	14.25	0.05	242.20
Log 2002 Passenger Density	8.32	4.39	0.00	15.29
Num. of Non-Stop Competitors	1.85	2.09	0.00	10.00
Num. of Hubs	2.36	1.43	0.00	5.00
Average Closest Hub Distance	1991.78	2249.40	0.00	10320.43
Carrier's Flight Capacity	63.36	254.33	0.00	11629.00
Dummy for Carrier's Segment Entry	0.17	0.37	0.00	1.00
Origin Hub Dummy	0.04	0.20	0.00	1.00
Destination Hub Dummy	0.04	0.19	0.00	1.00
Dummy for Distance > 250 Miles	0.95	0.21	0.00	1.00
Dummy for Distance > 500 Miles	0.84	0.37	0.00	1.00
Dummy for Distance > 1000 Miles	0.58	0.49	0.00	1.00
Dummy for Distance > 1500 Miles	0.37	0.48	0.00	1.00
Dummy for Distance > 2000 Miles	0.22	0.42	0.00	1.00
Dummy for Distance > 2500 Miles	0.11	0.32	0.00	1.00

Table 1.3: Entry and Capacity Variables Summary

[39]These variables include an interaction between the origin and destination population, multiplied by $1 \times e^{-12}$ (Origin Pop * Destination Pop), the log of the number of passengers served on the bidirectional segment in 2002 (Log 2002 Passenger Density), the number of carriers providing a nonstop flight in the market (Num. of Non-Stop Competitors), the average number of hubs operated by each carrier around its entire domestic flight network (Num. of Hubs), the average distance from the origin and destination to the closest hub operated by each carrier (Average Closest Hub Distance), the average number of flights offered by each carrier by segment (Carrier's Flight Capacity), and the average for an indicator determining whether each carrier offers any flights in the current time period on each segment (Dummy for Carrier's Segment Entry). Further, it provides averages for a series of dummy variables describing whether the carrier operates a hub on the origin or destination, as well as whether the segment flight distance is longer than a reference number of miles.

1.5 *Identification and Estimation*

1.5.1 Overview

Estimation Steps

Our estimation procedure involves two stages. In the first stage, we estimate the parameters of the discrete choice demand system as implemented by Berry and Jia (2010), which is a form of the estimation procedure for differentiated products markets proposed by Berry, Levinsohn, and Pakes (1995). We use these parameters along with the assumption that firms choose prices to maximize market-level profits given the prices chosen by other firms in the market, i.e. Assumptions 1, 2, and 3 stated in Section 1.3.3, to back out implied marginal costs by product. These marginal costs serve as the outcome variable in a subsequent regression of marginal costs on product features as specified in Section 1.3.3, where we use the estimation algorithm of Berry and Jia (2010) to accommodate the presence of unobserved cost variables in the model. Also in the first stage, we estimate reduced-form models of carrier segment entry and flight capacity choice strategies as functions of observable covariates.

The first stage estimation process allows us to recover realized profits by product. However, our second stage seeks to estimate the value of both realized and *counterfactual* capacity allocations. This requires a method for computing the prices that would arise given counterfactual entry and capacity allocations. In principle, this can be achieved by solving for optimal prices by market for each simulated counterfactual entry and capacity choice using the demand parameters estimated in the first stage and the first order conditions specified in equations 1.8. However, as documented in Snider (2009), this is computationally intensive. We instead follow Snider (2009) and parameterize the profit function, estimating the reduced-form relationship between realized profits and a set of observable product characteristics. We use this profit model to generate counterfactual profits by product in our second stage estimation process.

In the second stage, we estimate the choice-specific value for a reference legacy carrier of aircraft capacity (number of flights) changes around its U.S. domestic network, conditional on the competitive responses of opponent carriers. This involves a simulation and estimation procedure, where we use the models estimated in the first stage to simulate play in response to legacy carrier flight segment capacity changes for many periods. We use this simulated sample to estimate the choice-specific value of reallocating capacity from each of the flight segments the legacy carrier serves. We condition the choice-specific value function explicitly on network-wide characteristics, including existing capacity levels in each segment in our U.S. domestic flight sample, as well as the capacity allocation of the legacy carrier. This generates choice-specific value function models with many state variables, and we seek to reduce the dimensionality of these estimated functions in order to make our counterfactual exercises computationally feasible. We do so by employing Component-Wise Gradient Boosting (CWGB), which selects a parsimonious set of state variables in a data-driven manner.

We use these parsimoniously specified choice-specific value functions in a second simulation along with the estimated first stage models. In this simulation, we recover the value (from the legacy carrier's perspective) of responding to Southwest entry with increases in capacity for segments in our sample unentered by Southwest in 2008q1. We assume the legacy carrier draws capacity from the flight segment (the reservoir flight segment) with the *highest* marginal value, which represents the opportunity cost of committing capacity to the entered flight segment. Formally, this reservoir flight segment choice represents a one-step improvement strategy for the legacy carrier, which is the choice that maximizes the estimated choice-specific value function in the current period in a greedy manner, analogously to the first step of the well-known policy-function iteration method. We repeat this simulation both with and without the legacy carrier merger,which gives us the estimated value (from the legacy carrier's perspective) of defending each flight segment unentered by Southwest in 2008q1. In Section 1.6, we compare these values to Southwest's actual entry decisions from 2008q2 to 2014q4.

Identification Strategy

Successful identification of the value of capacity reallocation relies on the identification of parameters from four models: market-level demand, market-level marginal costs, reduced-form segment entry choices, and reduced-form segment flight capacity choices. For the first two models, we rely on the instrumental variables strategy of Berry and Jia (2010), introduced in Section 1.5.2.

For the reduced-form entry and capacity models, we impose parametric functional form assumptions as detailed in Section 1.3.2 (imposing probit and OLS specifications, respectively). Given these assumptions, the primary challenge for identification in this context involves controlling for unobserved characteristics that are correlated with market demand. These unobserved demand characteristics confound parameter identification if they are correlated other variables in each model, which is likely.

There are two identification strategies we employ, either separately or together, depending on the specification.[40] A first involves taking advantage of the panel structure of our dataset. To do so, we saturate our models with fixed effects, including origin and destination city effects, carrier effects, time effects, and interactions of these variables. These variables eliminate the effect of unobserved demand characteristics that are fixed across cities, time, carriers, or the interactions of these variables. They are also combined with observed variables such as origin and destination populations, which are meant to further absorb the effect of unobserved demand characteristics.[41]

A second identification strategy involves using our estimated structural market-

[40] We are currently in the process of incorporating reduced-form capacity and entry models that implement the two identification strategies outlined in this section. Our current predatory incentives estimates are based on the simpler models detailed in Section 1.5.2.

[41] One disadvantage of this strategy is that entry and capacity parameters are identified only by "within" changes in these variables (deviations from the fixed effect), which often lowers the signal to noise ratio supporting parameter estimates. This low signal to noise ratio may complicate the use of complementary identification strategies, such as the implementation of instrumental variables, since these instrumental variables are more likely to be "weak." We therefore refrain from implementing an instrumental variable strategy in addition to the fixed effects strategy already employed.

demand models to compute demand residuals, which we incorporate as additional regressors. These residuals are intended to capture any unobserved demand shocks that influence entry and capacity choices and would otherwise remain in the error term of these models. We use this strategy as a robustness check.

1.5.2 First Stage

First Stage: Demand

Since prices and the unobserved portion of utility, ξ_{jmt}, are often correlated in practice, we utilize the instrumental variable identification strategy and Generalized Method of Moments (GMM) estimation procedure of Berry and Jia (2010) to consistently estimate θ^{d}_{rt}. Following Berry, Levinsohn, and Pakes (1995), this estimation procedure forms moments of the unobservable product characteristics with a vector of instruments discussed in Section 1.5.2. In particular, we assume we have access to a vector of instrumental variables I_{mt} such that the expectation of the vector of unobserved product characteristics conditional on these instruments is zero, i.e.

$$E\left[\xi_{mt}|I_{mt}\right] = 0$$

for all m and t. These moment conditions imply:

$$E\left[h\left(I_{mt}\right)\xi_{mt}\right] = 0$$

for all m and t and any function $h\left(.\right)$. We estimate the parameters of the model using these moment conditions, solving for the unobserved product attributes for each candidate parameter vector using the contraction mapping algorithm of Berry and Jia (2010). Since we use their exact estimation routine, we present the details of this routine in the Appendix.

First Stage: Marginal Costs

Since the marginal costs associated with each airline product are unobserved, we follow Berry and Jia (2010), Berry, Carnall, and Spiller (2007), and Berry, Levinsohn, and Pakes (1995) and compute the marginal costs implied by the demand specification and Assumptions 1, 2, and 3.

We invert the system of equations in 1.8 using the estimated demand parameters $\widehat{\theta}_{rt}^{d}$ to solve for equilibrium product price markups. As with demand side unobservables, cost-side unobservables are computed using the contraction mapping algorithm of Berry and Jia (2010). We assume we have access to a vector of instrumental variables I_{mt} such that the expectation of the vector of cost-side unobservables conditional on these instruments is zero, i.e.

$$E\left[\omega_{mt}|I_{mt}\right] = 0$$

for all m and t. These moment conditions imply:

$$E\left[h\left(I_{mt}\right)\omega_{mt}\right] = 0$$

for all m and t and any function $h(.)$. We abuse notation by using the same notation for the vector of marginal cost and demand instrumental variables, since in practice, these will include different variables. Since we implement the exact estimation algorithm of Berry and Jia (2010), we present details in the Appendix.

First Stage: Demand and Marginal Cost Instruments

Since prices are endogenous, we need instruments to identify fare coefficients. We use the instrumental variables suggested by Berry and Jia (2010). First, we use rival product attributes and market competitiveness variables including route characteristics. For example, we use the percentage of rival routes that offer direct flights, the average distance of rival routes, and the number of all carriers. A second identification strategy is to find variables that affect costs but not demand. For this purpose, we use whether the *destination* is a hub for the ticketing carrier, since it affects the marginal cost of the flight (route traffic is denser), but it is excluded from demand. Performing a similar role, we use the number of cities to which a carrier flies nonstop from the destination airport, since this also reflects route density (and lower marginal costs), but is excluded from demand. Similarly, we use whether the flight connects at a hub, since costs are likely lower for these flights. Finally, we exploit a third identification strategy, which uses the fitted values of the twenty-fifth and seventy-fifth quantiles of fares on the route, since these quantiles capture nonlinear effects of exogenous route characteristics on prices.

First Stage: Reduced-Form Profit Function

In principle, for each counterfactual capacity and entry choice in the second stage of our estimation process, we could compute product and market-level variable profits for each carrier by re-solving for the prices that optimize the system of equations represented by equation 1.8. However, since we simulate thousands of counterfactual capacity and entry choices, the computational burden of doing this is very high. We therefore follow Snider (2009) and estimate a reduced-form model of product-level variable profits for each time period.

To estimate this model, we first compute product-level profits by using *actual* fares by product obtained from DB1B market data along with marginal costs computed using the structural marginal costs model estimated in Section 1.5.2. We obtain product shares (as a share of the total number of passengers by market) as well as the total number of passengers by market (divided by 0.10 to reflect that the DB1B market sample is a 10% sample) directly from DB1B market data.

Our outcome variable in this regression is the log of product-level profits per flight, which is regressed (using OLS) as a function of several market and product-level variables. We add several control variables, including: the log of passenger density in the market in 2002 (obtained from T100 market data), the number of hubs the carrier operates nationally, the average distance between the origin, connection, and destination to the nearest hub of the carrier, and indicators for whether the origin, connection, or destination is a hub for the carrier.

The regression also includes several variables related to flight capacity, which serve as important variables for facilitating changes in segment-level profitability in our capacity game. The first set are the number of flights offered by the reference carrier, i.e. capacity and capacity squared. We also add two sets of variables describing competition on the segment, including the total number of flights offered by all carriers operating on the segment as well as the total number of distinct carriers operating on the segment. We also include the square of these variables. These variables provide the primary mechanism for influencing profitability through capacity allocations in our capacity game. This is because, to the extent that the relationship between these regressors and profitability are negative, legacy carriers can increase the total capacity on a segment and decrease the profits per flight of all other carriers on the segment, including the low cost carrier entrant. The low cost carrier entrant must also weight the cost on profits per flight of entering a segment. Finally, we add interactions of the capacity and segment competitor variables with the origin population and destination population (multiplied by $1 \times e^{-12}$ to match the scale of other regressors in the model). These variables capture the effects of increases in own capacity, total segment capacity, and the total number of segment competitors on profitability. The population variable serves to capture any differential effects of capacity changes on segments with stronger demand, as proxied by endpoint population levels.

First Stage: Flight Capacity and Entry

We estimate two models of local carrier strategy functions, one for segment capacity changes and another for segment entry and exit (any flight offerings on the segment). We pool data from 2006q1 to 2008q4 to estimate both models. Formally, for the flight capacity specification, we denote our parameter estimates by $\widehat{\vartheta}_f^{cap}$ and our estimated mean flight capacity change for carrier f by $\Delta\widehat{a}_{fct}(s_{ct}, \mathbf{z}_{ct})$. We minimize the usual OLS loss function using pooled data on flight capacity changes, states, and local segment characteristics, i.e.

$$\widehat{\vartheta}_f^{cap} \equiv \arg\min_{\vartheta_f^{cap}} \left\{ \sum_{t=1}^{T} \sum_{m=1}^{K} \left(\Delta a_{fct} - (s_{ct}, \mathbf{z}_{ct})\, \vartheta_f^{cap} \right) \right\}$$

where we abuse notation by allowing $t = 1$ to T represent the range of time periods used for estimation, which can vary depending on the merger studied and the specification.

We estimate a similar model of carrier $t+1$ segment entry strategies using a probit specification. In this model, the outcome variables is the 0, 1 indicator corresponding to whether the segment has positive flight capacity, i.e. $\mathbb{I}\left(\Delta a_{fct} + \underline{a}_{fct-1} > 0\right) = 1$, where $\mathbb{I}(.)$ is the indicator function. We assume a carrier's flight capacity level or segment entry decision in period $t+1$ is a function of the origin and destination populations, the log of 2002 passenger volume for all carriers on the segment from T100 data, the number of nonstop competitors offering flights on the segment, the total number of hubs operated by the carrier across its domestic network, and the average distance between the hub of the carrier and the origin and destination of the segment. We also include a series of dummies in both specifications, including whether the segment includes any of the carrier's hubs, whether the distance of the segment exceeds certain thresholds, and carrier, city, and time dummies. For the segment entry specification, we additionally include whether the carrier offered any flights on the segment in period t.

1.5.3 Second Stage: Capacity Game

Overview

In this section, we describe the process of estimating the choice-specific value function of a reference legacy carrier in response to an entry event by a low cost carrier. We also describe how we use this estimated choice-specific value function to generate a one-step reallocation strategy, which we use to estimate the value (to a reference legacy carrier) of defending flight segments against new entry. The overall procedure is similar to the one employed by Manzanares, Jiang, and Bajari (2015). We outline the steps of our Algorithm in what follows.

Algorithm 1.5.1 *We generate a one-step reallocation strategy for a reference legacy carrier according to the following steps:*

1. *Use a pre-simulated grid of capacity allocations for the reference legacy carrier, as well as the pre-estimated competitor strategies to simulate play.*

2. *Use this simulated data to estimate the choice-specific value function of the reference legacy carrier.*

3. *Obtain a one-step reallocation strategy for the reference legacy carrier.*

4. *In a separate simulation, use the one-step reallocation strategy as the legacy carrier's strategy to estimate the value of defending each flight segment against new entry.*

Generate Simulation Sample (Step 1)

In this step, we use the estimated competitor strategy functions $\Delta\widehat{a}_{fct}(s_{ct}, \mathbf{z}_{ct})$ for $f \in -f$ and the estimated strategy function $\Delta\widehat{a}_{fct}(s_{ct}, \mathbf{z}_{ct})$ for the reference legacy carrier to simulate play for several periods. Denote simulated variables with superscript

∗. This simulation proceeds as follows. First, we pre-simulate a grid of total flight capacity levels at time t, capacity change choices at time t, and variables derived from these choices. We do this under the constraint that the total number of flights served by the carrier must be less than or equal to the actual total number of flights provided by the carrier in the data. This enforces our total flight capacity constraint. For the merged carrier, the total number of flights offered cannot exceed the total offered by both carriers in the data. The permuted grid provides a random sample of flight reallocations across the reference legacy carrier's network.

Upon receiving the reallocation, we simulate the flight capacity and entry responses of other carriers using the strategy functions estimated in the first stage. We then retrieve the product-level profits using the pre-estimated reduced-form profit models, which are conditional on the new simulated capacity levels. In the following periods, we simulate play using the previously estimated strategy functions for all carriers (including the reference carrier), retrieving the payoffs in each period according to the reduced-form profit functions and updated capacity characteristics.

We repeat this simulation process many times, which gives us a sample of simulated data from which to estimate the choice-specific value function of the reference legacy carrier. We estimate a separate choice-specific value functions for the unmerged Delta, the unmerged Northwest, and the merged Delta and Northwest.

Choice-Specific Value Function Estimation (Step 2)

It is well-known that solving for optimal policy functions in the context of discrete Markov decision problems suffers from a curse of dimensionality. This curse arises for two primary reasons. First, agents optimize over an *ex ante* sequence of functions, i.e. actions as functions of the state, rather than over an *ex ante* sequence of actions unconditional on the state. This generates many more candidate actions, since the optimal response may vary for different states. Second, in a dynamic setting, each choice must be optimal not only with respect to the current period, but also with respect to the expected evolution of the state and actions in all future periods. This expected evolution is summarized in the continuation value portion of the value function in definition 2.1. Continuation value in the choice-specific value function represents the expected value of choosing a particular action given the effect of this choice on the evolution of all future states and actions.

In many industry studies it is difficult to solve for the continuation value analytically, so researchers have instead relied on forward simulation. See Rust (1996) for an excellent review of solution methods in this context. In the industrial organization literature, researchers have developed methods for simulating and estimating parameters in the context of oligopolistic competition based on the general framework of Ericson and Pakes (1995). This framework assumes competition is generated by pure-strategy Markov Perfect Equilibria (MPE) and uses this assumption to simulate equilibrium behavior and estimate the parameters that rationalize these equilibria. The primary problem with this "full solution" approach is the simulation burden, since new equilibria must be computed for each realization path followed by the state. As pointed out by researchers, see e.g. Benkard (2004), this simulation burden often makes computation and estimation prohibitive in all but the most stylized dynamic contexts. More recent methods have reduced this simulation burden by assuming play is generated by one pure-strategy MPE and using revealed preference assumptions to recover parameters through estimation, see, for example, Bajari, Benkard, and Levin (2007). This style of method has enabled the estimation of parameters in the context of dynamic, strategic competition, even in network industries (including airlines), see Benkard, Bodoh-Creed, and Lazarev (2010), Aguirregabiria and Ho (2012), and Snider (2009) for recent examples.

However, none of the above-mentioned research attempted to estimate parameters in the context of dynamic, strategic industry competition with value functions explicitly made conditional on network-wide covariates, even though profit functions of firms in network industries are likely conditional on these covariates. In our context, we estimate the choice-specific value function of our reference legacy carrier as a function of 17700 regressors, including:

- indicators for whether the carrier offers flights from the origin and destination of each segment at time t (1770 regressors),
- the total number of carriers offering service on each segment at time t (1770 regressors),
- the total number of flights offered by all carriers on each segment at time t (1770 regressors),
- an indicator for whether the carrier offers any flights on each segment at time t (1770 regressors),
- the number of flights offered by the carrier on each segment at time t (1770 regressors),
- an indicator for whether the carrier offers any flights on each segment at time $t+1$ (1770 regressors),
- the number of flights added or subtracted by the carrier on each segment at time t (1770 regressors)
- a series of unidimensional interaction terms, including whether the carrier offers any flights on the segment multiplied by whether the carrier offers any flights from the origin and destination of the segment (1770 regressors), the number of flights added or subtracted by the carrier on the segment multiplied by the total number of flights offered by all carriers on the segment (1770 regressors), and the number of flights added or subtracted by the carrier on the segment multiplied by the total number of carriers offering flights on the segment (1770 regressors).

Although this specification allows us to study legacy carrier flight capacity reallocation strategies in a rich manner, the large number of state and action variables makes the simulation burden of using existing methods high. We therefore seek to model the choice-specific value function of each reference carrier as a parsimonious function of a subset of these variables in order to make simulation and estimation feasible. However, *a priori*, it is difficult to choose these variables transparently.

We use a tool from the Machine Learning literature called Component-Wise Gradient Boosting (CWGB) to estimate the choice-specific value of reallocating capacity to each segment in the reference legacy carrier's network. CWGB is a specific variant of boosting methods, which are a popular class of Machine Learning methods that accommodate the estimation of both linear and nonlinear models. Boosting methods work by sequentially estimating a series of simple models, deemed "base learners", and then forming a "committee" of predictions from these models through weighted averaging. See Hastie *et al.* (2009) for a survey of boosting methods.

We use the linear variant of CWGB as our primary estimator. Our simulated data represents a sample of previous plays of the game, i.e. flight capacity levels and changes for all carriers, where the outcome variable is total nation-wide discounted expected profits for the reference legacy carrier. The estimation algorithm is described in what follows.

Algorithm 1.5.2 ***CWGB Estimator (Linear)***

1. *Initialize the iteration* 0 *model, denoted as* $\widehat{V}_f^{c=0}$, *by setting* $\widehat{V}_f^{c=0} = \frac{1}{L}\sum_{l=1}^{L} V_{fl}$, *i.e. initializing the model with the empirical mean of the outcome variable.*

2. *In the first step, estimate* K *univariate linear regression models (without intercepts) of the relationship between* V_f *and each* $\mathbf{s}_{lt}^*, \Delta\mathbf{a}_{lft}^*$ *(and the variables derived from these) as the sole regressor.*

3. *Choose the model with the best OLS fit, denoted as* V_f^{W1}. *Update the iteration 1 model as* $\widehat{V}_f^{c=1} = \widehat{V}_f^{c=0} + \lambda V_f^{W1}$, *and use this model to calculate the iteration 1 fitted residuals, where* λ *is called the "step-length factor," which is often chosen using k-fold cross-validation (we set* $\lambda = 0.01$*).*

4. *Using the iteration 1 fitted residuals as the new outcome variable, estimate an individual univariate linear regression model (without an intercept) for each individual regressor* $\mathbf{s}_{lt}^*, \Delta\mathbf{a}_{lft}^*$ *(and the variables derived from these) as in iteration 1. Choose the model with the best OLS fit, denoted as* V_f^{W2}. *Update the iteration 2 model as:*

$$\widehat{V}_f^{c=2} = \widehat{V}_f^{c=1} + \lambda V_f^{W2}$$

5. *Continue in a similar manner for a fixed number of iterations to obtain the final model (we use* $C = 1000$ *iterations). The number of iterations is often chosen using k-fold cross-validation.*

As a consequence of this estimation process, it is usually the case that some regressors never comprise the best fit model in any iteration. If so, then this variable is excluded from the final model. This process gives us an estimate of the choice-specific value of reallocating capacity across the legacy carrier's network, which we denote as $\widehat{V}_f\left(\widetilde{\mathbf{s}}_t, \Delta\widetilde{\mathbf{a}}_{ft}\right)$, where as introduced in Section 1.3.2, $\widetilde{\mathbf{s}}_t$ and $\Delta\widetilde{\mathbf{a}}_{ft}$ represent the parsimonious set of state and action variables that remain after the CWGB model selection procedure (where, in practice, this process reduces the number of state and action variables dramatically).

Reallocation Strategy (Step 3)

Given the large number of state and action variables, we stop short of recomputing a best response for our reference legacy carrier. Instead, we estimate the first step of the policy function iteration method. It is well known that in the context of discrete state vectors, repeated policy function iteration derives the optimal policy. Further, when the state vector is discrete and finite, policy function iteration generates the optimal response remarkably fast (see Bertsekas (2012)). Specifically, we generate a one-step improvement policy for reference carrier f, denoted as $\widehat{\sigma}_f^1$, which represents policy function, i.e. the flight capacity reallocation, which maximizes the estimated choice-specific value function in the corresponding period t. We define this one-step reallocation policy as the vector $\widehat{\sigma}_f^1$[42] such that:

$$\widehat{\sigma}_f^1 \equiv \left\{ \sigma_f : \widetilde{\mathcal{S}}_t \to \Delta\mathcal{A}_{ft} \;\middle|\; \begin{array}{c} \sigma_f = \arg\max_{\Delta\mathbf{a}_{ft} \in \Delta\mathcal{A}_{ft}} \left\{ \widehat{V}_f\left(\widetilde{\mathbf{s}}_t, \Delta\widetilde{\mathbf{a}}_{ft} \right) \right\} \\ \text{for all } \widetilde{\mathbf{s}}_t \in \widetilde{\mathcal{S}}_t \end{array} \right\} \tag{1.9}$$

Each $\widehat{\sigma}_f^1$ is "greedy" in that it searches only for the action choices that maximize the estimated choice-specific value function in the current period, rather than the actions that maximize the value of choices across all time periods.

Value of Defense (Step 4)

Once $\widehat{\sigma}_f^1$ is obtained, we use this reallocation strategy as the strategy of the reference legacy carrier for simulating the value of defending each flight segment against new low cost carrier entry (from the legacy carrier's perspective). For the current results, the reference legacy carrier is either Delta, Northwest, or the merged Delta and Northwest, and the potential low cost carrier entrant is Southwest. The flight segments we consider are those unentered by Southwest as of 2008q1. We simulate this value in two steps for each flight segment.

In the first simulation, we force Southwest to enter and operate on the flight segment.[43] We assume that the legacy carrier responds by drawing flights from another

[42]As with the other policy functions, we abuse notation by suppressing the dependence of $\widehat{\sigma}_f^1$ on the corresponding states.

[43]The number of flights chosen by Southwest varies by specification. For our primary specification, Southwest operates three daily flights upon entering.

flight segment and increasing the number of flights on the entered flight segment for one period. The location of the flight reservoir for the legacy carrier is determined by $\widehat{\sigma}_f^1$, in that we assume flights are drawn from the flight segment with the *highest* marginal value of flight capacity. This represents the opportunity cost of investing flight capacity in the entered flight segment. We assume Southwest exits in the next period and simulate competition between carriers using the previously estimated capacity and entry strategy functions. The estimated profit functions allow us to recover the nation-wide expected profits of this entry event from the perspective of the legacy carrier.

In a second simulation, we force Southwest to enter the flight segment and remain, otherwise simulating competition for all carriers and many time periods using the previously estimated capacity and entry strategies. We also recover the nation-wide expected profits of the legacy carrier using the estimated profit functions. However, we do not force the legacy carrier to respond to the entry event with capacity reallocation. The difference in the legacy carrier's nation-wide expected profits between the first and second simulations gives us the value of defending the flight segment. We repeat these simulations for each flight segment separately for the unmerged Delta, the unmerged Northwest, and the merged Delta and Northwest.

Importantly, these simulations force us to commit to a particular exit threshold for Southwest. Specifically, in our primary specification reported in Section 1.6, we assume that Southwest exits after the legacy carrier increases capacity such that Southwest's variable profits drop to zero on the flight segment for one period. In practice, this exit threshold is unknown. For example, it is possible that Southwest would never exit in the face of increased competition by the incumbent carrier. Since the value of defending a flight segment from the legacy carrier's perspective is a function of how much capacity is needed to induce Southwest's exit, misspecifying the exit rule for Southwest will misspecify the value of defense. As a robustness check, we compare our estimated values of defending flight segments to *actual* Southwest entry events since 2008q1 in Section 1.6. This exercise serves as an "out-of-sample" test for our specification. It also provides our primary results.

1.6 Results

1.6.1 Model Estimates

First Stage: Demand and Marginal Costs

Table 1.4 presents the demand and marginal cost parameter estimates, using a two-stage GMM procedure, estimated separately for 2008q1 to 2008q3. Coefficients with a "1" label, such as Fare1, Connection1, and Constant1, are the demand coefficients corresponding to leisure travelers, while coefficients with a "2" label, i.e. Fare2, Connection2, and Constant2, are the demand coefficients corresponding to business travelers.

Both customer types disfavor higher prices. As found by Berry and Jia (2010) using samples from 1999 and 2006, business travelers appear less sensitive to price than leisure travelers during this period. For example, the coefficients on fare for business travelers (Fare 2) for 2008q1, q2, and q3, are -0.40, -0.37, and -0.35, respectively, and are statistically significant at the 1 percent level. In contrast, the fare coefficients for leisure travelers during the same time period are -2.05, -3.00, and -1.90, although coefficients on the last two quarters are imprecisely estimated.

Overall, the remaining coefficients are mostly of the expected sign. For example, the point estimates on connecting flights (Connection1 and Connection2) are negative for both business and leisure travelers, indicating that connections are disfavored (although these coefficients are imprecisely estimated). Passengers prefer more departures per time period (No. departures), with coefficients of 0.20, 0.29, and 0.27 for 2008q1, q2, and q3, respectively.

Coefficients on flight distance and distance squared (Distance, Distance^2 respectively) show that passengers generally prefer longer distance flights, reflected in positive coefficients for Distance.

	2008q1	2008q2	2008q3		2008q1	2008q2	2008q3
Fare 1	−2.05*	−3.00	−1.90				
	(1.24)	(5.36)	(1.35)	Demand Carrier Dummy			
Connection 1	−1.29	−1.24	−1.28	Other	0.19	0.15	0.16
	(1.72)	(3.01)	(1.91)		(0.14)	(0.13)	(0.14)
Constant 1	−2.00	−2.66	−2.74	JetBlue	0.38***	0.40***	0.47***
	(3.39)	(6.33)	(2.99)		(0.11)	(0.10)	(0.10)
Fare 2	−0.40***	−0.37***	−0.35***	Continental	0.53***	0.66***	0.74***
	(0.05)	(0.04)	(0.04)		(0.06)	(0.06)	(0.06)
Connection 2	−0.001	−0.05	−0.08*	Delta	0.60***	0.62***	0.67***
	(0.04)	(0.04)	(0.04)		(0.05)	(0.05)	(0.05)
Constant 2	−2.00***	−2.00***	−2.00***	Northwest	0.48***	0.48***	0.50***
	(0.22)	(0.20)	(0.21)		(0.06)	(0.06)	(0.06)
No. destination	−0.24*	−0.05	0.09	United	0.67***	0.64***	0.67***
	(0.14)	(0.14)	(0.14)		(0.05)	(0.05)	(0.05)
No. departures	0.20**	0.29***	0.27***	US Airways	0.75***	0.68***	0.73***
	(0.08)	(0.09)	(0.08)		(0.06)	(0.06)	(0.06)
Distance	1.00***	1.00***	1.00***	Southwest	0.52***	0.52***	0.56***
	(0.16)	(0.16)	(0.16)		(0.06)	(0.06)	(0.06)
$Distance^2$	−0.13***	−0.14***	−0.14***				
	(0.03)	(0.03)	(0.04)	Cost Carrier Dummy			
Tour	−0.25***	−0.17**	−0.19**	Other	−0.30***	−0.35***	−0.31***
	(0.08)	(0.08)	(0.08)		(0.06)	(0.06)	(0.06)
Slot-Control	−0.03	−0.10*	−0.10*	JetBlue	0.08	0.01	−0.09
	(0.05)	(0.05)	(0.05)		(0.07)	(0.06)	(0.06)
Cost Const Short	−0.30***	−0.26**	−0.39***	Continental	0.36***	0.30***	0.29***
	(0.12)	(0.11)	(0.12)		(0.06)	(0.05)	(0.06)
Cost Dist Short	0.78***	0.76***	0.89***	Delta	0.10*	0.04	0.03
	(0.08)	(0.07)	(0.08)		(0.06)	(0.05)	(0.05)
Cost Connect Short	0.41***	0.40***	0.34***	Northwest	0.17***	0.07	0.18***
	(0.03)	(0.03)	(0.03)		(0.06)	(0.06)	(0.06)
Cost Const Long	0.29**	0.32***	0.26**	United	0.47***	0.33***	0.38***
	(0.12)	(0.12)	(0.12)		(0.05)	(0.05)	(0.05)
Cost Dist Long	0.56***	0.53***	0.58***	US Airways	0.55***	0.41***	0.48***
	(0.03)	(0.02)	(0.03)		(0.05)	(0.05)	(0.05)
Cost Connect Long	0.22***	0.22***	0.17***	Southwest	−0.41***	−0.46***	−0.33***
	(0.04)	(0.04)	(0.04)		(0.05)	(0.05)	(0.05)
HubMC	−0.24***	−0.15***	−0.11***	λ	0.10***	0.10***	0.10***
	(0.03)	(0.03)	(0.03)		(0.02)	(0.02)	(0.02)
SlotMC	0.21***	0.17***	0.21***	γ	0.01	0.01	0.02
	(0.03)	(0.03)	(0.03)		(0.01)	(0.02)	(0.01)
Observations	23,320	19,207	18,315				

Note: *p<0.1; **p<0.05; ***p<0.01

Table 1.4: Static Price Competition Estimation (Two Stage GMM), 2008q1 - 2008q3

Positive coefficients for Distance are expected, since it is likely that passengers have fewer outside options for longer distance flights, such as bus and car travel, which is reflected in prices. The coefficients for Distance^2 are negative, which could reflect a distaste for flights as they become "too" long, possibly increasing passenger discomfort. The coefficients on indicators for tourist destinations (Florida and Las Vegas), labeled as Tour, are generally negative, reflecting the large composition of price-sensitive leisure travelers heading to these destinations. Finally, travelers have a distaste for traveling through slot controlled airports generally, which is consistent with the findings for 1999 and 2006 of Berry and Jia (2010). This result may reflect a distaste for heavily crowded airports, since slot-controlled airports consist of the most crowded airports in the U.S. by passenger volume.

Marginal cost parameter estimates are also displayed in Table 1.4, including the variables denoted by "Cost." Marginal costs increase for both short haul (less than 1500 miles round trip) and long haul flights with flight distance (Cost Dist Short and Cost Dist Long) for all time periods, reflecting higher costs of fuel and amenities associated with longer distance flights. The number of connections (variables labeled Cost Connect Short and Cost Connect Long) are positively related to marginal costs for both long haul and short haul flights for all time periods. A positive relationship between the number of connections and costs indicates that connecting is costly for carriers, since it involves two additional landings and takeoffs for round trip flights and since most of a flight's fuel costs are incurred during landings and takeoffs. Having a hub at the origin, destination, or stop, lowers marginal costs in all time periods (HubMC coefficients). In contrast, flights through slot-controlled airports have higher marginal costs (SlotMC coefficients), likely due to higher landing fees and congestion.

First Stage: Reduced-Form Variable Profits

The estimated coefficients for the reduced-form log of profits per flight model for 2008q1, 2008q2, and 2008q3 are displayed in Table 1.5.

	Dependent variable: Log(Profit per Flight)		
	2008q1	2008q2	2008q3
(Intercept)	25.892***	26.113***	26.203***
	(0.271)	(0.266)	(0.268)
Origin Pop * Dest. Pop	0.007***	0.007***	0.008***
	(0.001)	(0.001)	(0.001)
Log 2002 Passenger Density	−0.279***	−0.273***	−0.315***
	(0.015)	(0.013)	(0.014)
Avg. Closest Hub Distance	−2.436e-04***	−2.351e-04***	−1.325e-04***
	(4.938e-05)	(4.869e-05)	(4.815e-05)
Origin Hub	0.637***	0.613***	0.743***
	(0.038)	(0.037)	(0.037)
Connection Hub	0.863***	0.855***	0.922***
	(0.035)	(0.035)	(0.035)
Destination Hub	0.668***	0.611***	0.730***
	(0.038)	(0.038)	(0.037)
Market Capacity	−8.429e-05***	−8.683e-05***	−9.627e-05***
	(5.755e-06)	(5.790e-06)	(5.880e-06)
Market Capacity^2	9.046e-10***	9.562e-10***	9.306e-10***
	(7.993e-11)	(8.751e-11)	(7.734e-11)
Market Competitors	−0.226***	−0.257***	−0.318***
	(0.046)	(0.045)	(0.045)
Market Competitors^2	0.010***	0.014***	0.020***
	(0.003)	(0.003)	(0.003)
Observations	18,646	19,203	18,900
R^2	0.520	0.515	0.525
Adjusted R^2	0.517	0.513	0.523

Note: Distance dummy variables, carrier dummy variables and city dummy variables are suppressed from the table. *p<0.1; **p<0.05; ***p<0.01.

Table 1.5: Reduced-Form Profit Estimation 2008q1-q3

The origin and destination population interaction term is positively related to the log of profits per flight in all time periods, which likely reflects the presence of unobserved demand variables that are correlated with population and profits per flight. The log of 2002 passenger volume is negatively related to profits per flight, reflecting an overall higher per flight profitability of lower passenger density markets (which attract fewer competitors). Profits per flight fall as the average distance between the origin, stop, and destination to the carrier's nearest hub rises, which likely reflects the higher marginal costs of providing these flights for hub carriers. Having a hub associated with the origin, connection, or destination of an airline product increases profits per flight. This is consistent with previous studies which find a hub premium associated with carrier flights through own hubs.

Our estimated coefficients for flight capacity variables have the expected sign. Profits per flight fall at a decreasing rate with increases in the total number of flights in the market provided by all carriers, as indicated by a negative coefficient on Market Capacity and a positive coefficient on Market Capacity^2. This pattern also holds with the total number of competitors in the market, where profits per flight fall at a decreasing rate with the number of market competitors (see Market Competitors and Market Competitors^2).

The coefficients on the capacity variables have important implications for our value of defense simulation. For example, a legacy carrier that wishes to increase capacity in response to the entry of a low cost carrier can lower the profits per flight of the low cost carrier (and all carriers in a market) by increasing capacity. This increased capacity lower the profits per flight of other carriers through the negative coefficient on Market Capacity. Finally, the entry of a new competitor tends to decrease profits per flight through the negative coefficient on Market Competitors.

An important weakness of this specification is that, since our outcome variable is the log of variable profits per flight, we exclude the possibility of negative variable profits per flight, i.e. fares falling below marginal costs. In antitrust law, plaintiffs proving predation must show evidence of below cost pricing by the alleged predator. The cost standard often used is average variable cost, although under current antitrust standards, other cost standards are allowed. Under the average variable cost standard, our profit specification prevents legacy carriers from engaging in predation *per se*. In a series of robustness checks (results forthcoming), we are repeating our capacity game using models with profits per flight and profits as the dependent variable, which allows legacy carriers to price below variable costs.

First Stage: Entry and Capacity Strategy Functions

Table 1.6 presents the estimated segment entry and flight capacity strategy functions used to simulate counterfactual entry and capacity choices. If the carrier offers any flights on a segment in a given time period, they are more likely to offer flights in the next time period, as indicated by the positive coefficient on current period segment entry (Segment Entry$_t$). Higher origin and destination populations (Origin Pop * Destination Pop * $1 \times e^{-12}$) and more passengers served in 2002 (Log 2002 Passenger Density) are associated with more offered flights per segment in the capacity specification. Segments with more 2002 passengers served also generate a higher probability of entry, reflecting the general attractiveness of serving segments with stronger demand. Carriers are less likely to enter segments containing more competitors offering nonstop flights. They also offer fewer flights in these segments, conditional on entry. A higher number of hubs tends to increase its likelihood of entering new domestic segments. Carriers operating many national hubs also offer more flights per segment.

Carriers are more likely to enter segments with an endpoint at one of their hubs and offer more flights on these segments. They are less likely to offer flights and also offer fewer flights per segment as the flight distance increases. Fewer flights per segment on longer distance flights is consistent with the use of larger long-haul aircraft, which transport more passengers per flight. Finally, carriers are more likely to enter segments and offer more flights per segment in segments farther away from their hubs.

	Dependent variable:	
	Segment Entry$_{t+1}$	Capacity$_{t+1}$
	Probit	*OLS*
(Intercept)	-4.867^{***}	-32.032
	(0.152)	(59.563)
Segment Entry$_t$	4.098^{***}	
	(0.022)	
Origin Pop * Destination Pop	-0.197	$1,494.519^{***}$
	(0.193)	(42.311)
Log 2002 Passenger Density	0.114^{***}	26.930^{***}
	(0.006)	(2.179)
Num. of Non-Stop Competitors	-0.113^{***}	-9.136^{***}
	(0.008)	(2.368)
Num. of Hubs	0.112^{***}	31.810^{***}
	(0.020)	(8.675)
Average Closest Hub Distance	0.0002^{***}	0.050^{***}
	(0.00002)	(0.007)
Origin Hub Dummy	0.804^{***}	205.974^{***}
	(0.040)	(8.040)
Destination Hub Dummy	0.636^{***}	205.170^{***}
	(0.042)	(8.824)
Dummy for Distance > 250 Miles	0.019	-39.091^{***}
	(0.043)	(10.684)
Dummy for Distance > 500 Miles	-0.075^{***}	-197.913^{***}
	(0.029)	(7.437)
Dummy for Distance > 1000 Miles	-0.111^{***}	-146.767^{***}
	(0.028)	(7.645)
Dummy for Distance > 1500 Miles	-0.153^{***}	-149.321^{***}
	(0.035)	(9.838)
Dummy for Distance > 2000 Miles	-0.064	-259.758^{***}
	(0.042)	(12.415)
Dummy for Distance > 2500 Miles	-0.176^{***}	-31.512^{*}
	(0.059)	(18.287)
Observations	225,852	40,416
R^2	0.931	0.396
Adjusted R^2	0.932	0.395
Log Likelihood	-10,559.060	
Akaike Inf. Crit.	21,300.120	
Residual Std. Error		479.260 (df = 40326)
F Statistic		297.105^{***} (df = 89; 40326)

Note: *p<0.1; **p<0.05; ***p<0.01. Estimates of carrier dummy variables, city dummy variables and time dummy variables are suppressed from the probit and OLS tables.

Table 1.6: Estimation of Entry Strategies and Capacity Strategies

Second Stage: Legacy Carrier Value Functions [44]

Tables 1.7 through 1.9 provide the choice-specific value of flight capacity for Delta, Northwest, and the merged Delta and Northwest, for 2008q2, which is the period in which each carrier reallocates capacity in our value of defense simulation. Each coefficient represents the incremental gain (loss) in expected variable operating profits (in U.S. $) from adding one additional flight per quarter to the corresponding segment.

Marginal Value of Flight	DL	Marginal Value of Flight	DL
New York Memphis	-4.36e+4	Atlanta Tulsa	-1.66e+4
Spokane Salt Lake City	-4.36e+4	Atlanta Tucson	-5.36e+4
Orlando Memphis	-4.76e+4	Hartford Cincinnati	-6.09e+4
Minneapolis-St. Paul Tucson	-8.89e+4	Albuquerque Atlanta	-5.07e+4
New Orleans Salt Lake City	-8.89e+4	Boston Cleveland	-1.16e+4
Albuquerque Cincinnati	-2.27e+5	Boston Cincinnati	-3.41e+3
Philadelphia Salt Lake City	-7.34e+4	Los Angeles New Orleans	-5.34e+4
Salt Lake City Sacramento	-1.61e+4	Washington DC Cincinnati	-5.05e+3
Atlanta Denver	-2.60e+4	Cincinnati Indianapolis	-8.57e+3
Atlanta Chicago	-6.65e+6	Dallas Salt Lake City	-2.34e+4
Atlanta Norfolk	-1.84e+4	Denver Salt Lake City	-5.26e+3
Atlanta Louisville	-7.76e+3	Detroit Norfolk	-1.49e+4
Atlanta St. Louis	-4.73e+3	Detroit Pittsburgh	-1.47e+5
Offset	5.59e+6		

Table 1.7: Estimated Choice-Specific Value of Flight Capacity (Boosted Regression): Delta Airlines, 2008q2

The starkest difference between the value functions for the unmerged Delta and

[44] The results of this section are based on a previous iteration of the demand and marginal cost parameters incorporating coefficients obtained from a first stage GMM estimation process and more basic specifications for the reduced-form entry, capacity, and profit models. Updated value of defense results using the intermediate model estimates reported in Sections 1.6.1 to 1.6.1 are forthcoming. A summary of the previous intermediate model results is available upon request.

Northwest (Tables 1.7 and 1.8) and the merged Delta/Northwest (Table 1.9) is that the unmerged carriers have an incentive to reduce capacity in all segments that enter each model, while the merged carrier has an incentive to raise capacity in several segments. This is an important difference in our value of defense game, since the relative increase in the value of allocating capacity to certain segments for the merged carrier raises the opportunity cost of removing capacity from those segments to respond to the entry of a low cost carrier in another segment. In particular, the merged carrier gains from allocating capacity to several MSP-based segments, including MSP to Albuquerque, New Orleans, Oklahoma City, Pittsburgh, and Sacramento, as well as non MSP-based segments including four out of Delta's historical hub in Atlanta (Atlanta to Nashville, Dallas, and Denver), and two out of Los Angeles (Los Angeles to Denver and Honolulu).

Marginal Value of Flight	NW	Marginal Value of Flight	NW
New York Minneapolis-St. Paul	-4.08e+4	Birmingham New York	-1.17e+5
Indianapolis Minneapolis-St. Paul	-7.69e+4	Nashville Memphis	-1.19e+5
Jacksonville Minneapolis-St. Paul	-1.78e+5	Nashville Minneapolis-St. Paul	-1.09e+5
Memphis Milwaukee	-3.15e+5	Boston Indianapolis	-6.56e+4
Memphis New Orleans	-1.75e+5	Los Angeles Reno	-1.78e+5
Albuquerque Cincinnati	-3.57e+5	Cleveland Memphis	-6.87e+4
Atlanta Detroit	-8.70e+3	Albany Cleveland	-4.66e+5
Hartford Detroit	-6.24e+4	Charlotte Minneapolis-St. Paul	-4.77e+4
Hartford Houston	-1.02e+6	Denver Memphis	-1.72e+5
Offset	2.04e+07		

Table 1.8: Estimated Choice-Specific Value of Flight Capacity (Boosted Regression): Northwest Airlines, 2008q2

In contrast, the unmerged Delta and Northwest each gain by generally reducing capacity across the country. For example, Delta gains by reducing capacity in several of its hubs, including Atlanta (to Albuquerque, Denver, Chicago, Norfolk, Louisville,

Marginal Value of Flight	DLNW	Marginal Value of Flight	DLNW
Indianapolis Las Vegas	-2.44e+2	Atlanta Las Vegas	-7.80e+1
Memphis Seattle	-3.62e+2	Albuquerque Minneapolis-St. Paul	2.94e+1
Minneapolis-St. Paul New Orleans	1.09e+4	Nashville Miami	-9.89e+1
Minneapolis-St. Paul Oklahoma City	1.32e+3	Buffalo Cincinnati	-4.70e+2
Minneapolis-St. Paul Pittsburgh	1.05e+3	Buffalo Detroit	-3.93e+2
Minneapolis-St. Paul Sacramento	1.76e+3	Buffalo Southwest Florida	-1.30e+5
Reno Tucson	-9.59e+4	Los Angeles Denver	2.29e+3
Atlanta Nashville	1.37e+2	Los Angeles Honolulu	2.99e+2
Atlanta Dallas	3.36e+1	Cincinnati San Diego	-7.67e+2
Atlanta Denver	8.68e+1	Offset	3.47e+8

Table 1.9: Estimated Choice-Specific Value of Flight Capacity (Boosted Regression): Delta/Northwest Merged, 2008q2

St. Louis, Tulsa, and Tucson), Cincinnati (to Albuquerque, Boston, Hartford, and Washington DC), New York (to Memphis), and Los Angeles (to New Orleans), as well as in several of Northwest's hubs, including Detroit (to Pittsburgh), Salt Lake City (to Sacramento, Dallas, and Denver), and Minneapolis-St. Paul (to Tucson). Similarly, Northwest gains by reducing capacity in several of its hubs, including Minneapolis-St. Paul (to New York, Indianapolis, Jacksonville, Nashville, and Charlotte), Memphis (to Milwaukee, New Orleans, Nashville, Cleveland, and Denver), and Detroit (to Atlanta and Hartford).

1.6.2 Value of Defense

Delta and Northwest, Chicago to MSP (Entry by Southwest Airlines)

Delta and Northwest announced their intentions to merge in 2008q2, creating what was at the time the world's largest airline. Shortly thereafter, in November of 2008, Southwest announced that it would commence its first substantial presence at Minneapolis

St. Paul (MSP) airport by operating flights from Chicago Midway to MSP beginning in March of 2009. This entry initiated a general increase in the share of low cost carrier flight offerings at MSP, which had remained low throughout the late 1990s and 2000s. Instead of fighting this entry aggressively as Northwest had done throughout its time as the dominant hub carrier at MSP, the merged Delta and Northwest reduced capacity in 2008 and 2009, which as of 2014q4 had not yet risen back to pre-recession levels.

In this section, we characterize the incentives for Southwest Airlines, Delta Airlines, and Northwest Airlines immediately before and after the Delta and Northwest merger, focusing first on Southwest's entry into the Chicago to Minneapolis, St. Paul (MSP) segment. To calibrate the number of flights needed to induce Southwest's exit, we compute the profitability (variable operating profits) of entry for Southwest given various levels of total flights offered by all carriers in a given market. Second, we detail the incentives for capacity allocation faced by the unmerged Delta and Northwest and compare these incentives to those faced by the merged Delta and Northwest.

Table 1.10 shows our estimates of the profitability for Southwest of offering 280 flights per quarter (˜3 per day) on the Chicago to MSP segment, starting in 2008q2. The expected profitability for Southwest generally falls as the number of flights offered by other carriers (column 3) increases. For example, when the number of flights offered by other carriers in the market is 100, Southwest expects a variable profit of $39.61 million. Expected variable profits fall and go negative when other carriers offer at least 700 flights per quarter on the segment.

Table 1.11 presents the results of our primary simulation for the Chicago to MSP segment. This table shows the value of defending the Chicago to MSP segment from Southwest entry, for Delta and Northwest as unmerged carriers, as well as for the merged Delta and Northwest. We assume legacy carriers allocate 700 flights to the segment when responding to Southwest's entry. This table shows that the value of defending Chicago to MSP against Southwest's entry decreased for the merged Delta and Northwest as compared with the unmerged carriers. The unmerged Delta gained the most from defending the flight segment, with a successful defense providing an increase of 1.3% of total national operating profits for the carrier in 2008q1. For Northwest, it appears that defending the flight segment provided little value absent the merger, with the value of defense accounting for -0.17% of 2008q1 total national profits. However, the value of defense in this segment is much lower for the merged Delta and Northwest than for its unmerged counterparts, accounting for large losses representing -1.1% of the combined carrier's total national profits in 2008q1. Relative to the unmerged carriers, these differences in value represent 1.77 and 1.07 percentage point decreases with respect to Delta and Northwest, respectively.

Expected Variable Profits for Southwest (Chi to MSP)	Total Number of Flights Offered in the Market per Quarter (Chi to MSP)
39.614	100
31.815	200
24.015	300
16.216	400
8.417	500
0.618	600
-7.182	700
-14.981	800
-22.780	900
-30.580	1000

Table 1.10: Profitability of Offering 280 flights in Chicago to MSP, 2008q2, Given Total Market Capacity (in Millions of US $)

The mechanism for this drop in value is apparent from the estimated value func-

Carrier	Value of Defense (700 flights), % of 2008q1 National Profits
Delta	1.263%
Northwest	-0.173%
Delta and Northwest (Merged)	-1.096%
Difference, Value of Defense Pre to Post Merger (Delta)	-1.767%
Difference, Value of Defense Pre to Post Merger (Northwest)	-1.070%

Note: based on 500 simulation runs.

Table 1.11: Change in Value of Defending Chicago to MSP against Southwest Entry, Delta and Northwest, Pre to Post-Merger

tions for each carrier, as previously presented in Tables 1.7 to 1.9. [45] For each of the unmerged Delta and Northwest, the opportunity cost of moving flights from other segments to Chicago to MSP is actually *positive*, since the coefficients on increasing capacity are negative on these flight segments. For instance, for Delta, prior to considering the costs of increased capacity in the Chicago to MSP market, moving one flight away from each segment listed in Table 1.7 increases nation-wide discounted expected profits by $7.8 million. These increases are similar for Northwest, where removing one flight from each market listed in Table 1.8 increases nation-wide discounted expected profits by $3.5 million.

In contrast, upon merging with Delta, the opportunity cost of reallocating capacity rose, as shown by the estimated coefficients in Table 1.9. The merged carrier has incentives to allocate additional capacity to nine segments, which makes taking away

[45] In the presented results, we assume the legacy carrier allocates the desired number of flights proportionally based on the value of reallocation as estimated in the value function. We then take the "floor" of each designated allocation, to keep the number of flights as integers, and also to keep the total number of reallocated flights less than or equal to 700. In ongoing robustness checks, we alter the flight segments from which the legacy carrier draws capacity (to, for example, draw from the highest marginal value segment).

some of the fixed stock of flights from these segments costly. Reallocating one flight away from each segment listed in Table 1.9 lowers nation-wide discounted expected profits by $0.21 million. In effect, defending the Chicago to MSP flight segment for the merged firm involves a reallocation of capacity away from segments where it has an incentive to increase capacity. This adds to the losses incurred by the merged carrier in the entered market during the period(s) of increased competition.

Delta and Northwest, All Segments Unentered by Southwest Airlines in 2008q1

As shown in Table 1.12, in the first quarter of 2008, Southwest operated no nonstop flights in 569 segments in our OAG sample. By the final time period in our sample (the fourth quarter of 2014), Southwest had begun offering flights in 372 of these segments, with 197 segments still unentered. Appendix Table A.3 provides a full list of these segments with the corresponding quarter when Southwest began offering flights (or a “Never Entered” designation if they failed to offer flights by 2014q4). In this section, we explore whether the value of defense, both from Delta and Northwest’s perspective as well as from Southwest’s perspective, appears related to Southwest’s entry decisions after 2008q1.

Table 1.13 presents our primary results for the segments unentered by Southwest in 2008q1. These results appear to confirm the hypothesis that Southwest was sensitive to changes in the merged Delta’s defense incentives when making entry decisions during this period. First, upon merging, the value of defense for Delta and Northwest increased more in segments never entered by Southwest relative to those eventually entered, with a mean and median change of $27.56 and $22.45 million for segments never entered versus $17.93 and $13.66 million for those eventually entered. From the perspective of the unmerged Delta and Northwest, the value of defense was higher in markets never entered by Southwest relative to those eventually entered, with a mean and median value of $16.56 and $14.74 million for the never entered segments versus $9.54 and $7.81 million for those eventually entered. This relationship also holds for the merged

Delta and Northwest, where the mean and median value of defense for segments never entered by Southwest is \$44.12 and \$40.37 million versus \$27.47 and \$19.60 million for segments eventually entered. A complete distribution summary of value of defense is available in Appendix Table A.4.

Quarter	Number of Segments Entered	Quarter	Number of Segments Entered	Quarter	Number of Segments Entered	Quarter	Number of Segments Entered
2008q2	9	2010q1	4	2011q4	2	2013q3	25
2008q3	4	2010q2	4	2012q1	37	2013q4	13
2008q4	1	2010q3	1	2012q2	5	2014q1	7
2009q1	49	2010q4	2	2012q3	3	2014q2	3
2009q2	19	2011q1	2	2012q4	8	2014q3	2
2009q3	12	2011q2	1	2013q1	19	2014q4	2
2009q4	42	2011q3	2	2013q2	94	Never Entered	197

Table 1.12: Southwest Unentered Segments in 2008q1

In summary, in the segments Southwest eventually entered versus those they avoided, capacity increases by Delta and Northwest was less valuable for Delta, Northwest, and the merged Delta and Northwest. Also, the value of defense in the segments eventually entered increased less upon the merger of Delta and Northwest.

Figure 1.2 compares the probability of new entry by Southwest with the mean value of defense change for Delta and Northwest by flight segment upon merging. For example, the value of defending against Southwest entry in the Nashville to MSP flight segment for Delta fell by \$21.9 million upon merging. For Northwest, this value fell by \$5.6 million. We average these two values together to obtain a mean value of defense change for the merged Delta on the Nashville to MSP flight segment of -\$13.7 million. The probabilities of Southwest entry from 2008q1 to 2014q4 (the last date in our

Value of Defense (Millions of $)	Median	Mean
Merger Change, Southwest Never Entered	22.45	27.56
Merger Change, Southwest Entered After 2008q1	13.66	17.93
Unmerged, Southwest Never Entered	14.74	16.56
Unmerged, Southwest Entered After 2008q1	7.81	9.54
Merged, Southwest Never Entered	40.37	44.12
Merged, Southwest Entered After 2008q1	19.6	27.47
Southwest, Southwest Never Entered	-0.59	-0.58
Southwest, Southwest Entered After 2008q1	-0.26	-0.45

Table 1.13: Value of Defense (Median and Mean)

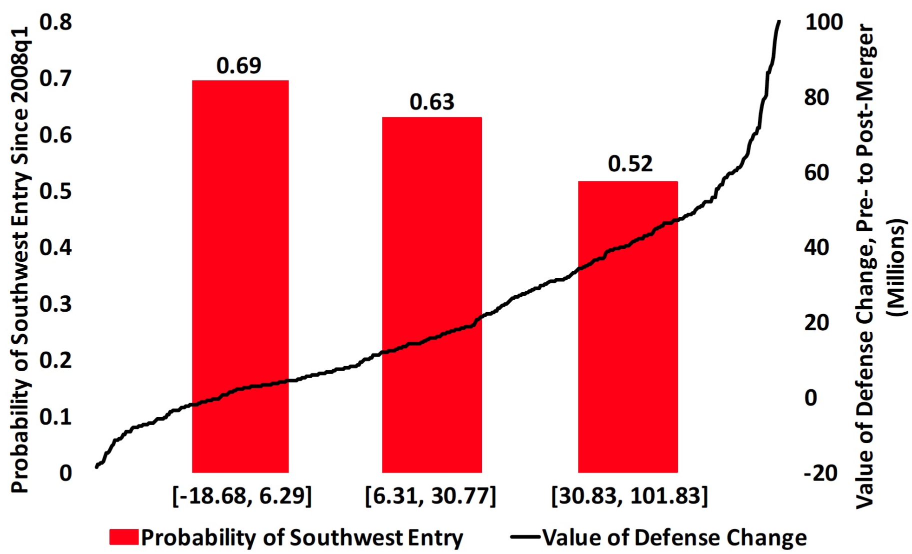

Figure 1.2: Probability of Southwest Entry and the Mean Value of Defense Change, Pre- to Post-Merger, Delta and Northwest

sample) are computed for flight segments in the specified mean value of defense change bins, considering only flight segments unentered by Southwest in 2008q1. Figure 1.2

shows that the probability of Southwest's entry was smaller on flight segments that exhibited the largest gains in the value of defense for the merged Delta. In other words, Southwest appeared to avoid flight segments that became increasingly valuable for the merged Delta to defend. For instance, on flight segments where the value of defense increased the most, Southwest's probability of entering these segments from 2008q1 to 2014q4 was 0.52. On flight segments where the value of defense increased the least or decreased, Southwest's probability of entry during the same time period was 0.69. These results suggest that Southwest was sensitive to changes in the incentives of Delta and Northwest to defend flight segments when making entry decisions.

Table 1.14 presents the primary changes in the data induced by the merger of Delta and Northwest, which in turn change the value of defense on each flight segment.[46] The characteristics included in this table are variables found in the reduced-form profit specification presented in Table 1.5. As before, the flight segments considered are those unentered by Southwest in 2008q1, where "Southwest Entered" indicates flight segments that Southwest entered from 2008q1 to 2014q4, while "Southwest Unentered" indicates flight segments on which Southwest offered no flights during the same time period. Southwest entry decisions on flight segments are allocated to airline products to accommodate the possibility that Southwest utilizes the flight segment for both nonstop and onestop flights.[47] These average characteristics mostly show how flight segments not entered by Southwest were associated with airline products that became more profitable for the merged Delta due to changes in market structure induced by the merger. For example, the end points of flight segments not entered by Southwest grew closer to existing hubs of Delta or Northwest upon the merger than the end points of flight segments entered by Southwest. On average, the merger made flight

[46] We focus on data from the second quarter of 2008, which is the time period when we simulate our counterfactual merger and values of defense.

[47] To complete this allocation, we assign entered flight segments to the first and second legs of a hypothetical airline product, as well as to a nonstop airline product. We assume Southwest offers a onestop airline product if both legs are served by flight segments that Southwest has entered.

segments unentered by Southwest 146 miles closer to Delta or Northwest hubs, while it made flight segments entered by Southwest 180 miles closer to these hubs. Closer hubs imply lower marginal costs and higher profits for the merged Delta. Similarly, on some flight segments, Delta or Northwest gained a hub by merging. Hubs generally provide higher carrier profits through increased pricing power and lower marginal costs. On average, the merged Delta gained hubs at the origins, connections, and destinations of airline products it offered more often when these airline products coincided with flight segments unentered by Southwest as opposed to those entered by Southwest.

Mean Merger Change Across Flight Segments	Southwest Entered	Southwest Unentered
Closest Hub Distance (Miles)	-145.91	-180.25
Origin Hub Indicator	0.076	0.078
Stop Hub Indicator	0.070	0.074
Destination Hub Indicator	0.076	0.078
Number of Competitors	-0.893	-0.766
Profits Per Product-Quarter (Thousands)	$11.38	$14.65
Marginal Cost Per Passenger	-$0.012	-$0.013
Mean Cost of Reallocating 700 Flights (Millions)	$7.49	$7.49

Table 1.14: Merger-Induced Changes in Characteristics Affecting Profitability (Delta and Northwest Merger, 2008q2 Data)

The final three variables considered in Table 1.14 present changes in profitability more directly. First, unentered Southwest flight segments were associated with higher gains in profits per airline product per quarter for the merged Delta, changing by $14.65 thousand as opposed to $11.38 thousand for flight segments entered by Southwest. In the same spirit, marginal costs per passenger dropped more for the merged Delta on airline products associated with unentered Southwest flight segments (-$0.013) than on those associated with entered Southwest flight segments (-$0.012). Third, the figure presents the change in the mean cost of reallocating seven hundred flights for the merged

Delta. This cost is computed by pulling seven hundreds flights in equal proportion from all flight segments listed in Tables 1.7, 1.8, and 1.9 for Delta, Northwest, and the merged Delta, respectively. We then take the difference between these costs for the merged Delta and the unmerged Delta as well as for the merged Delta and the unmerged Northwest, and then average these differences. The cost of reallocating flights increased by $7.4 million, on average, reflecting the increased marginal value of capacity on many flight segments across the merged Delta's network, as presented in Tables 1.7, 1.8, and 1.9. Finally, the only variable that appears to have the "wrong" sign is the number of competitors variable. The Delta and Northwest merger induces, at most, the elimination of one competitor in markets where the unmerged Delta and Northwest both offer products. On average, Delta and Northwest were more likely to experience this drop in competition (and increase in pricing power) in markets associated with entered Southwest flight segments versus those associated with unentered Southwest flight segments. In the context of the rest of Table 1.14, this provides some evidence that Southwest was induced to enter flight segments associated with markets where the merged Delta and Northwest gained pricing power through the loss of a competitor, but not where the merged Delta gained profitability through other means, such as decreases in marginal costs and increases in pricing power due to closer or newly obtained hubs. Notwithstanding this qualification, overall, Table 1.14 indicates that Southwest tended to avoid entering flight segments associated with airline products that increased in per-period profitability for the merged Delta.

1.7 Conclusion

Throughout its history, Northwest Airlines served as the dominant hub carrier at Minneapolis, St. Paul (MSP) airport, building a reputation as one of the most aggressive responders to low cost carrier entry, especially into MSP. Consequently, MSP maintained a relatively small low cost carrier presence and some of the highest airfares in the country. Northwest's incentives appeared to change after its merger with Delta, announced in 2008q2. Immediately after announcing this merger, Southwest Airlines announced its first nonstop flight offerings from the airport, with flights from MSP to Chicago. Other low cost carriers followed, and the share of low cost carrier flights to or from MSP rose from below 20 percent immediately preceding the merger to almost 50 percent by the end of 2014.

What would drive a dominant incumbent with a history of aggressively responding to new entrants to seemingly give up this competitive position and accommodate entry after a merger? This chapter answers this question by studying how the incentives of legacy carriers to accommodate low cost carrier entrants change when they merge with other legacy carriers. To do so, we propose and estimate a model of dynamic, strategic airline competition where defending a flight segment against new entrants involves a reallocation of aircraft capacity from other flight segments the legacy carrier serves. This increase in capacity increases competition and lowers profits for the new entrant. In our model, mergers change the value of defending flight segments by changing the opportunity costs of reallocating capacity, given the merged airline's combined fleet and flight network. Using this model and a rich and comprehensive sample of airline fares, flight segments, and scheduled flights by U.S. carriers from 2005 to 2014, we find that the entry decisions of Southwest airlines since 2008 appeared sensitive to changes in the incentives of Delta and Northwest to defend flight segments in its U.S. domestic network. Specifically, Southwest entered flight segments since 2008q1 that, from Delta and Northwest's perspective, became more expensive to commit aircraft capacity to, relative to the rest of its network.

We are in the process of extending this chapter in a variety of ways. First, we are generating new results and robustness checks related to the Delta and Northwest merger using 1) a variety of alternative specifications of the input models presented in the Results section, and 2) data from an assortment of alternative time periods. Second, we are proposing and estimating fixed, entry, and exit costs for carriers. Third, we are exploring how to adapt recently proposed inference procedures for high-dimensional sparse linear models to our dynamic optimization problem setting. Fourth, we are extending this setup to study other legacy carrier mergers that occurred in the time period covered by our data, including the United and Continental merger and the American and US Airways merger. We introduce some of this ongoing work in the Appendix A.3.

Chapter 2

IMPROVING POLICY FUNCTIONS IN HIGH-DIMENSIONAL DYNAMIC GAMES

2.1 Introduction

Many dynamic games of interest in economics have state spaces that are potentially very large, and solution algorithms considered in the economics literature do not scale to problems of this size. Consider the game of Chess, which is a two-player board game involving sequential moves on a board consisting of 64 squares and which can be characterized as Markovian, with the existing board configuration serving as the current state. Since games end after the maximum allowable 50 number of moves, solving for pure Markov-perfect equilibrium strategies is in principle achievable using backward induction, since all allowable positions of pieces and moves could be mapped into an extensive form game tree.[1] In practice, however, there are at least two challenges to implementing this type of solution method.

The first challenge is the high number of possible branches in the game tree. For example, an upper bound on the number of possible terminal nodes is on the order of 10^{46}.[2] Fully solving for equilibrium strategies requires computing and storing s-tate transition probabilities at each of a very large number of nodes, which is both analytically and computationally intractable.

The second challenge is deriving the strategies of opponents. Equilibrium reasoning motivates fixed-point methods for deriving equilibrium best responses. However, it is

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[1] Recently, researchers have found that this is even more complicated for games like Chess, which may have no uniform Nash equilibria in pure or even mixed positional strategies. See Boros, Gurvich and Yamangil (2013) for this assertion.

[2] See Chinchalkar (1996).

not clear that equilibrium assumptions will generate good approximations of opponent play in Chess, since players may engage in suboptimal strategies, making Nash-style best responses derived *a priori* possibly suboptimal. Similarly, it is not clear whether developing and solving a stylized version of Chess would produce strategies relevant for playing the game.

Recently, researchers in computer science and artificial intelligence have made considerable progress deriving strategies for high-dimensional dynamic games such as Chess using a general approach very different from that used by economists, which has two broad themes. First, to derive player strategies, they rely more heavily on data of past game play than on equilibrium assumptions. Second, instead of focusing on deriving optimal strategies, they focus on continually improving upon the best strategies previously implemented by other researchers or game practitioners. This general approach has provided a series of successful strategies for high-dimensional games.[3]

In this chapter, we propose an approach which proceeds in this spirit, combining ideas developed by researchers in computer science and artificial intelligence with those developed by econometricians for studying dynamic games to solve for policy improvements for a single agent in high-dimensional dynamic games, where strategies are restricted to be Markovian.

This algorithm can be characterized by two attributes that make it useful for deriving strategies to play high-dimensional games. First, instead of deriving player strategies using equilibrium assumptions, we utilize data on a large number of previous plays of the game. Second, we employ an estimation technique from Machine Learning that reduces the dimensionality of the game in a data-driven manner, which simultaneously makes estimation feasible.

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[3]These include, *inter-alia*, the strategy of the well-publicized computer program "Deep Blue" (developed by IBM), which was the first machine to beat a reigning World Chess Champion, and the counterfactual regret-minimization algorithm for the complex multi-player game Texas Hold'em developed by Bowling, Burch, Johanson and Tammelin (2015), which has been shown to beat successful players in practice.

The data provides us with sequences of actions and states describing many plays of the game, indexed by time, and the assumption that strategies are Markovian allows us to model play in any particular period as a function of a set of payoff relevant state variables.[4] Using this data, we estimate opponent strategies as a function of the state, as well as a law of motion. We also borrow from the literature on the econometrics of games and estimate the choice-specific value function, making the choice-specific value function the dependent variable in an econometric model.[5] After fixing the strategy of the agent for all time periods beyond the current time period using a benchmark strategy, we use the estimated opponent strategies and law of motion to simulate and then estimate the value of a one-period deviation from the agent's strategy in the current period.[6] This estimate is used to construct a one-step improvement policy by maximizing the choice-specific value function in each period as a function of the state, conditional on playing the benchmark strategy in all time periods beyond the current one.

Since the settings we consider involve a large number of state variables, estimating opponent strategies, the law of motion, and the choice-specific value function in this algorithm is infeasible using conventional methods. As a consequence, we utilize a technique from Machine Learning which makes estimation and simulation in high-dimensional contexts feasible through an approximation algorithm that selects the parsimonious set of state variables that minimizes the loss associated with predicting our outcomes of interest using a fixed metric. Machine Learning refers to a set of methods developed and used by computer scientists and statisticians to estimate

[4]We note that in principle there is some scope to test the Markov assumption. For example, we could do a hypothesis test of whether information realized prior to the current period is significant after controlling for all payoff relevant states in the current period.

[5]See Pesendorfer and Schmidt-Dengler (2008) for an example using this approach. Also see Bajari, Hong, and Nekipelov (2013) for a survey on recent advances in game theory and econometrics.

[6]In practice, the benchmark strategy could represent a previously proposed strategy that represents the highest payoffs agents have been able to find in practice. For example, in spectrum auctions, we might use the well known "straightforward bidding" strategy or the strategy proposed by Bulow, Levin, and Milgrom (2009).

models when both the number of observations and controls is large, and these methods have proven very useful in practice for predicting accurately in cross-sectional settings. See Hastie *et al.* (2009) for a survey. There has been relatively little attention to the problem of estimation when the number of controls is very large in econometrics until recently. See Belloni, Chernozhukov, and Hansen (2010) for a survey of some recent work. In our illustration, we utilize a Machine Learning method known as Component Wise Gradient Boosting (CWGB), which we describe in detail in Section 2.2.2. This technique was developed and characterized theoretically in a series of articles by Breiman (1998, 1999), Friedman *et al.* (2000), and Friedman (2001). Also see Hastie *et al.* (2009) for an introduction to the method.[7] As with many other ML methods, CWGB works by projecting the estimand functions of interest onto a low-dimensional set of parametric basis functions of regressors, with the regressors and basis functions chosen in a data-driven manner. CWGB methods can accommodate non-linearity in the data generating process, are computationally simple, and, unlike many other non-linear estimators, are not subject to problems with convergence in practice. As a result of the estimation process, CWGB often reduces the number of state variables dramatically, and we find that these parsimonious approximations perform well in our application as compared with other variable and model selection procedures, suggesting that many state representations in economics might be computationally wasteful. [8] For example, we find that choice-specific value functions in our spatial location game are well-approximated by between 6 and 7 state variables (chosen from the original

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[7] We choose this method because among the methods considered, it had the highest level of accuracy in out-of-sample prediction. We note that there are relatively few results about "optimal" estimators in high-dimensional settings. In practice, researchers most often use out-of-sample fit as a criteria for deciding between estimators.

[8] As with other Machine Learning estimators, the relative performance of CWGB as compared with other methods may depend on the application considered. In general, Machine Learning methods do not necessarily dominate existing estimators in econometrics. For example, Hansen (forthcoming) shows that whether the Lasso estimator generates a lower mean-squared error than OLS depends on the extent to which many of the true coefficients on regressors are equal to zero, i.e. the extent to which the parameter space is "sparse."

1817).

Our algorithm contributes a data-driven method for deriving policy improvements in high-dimensional dynamic Markov games which can be used to play these games in practice. High-dimensional dynamic games include, for example, Chess, Go, Texas Hold 'em, spectrum auctions, and the entry game we study in this chapter. It also extends a related literature in approximate dynamic programming (ADP). ADP is a set of methods developed primarily by engineers to study Markov decision processes in high-dimensional settings. See Bertsekas (2012) for an extensive survey of this field. Within this literature, our approach is most related to the rollout algorithm, which is a technique that also generates a one-step improvement policy based on a choice-specific value function estimated using simulation. See Bertsekas (2013) for a survey of these algorithms. Although originally developed to solve for improvement policies in dynamic engineering applications, the main idea of rollout algorithms–obtaining an improved policy starting from another suboptimal policy using a one-time improvement–has been applied to Markov games by Abramson (1990) and Tesauro and Galperin (1996). We appear to be the first to formalize the idea of estimating opponent strategies and the law of motion as inputs into the simulation and estimation of the choice-specific value function when applying rollout to multi-agent Markov games. This is facilitated by separating the impact of opponent strategies on state transitions from the payoff function in the continuation value term of the choice-specific value function, which is a separation commonly employed in the econometrics of games literature. Additionally, we extend the rollout literature by using a recently developed Machine Learning estimator to select regressors in high-dimensional contexts in a data-driven manner.

We note that in practice there are several limitations to the approach we describe. A first is that we do not derive an equilibrium of the game. Hence we are unable to address the classic questions of comparative statics if we change the environment. That said, to the best of our knowledge, the problem of how to derive equilibria in games with very large state spaces has not been solved in general. We do suspect that finding a computationally feasible way to derive policy improvements in this setting may be useful as researchers make first steps in attacking this problem. A second limitation is that we assume opponent strategies are fixed. In practice, competitors might reoptimize their strategies after observing our play.[9] A third limitation is that we do not derive theoretical characterizations of the optimality properties of our Machine Learning estimator or policy function improvements, i.e. whether our policy function improvements converge generally. Many Machine Learning estimators, including the one we use in this chapter, simultaneously perform model selection and estimation at the same time. This feature can generate corner solutions, making the derivation of fundamental estimator properties, such as consistency and asymptotic distributions, potentially more challenging. Although Machine Learning estimators are typically used on datasets that are very large, often making sampling distributions a less important criteria than predictive accuracy, sampling distributions may influence the convergence of our policy function improvements in the context of smaller samples.

That said, it is not clear that equilibrium theory is a particularly useful guide to play in these settings, even if theory tells us that equilibrium exists and is unique. In economics, much of the guidance has been based on solving very stylized versions of these games analytically or examining the behavior of subjects in laboratory experiments. Our method complements these approaches by providing strategies useful for playing high-dimensional games in practice. Artificial intelligence and computer science researchers, along with decision makers in industry and policy have used data as an important input into deriving strategies to play games. We believe that our example shows that certain economic problems may benefit from the intensive use of data and modeling based on econometrics and Machine Learning.

The rest of the chapter proceeds as follows. The next section describes the class of

[9] It may be possible to mitigate this problem to some extent in practice. For example, if researchers can observe newly reoptimized opponent play, they can reestimate opponent strategies and use our method to derive new policy improvements to compete against these strategies.

games for which our algorithm is useful and then describes Component-Wise Gradient Boosting as well as an algorithm for generating policy function improvements. Section 3 concludes.

2.2 Method Characterization

2.2.1 Game Model

In this section, we formally characterize a class of games for which our method is useful for finding policy function improvements.

Preliminaries

We define a discrete number of time periods, denoted as $t = 1, ..., T$ with $T < \infty$, and a discrete number of players, denoted as $i \in \mathcal{I} \equiv \{1, ..., N\}$. We refer to the competitors of a reference player i as players $-i$, where $-i \equiv \{\neg (i \cap \mathcal{I})\}$. Finally, we denote observations of player actions and states (defined below) found within data using the index $l = 1, ..., L$ with $L < \infty$.

State

Define a state vector, denoted as $\mathbf{s}_t$ for each t, as

$$\mathbf{s}_t \equiv (s_{1t}, ..., s_{K_s t}) \in \mathcal{S}_t \subseteq \mathbb{R}^{K_s}$$

where $s_{1t}, ..., s_{K_s t}$ represent a set of K_s state variables at time t, $\mathcal{S}_t$ represents the support of $\mathbf{s}_t$, and $\mathbb{R}^{K_s}$ represents the K_s-ary Cartesian product over K_s sets of real numbers $\mathbb{R}$. The set $\mathcal{S}_t$ can be discrete, continuous, or both. In practice, the number of state variables, i.e. K_s, can be large. At time t, the state at time $t+1$ is random and is denoted as $\mathbf{S}_{t+1}$ with realization $\mathbf{S}_{t+1} = \mathbf{s}_{t+1}$.

Importantly, in the econometrics of games literature, researchers often seek to model functions of the state, such as payoffs, opponent strategies, and the law of motion (defined formally in the sub sections that follow), using general functional forms. In these settings, the cardinality of $\mathcal{S}_t$, denoted as $|\mathcal{S}_t|$, becomes important, and this cardinality is potentially very large. For example, in our entry game application, although $K_s = 1817$, the average $|\mathcal{S}_t|$ (average by time period) is greater than 10^{85}. See the Appendix for a derivation of the cardinality of the state in our entry game application.

We also define the dimension-reduced state vector that remains as a result of the Component-Wise Gradient Boosting (CWGB) estimation process described in Section 2.2.2. Define this state vector, denoted as $\widetilde{\mathbf{s}}_t$ for all t, as

$$\widetilde{\mathbf{s}}_t \equiv \left(s_{1t}, ..., s_{K_{s,GB}t}\right) \in \widetilde{\mathcal{S}}_t \subseteq \mathbb{R}^{K_{s,GB}}$$

where $K_{s,GB}$ represents the number of state variables that remain after CWGB, such that $K_{s,GB} \leq K_s$. In practice, it is often the case that the dimension of $\widetilde{\mathbf{s}}_t$ is much smaller than the dimension of the original state vector $\mathbf{s}_t$, i.e. $K_{s,GB}$ is much smaller than K_s, making the cardinality of $\widetilde{\mathcal{S}}_t$ much smaller than the cardinality of $\mathcal{S}_t$. This cardinality reduction plays an important role in making the forward simulation step of our algorithm feasible (see Section 2.2.2), since we only simulate realizations of the dimension-reduced state rather than realizations of the original state.

Actions

Each player chooses a vector of feasible actions, denoted as $\mathbf{a}_{it}$ for all t, and defined as

$$\mathbf{a}_{it} \equiv (a_{1it}, ..., a_{K_a it}) \in \mathcal{A}_{it} \subseteq \mathbb{R}^{K_a}$$

where $a_{1it}, ..., a_{K_a it}$ represent a set of K_a action variables at time t, $\mathcal{A}_{it}$ represents the discrete support of $\mathbf{a}_{it}$, and $\mathbb{R}^{K_a}$ represents the K_a-ary Cartesian product over K_a sets of real numbers $\mathbb{R}$. We abuse the notation of $\mathbf{a}_{it}$ by suppressing its possible dependence on $\mathbf{s}_t$. We further define the profile of actions across all competitors $-i$

as $\mathbf{a}_{-it} \equiv (\mathbf{a}_{1t}, ..., \mathbf{a}_{i-1t}, \mathbf{a}_{i+1t}, ..., \mathbf{a}_{Nt})$ with support $\mathcal{A}_{-it} \subseteq \mathbb{R}^{K_a(N-1)}$, and a profile of actions across all players including i as $\mathbf{a}_t \equiv (\mathbf{a}_{1t}, ..., \mathbf{a}_{Nt})$ with support $\mathcal{A}_t \subseteq \mathbb{R}^{K_a N}$.

The action vector serves as either an outcome variable or set of regressors in the models estimated in Section 2.2.2. In practice, when actions represent an outcome, we redefine $\mathcal{A}_{it}$ so as to constrain its cardinality to be sufficiently small, since our method requires us to evaluate policies at each action in $\mathcal{A}_{it}$ for a subset of states. This often means that we will redefine the problem such that each action we consider is a scalar rather than a vector, which is separately denoted as a_{it} to distinguish it from $\mathbf{a}_{it}$. For example, in our entry game application, $K_a = 1$ and a_{it} is a scalar 0, 1 indicator over the choice of placing a facility in a given location, which gives $|\mathcal{A}_{it}| = 2$ for all t.

When actions represent a set of regressors, as is the case when estimating the law of motion in Section 2.2.2, we allow the dimensionality of the action vector to remain high. As is the case with the state vector, the CWGB estimation process selects a subset of the original action variables, which we define as

$$\widetilde{\mathbf{a}}_{it} \equiv \left(a_{1it}, ..., a_{K_{a,GB}it}\right) \in \widetilde{\mathcal{A}}_{it} \subseteq \mathbb{R}^{K_{a,GB}}$$

where $K_{a,GB} \leq K_a$.

Law of Motion

We make the following assumption on the evolution of states over time.

Assumption (A1). States evolve according to the Markov property, i.e. for all $\mathbf{s}_{t+1} \in \mathcal{S}_{t+1}$, $\mathbf{s}_t \in \mathcal{S}_t$, and $\mathbf{a}_t \in \mathcal{A}_t$,

$$F\left(\mathbf{S}_{t+1} \leq \mathbf{s}_{t+1} | \mathbf{s}_1, ..., \mathbf{s}_t, \mathbf{a}_1, ..., \mathbf{a}_t\right) = F\left(\mathbf{S}_{t+1} \leq \mathbf{s}_{t+1} | \mathbf{s}_t, \mathbf{a}_t\right)$$

where,

$$F\left(\mathbf{S}_{t+1} \leq \mathbf{s}_{t+1} | \mathbf{s}_t, \mathbf{a}_t\right) \equiv \Pr\left(S_{1t+1} \leq s_{1t+1}, ..., S_{K_s t+1} \leq s_{K_s t+1} | \mathbf{s}_t, \mathbf{a}_t\right)$$

Here, $F(.)$ represents the cdf of $\mathbf{S}_{t+1}$, which we deem the law of motion. In some applications, the law of motion may vary across time periods, although we abstract away from this possibility for expositional simplicity. We allow the transitions for a subset of state variables to be independent of player actions.

Period Return

The von Neumann-Morgenstern utility function for player i at time t is:

$$u_i(\mathbf{s}_t, \mathbf{a}_{it}, \mathbf{a}_{-it}) \equiv \pi_i(\mathbf{s}_t, \mathbf{a}_{it}, \mathbf{a}_{-it}) + \epsilon_{it}$$

where ϵ_{it} is a continuous random variable observed only by player i at time t and which has a density $f(\epsilon_{it})$ and cumulative distribution function $F(\epsilon_{it})$. The error ϵ_{it} can be interpreted as a preference shock unobserved by both the econometrician as well as by the other players and which makes player strategies as a function of the state random (see Section 2.2.1). It can also be interpreted as an unobserved state variable. See Rust (1987) for a discussion of this interpretation within the context of dynamic optimization problems. We make the following assumption on the distribution of ϵ_{it}.

Assumption (A2). The private shock ϵ_{it} is distributed *iid* across agents, actions, states, and time.

The term $\pi_i(\mathbf{s}_t, \mathbf{a}_{it}, \mathbf{a}_{-it})$ is a scalar which is a function of the current state $\mathbf{s}_t$ and the action vector for players i and $-i$, i.e. $\pi_i(\mathbf{s}_t, \mathbf{a}_{it}, \mathbf{a}_{-it}) : \mathcal{S}_t \times \mathcal{A}_{it} \times \mathcal{A}_{-it} \to \mathbb{R}$, where $\mathbb{R}$ is the set of real numbers. We assume payoffs are additively separable over time.

Strategies

We assume that players choose actions simultaneously at each time t. A strategy for agent i is a vector-valued function $\mathbf{a}_{it} = \delta_i(\mathbf{s}_t, \epsilon_{it})$, which maps the state at time t and agent i's time t private shock to agent i's time t action vector $\mathbf{a}_{it}$. From the perspective of all other players $-i$, player i's policy function as a function of the state can be represented by the conditional probability function $\sigma_i\left(\mathbf{A}_{it}=\mathbf{a}_{it}|\mathbf{s}_t\right)$, such that:

$$\sigma_i\left(\mathbf{A}_{it}=\mathbf{a}_{it}|\mathbf{s}_t\right)=\int \mathbb{I}\left\{\delta_i\left(\mathbf{s}_t,\epsilon_{it}\right)=\mathbf{a}_{it}\right\}dF\left(\epsilon_{it}\right)$$

where $dF\left(\epsilon_{it}\right)\equiv f\left(\epsilon_{it}\right)d\epsilon_{it}$ and where the notation $\mathbf{A}_{it}$ emphasizes that actions are random from the perspective of other players (we use the notation A_{it} when actions are a random variable rather than a random vector). Abusing notation, we often abbreviate $\sigma_i\left(\mathbf{A}_{it}=\mathbf{a}_{it}|\mathbf{s}_t\right)$ as σ_i. Further define the product of the profile of policy functions for all players $-i$ at time t as $\sigma_{-i}\left(\mathbf{A}_{-it}=\mathbf{a}_{-it}|\mathbf{s}_t\right)\equiv\prod_{j\in -i}\sigma_j\left(\mathbf{A}_{jt}=\mathbf{a}_{jt}|\mathbf{s}_t\right)$, which we abbreviate as $\sigma_{-i}\left(\mathbf{a}_{-it}|\mathbf{s}_t\right)$. Finally, we separately denote a potentially suboptimal policy function for player i at time t as $\overline{\sigma}_i$, which plays a special role in our policy improvement algorithm detailed in Section 2.2.2. For simplicity, we abstract away from the possibility that each player's policy function changes over time. It is straightforward to relax this simplification in what follows.

Value Function and Choice-Specific Value Function

Value Function. Let β be a common discount factor. We define the following *ex ante* value function for player i at time t,

$$V_i\left(\mathbf{s}_t,\epsilon_{it}\right)\equiv \max_{\mathbf{a}_{it}\in\mathcal{A}_{it}}\left\{\sum_{\mathbf{a}_{-it}\in\mathcal{A}_{-it}}\left(\pi_i\left(\mathbf{s}_t,\mathbf{a}_{it},\mathbf{a}_{-it}\right)+\epsilon_{it}+\beta\mathbb{E}_{\mathbf{s}_{t+1},\epsilon_{it+1}}\left[V_i(\mathbf{s}_{t+1},\epsilon_{it+1})|\mathbf{s}_t,\mathbf{a}_{it},\mathbf{a}_{-it}\right]\right)\sigma_{-i}\left(\mathbf{a}_{-it}|\mathbf{s}_t\right)\right\} \tag{2.1}$$

where,

$$\mathbb{E}_{\mathbf{S}_{t+1},\epsilon_{it+1}}\left[V_i(\mathbf{s}_{t+1},\epsilon_{it+1})|\mathbf{s}_t,\mathbf{a}_{it},\mathbf{a}_{-it}\right] = \int_{\mathbf{s}_{t+1}\in\mathcal{S}_{t+1}}\int_{\epsilon_{it+1}} V_i(\mathbf{s}_{t+1},\epsilon_{it+1})dF\left(\mathbf{s}_{t+1}|\mathbf{s}_t,\mathbf{a}_{it},\mathbf{a}_{-it}\right)dF\left(\epsilon_{it+1}\right)$$

where it is assumed agent i makes the maximizing choice $\mathbf{a}_{it}$ in each period $t = 1, ..., T$ and that the value function is implicitly indexed by the profile of policy functions for all agents. We allow opponent strategies to be optimal or suboptimal, which facilitates the use of our method in practical game settings. The expectation $\mathbb{E}_{\mathbf{S}_{t+1},\epsilon_{it+1}}$ is taken over all realizations of the state $\mathbf{S}_{t+1}$, conditional on the current state and actions, and the unobserved private shock for agent i in period $t+1$.

Choice-Specific Value Function. We also define the following *ex ante* choice-specific value function for player i:

$$V_i\left(\mathbf{s}_t,\epsilon_{it};\mathbf{a}_{it},\overline{\sigma}_i\right) \equiv \sum_{\mathbf{a}_{-it}\in\mathcal{A}_{-it}}\Big(\pi_i\left(\mathbf{s}_t,\mathbf{a}_{it},\mathbf{a}_{-it}\right)+\epsilon_{it}+\beta\mathbb{E}_{\mathbf{S}_{t+1},\epsilon_{it+1}}\left[V_i(\mathbf{s}_{t+1},\epsilon_{it+1};\overline{\sigma}_i)|\mathbf{s}_t,\mathbf{a}_{it},\mathbf{a}_{-it}\right]\Big)\sigma_{-i}\left(\mathbf{a}_{-it}|\mathbf{s}_t\right) \tag{2.2}$$

where,

$$\mathbb{E}_{\mathbf{S}_{t+1},\epsilon_{it+1}}\left[V_i(\mathbf{s}_{t+1},\epsilon_{it+1};\overline{\sigma}_i)|\mathbf{s}_t,\mathbf{a}_{it},\mathbf{a}_{-it}\right] = \int_{\mathbf{s}_{t+1}\in\mathcal{S}_{t+1}}\int_{\epsilon_{it+1}} V_i(\mathbf{s}_{t+1},\epsilon_{it+1};\overline{\sigma}_i)dF\left(\mathbf{s}_{t+1}|\mathbf{s}_t,\mathbf{a}_{it},\mathbf{a}_{-it}\right)dF\left(\epsilon_{it+1}\right)$$

Our choice-specific value function represents the value of a particular action choice $\mathbf{a}_{it}$, conditional on the state $\mathbf{s}_t$, the agent's private shock, ϵ_{it}, and a potentially suboptimal strategy played by agent i beyond the current time period, $\overline{\sigma}_i$. Both value functions we define abstract away from the possibility that the value function changes over time. This simplification is not necessary for implementing our method and can be relaxed if researchers have access to enough data to efficiently estimate separate choice-specific value functions per time period.

2.2.2 Policy Function Improvement

In this section, we outline our algorithm for generating a one-step improvement policy as well as our Machine Learning estimator of choice.

Algorithm 2.2.1 *We generate a one-step improvement policy according to the following steps:*

1. *Estimate the strategies of competitors, and, if necessary, the law of motion and the payoff function, using a Machine Learning estimator to select a parsimonious subset of state variables.*

2. *Fix an initial strategy for the agent.*

3. *Use the estimated competitor strategies, payoff function, law of motion, and fixed agent strategy to simulate play.*

4. *Use this simulated data to estimate the choice-specific value function.*

5. *Obtain a one-step improvement policy.*

6. *Repeat by returning to step 1 and using the one-step improvement policy as the fixed initial agent strategy.*

Since we seek to improve a strategy of a reference agent i, we assume the researcher knows $F(\epsilon_{it+1})$ for this agent. In particular, for expositional clarity, we set $\epsilon_{it} = 0$ for all $t = 1, ..., T$ for agent i. Prior to describing the steps of Algorithm 2.2.1 in detail, we describe our Machine Learning estimator.

Component-Wise Gradient Boosting

We use Component-Wise Gradient Boosting (CWGB) in Algorithm 2.2.1, Step 1, to estimate models corresponding to opponent strategies, and, if necessary, the law of motion and payoff function for a reference agent i. CWGB is a specific variant of boosting methods, which are a popular class of Machine Learning methods that accommodate the estimation of both linear and nonlinear models. Boosting methods work by sequentially estimating a series of simple models, deemed "base learners," and then forming a "committee" of predictions from these models through weighted averaging. See Hastie *et al.* (2009) for a survey of boosting methods.

We present the linear variant of CWGB we employ and then briefly discuss how this setup can be generalized to nonlinear contexts. To facilitate the description of CWGB, we show how it can be used to estimate the opponents' strategy functions, i.e. σ_j for $j \in -i$, which are estimations employed in Algorithm 2.2.1, Step 1. We assume researchers have access to a random sample of previous plays of the game for each player $j \in -i$, i.e. $\{a_{jlt}, \mathbf{s}_{lt}\}_{l=1,t=1}^{L,T}$, where the subscript $l = 1, ..., L$ indexes individual observations of play attributable to player j. For the purposes of this description, we assume the support of a_{jt} is binary, 0, 1, which means that the linear CWGB estimator we employ effectively estimates a linear probability model of the probability of choice a_{jt} conditional on the dimension-reduced state vector $\widetilde{\mathbf{s}}_t$.[10] The estimator works according to the following steps.

Algorithm 2.2.2 ***CWGB Estimator (Linear)***

1. *Initialize the iteration* 0 *model, denoted as* $\widehat{\sigma}_j^{c=0}$*, by setting* $\widehat{\sigma}_j^{c=0} = \frac{1}{LT} \sum_{l=1}^{L} \sum_{t=1}^{T} a_{jlt}$*, i.e. initializing the model with the empirical mean of the outcome variable.*[11]

[10]Section 2.2.2 discusses the case where the support of a_{jt} is not binary.

[11]We abuse notation slightly here, since in principle, L can vary by time period.

2. *In the first step, estimate* K_s *univariate linear regression models (without intercepts) of the relationship between* a_{jt} *and each* s_{kt} *as the sole regressor, denoted as* $\widehat{b}\left(s_{1t}\right) = \widehat{\beta}_{s_{1t}} s_{1t}, ..., \widehat{b}\left(s_{K_s t}\right) = \widehat{\beta}_{s_{K_s t}} s_{K_s t}$ *where each* $b\left(.\right)$ *is a linear base learner and each* $\widehat{\beta}_{s_{kt}}$ *is a univariate linear regression parameter.*[12]

3. *Choose the model with the best OLS fit, denoted as* $\widehat{b}_{W1}\left(s_{W1t}\right)$ *for some* $W1 \in \{1, ..., K_s\}$. *Update the iteration 1 model as* $\widehat{\sigma}_j \left(A_{jt} = a_{jt} | s_{W1t}\right)^{c=1} = \widehat{\sigma}_j^{c=0} + \widehat{b}_{W1}\left(s_{W1t}\right)$ *and use it to calculate the iteration 1 fitted residuals.*

4. *Using the iteration 1 fitted residuals as the new outcome variable, estimate an individual univariate linear regression model (without an intercept) for each individual regressor* s_{kt} *as in iteration 1. Choose the model with the best OLS fit, denoted as* $\widehat{b}_{W2}\left(s_{W2t}\right)$ *for some* $W2 \in \{1, ..., K_s\}$. *Update the iteration 2 model as:*

$$\widehat{\sigma}_j \left(A_{jt} = a_{jt} | s_{W1t}, s_{W2t}\right)^{c=2} = \widehat{\sigma}_j \left(A_{jt} = a_{jt} | s_{W1t}\right)^{c=1} + \lambda \widehat{b}_{W2}\left(s_{W2t}\right)$$

   where λ *is called the "step-length factor," which is often chosen using k-fold cross-validation (we set* $\lambda = 0.01$*). Use* $\widehat{\sigma}_j \left(A_{jt} = a_{jt} | s_{W1t}, s_{W2t}\right)^{c=2}$ *to calculate iteration 2 residuals.*

5. *Continue in a similar manner for a fixed number of iterations to obtain the final model (we use* $C = 1000$ *iterations). The number of iterations is often chosen using k-fold cross-validation.*

As a consequence of this estimation process, it is usually the case that some regressors never comprise the best fit model in any iteration. If so, then this variable is excluded from the final model, yielding the dimension-reduced state vector $\widetilde{\mathbf{s}}_t$ defined in section 2.2.1 and the estimated opponent strategy models $\widehat{\sigma}_j \left(A_{jt} = a_{jt} | \widetilde{\mathbf{s}}_t\right)$ for each

[12] These linear regression models could also be estimated with an intercept term, which would vary for each of the K_s models.

$a_{jt} \in \mathcal{A}_{jt}$ and $j \in -i$. CWGB estimates are easily computed using one of several available open-source packages, including H_2O as well as mboost and gbm in R.[13] For the linear variant of CWGB, we use the glmboost function available in the mboost package of R. See Hofner *et al.* (2014) for an introduction to implementing CWGB in R using the mboost package.

The total number of iterations C and the step length factor λ are tuning parameters for the algorithm, typically chosen using k-fold cross-validation. Cross-validation is a subset of the out-of-sample testing that is used as the primary criteria for judging the performance of Machine Learning models in practice. Out-of-sample testing involves the creation of a training dataset, which is used to estimate the models of interest, and a testing dataset (a "holdout" sample), which is used to evaluate the performance of these estimators. The separation of training and testing datasets is important for evaluating estimators, since in general, adding regressors to a model often reduces training sample prediction error but does not necessarily improve out-of-sample prediction error. A common criteria for evaluating estimator performance on the testing dataset is the Mean-Squared Error (MSE) criteria. Training and testing models is feasible in settings where the number of observations is large, since this allows both datasets to have a sufficient number of observations to generate precise estimates. See Hastie *et al.* (2009) for an introduction to the common practice of training and testing in Machine Learning.

Of C and λ, the number of iterations (C) has proven to be the most important tuning parameter in CWGB models, and the most useful practical criterion for choosing λ is that it should be small (e.g., $\lambda = 0.01$ or $\lambda = 0.1$, see Hofner *et al.* (2014) and Schmid and Hothorn (2008)). On the one hand, choosing a C that is too large may

[13] H_2O is an open source software developed for implementing Machine Learning methods on particularly large datasets and is available from http://0xdata.com/. The documentation for the gbm and mboost packages in R, respectively, are available from http://cran.r-project.org/web/packages/gbm/index.html and http://cran.r-project.org/web/packages/mboost/index.html.

result in overfitting, i.e. low MSE in sample, but poor MSE out-of-sample. On the other hand, choosing a C that is too low also results in poor out-of-sample performance. As a consequence, C is often chosen by minimizing cross-validation error on randomly chosen holdout samples. For example, when performing 10-fold cross validation for a given value of C in this context, the researcher randomly chooses 10% of the observations to include in a holdout sample. Then Algorithm 2.2.2 is run on the remaining 90% of the data, i.e. the training sample, to obtain the estimated model, which used to compute the MSE on the 10% testing sample. This process is repeated nine additional times using the same value of C, each with a different randomly chosen holdout and training sample, and the total MSE across all 10 folds is recorded. A 10-fold cross-validation procedure is carried out for every candidate value of C, and the value of C that generates the lowest total MSE is chosen. More generally, K-fold cross-validation generates K testing samples. The mboost package provides a simple command for implementing K-fold cross-validation automatically.[14]

Generalizations of CWGB are achieved primarily through the choice of alternative base learners $b(.)$, subsets of regressors included in each base learner model, and loss functions. For example, nonlinear versions of gradient boosting might employ regression trees instead of linear $b(.)$, or they might use subsets of regressors larger than one as part of the base learning models to accommodate interactions among regressors. We direct readers interested in a more comprehensive introduction to boosting methods to Hastie *et al.* (2009) and Hofner *et al.* (2014).

Opponent Strategies, Period Return, and the Law of Motion (Step 1)

The first step of Algorithm 2.2.1 involves estimating opponent strategy functions, and if needed, the payoff function for agent i and the law of motion. To do so, we make the following assumption.

[14] See Hofner *et al.* (2014) for details on selecting C using cross-validation.

Assumption (A3). Researchers have access to *iid* random samples of the form **(i)** $\{a_{jlt}, \mathbf{s}_{lt}\}_{l=1,t=1}^{L,T}$ for each $j \in -i$, **(ii)** $\{\pi_i(\mathbf{s}_{lt}, \mathbf{a}_{lt}), \mathbf{s}_{lt}, \mathbf{a}_{lt}\}_{l=1,t=1}^{L,T}$, and **(iii)** $\{\widetilde{\mathbf{s}}_{lt+1}, \widetilde{\mathbf{s}}_{lt}, \widetilde{\mathbf{a}}_{lt}\}_{l=1,t=1}^{L,T}$.

We invoke (A3)(i) to estimate a separate strategy function model for each $j \in -i$, with each model denoted as $\widehat{\sigma}_j(A_{jt} = a_{jt}|\widetilde{\mathbf{s}}_t)$.[15] As a prerequisite to estimation, we assume the action space can be redefined in a way that makes it low-dimensional, as described in Section 2.2.1. In our application described in Section **??**, we assume the support of the action is binary 0,1, noting that there are more general forms of boosting estimators capable of classification in the case of discrete categorical variables with more than two choices.[16] For the binary case, we propose estimating a linear probability model using CWGB as demonstrated in Algorithm 2.2.2. We abuse the notation of $\widetilde{\mathbf{s}}_t$, since in practice, the state variables included in $\widetilde{\mathbf{s}}_t$ may vary across models.

Often, the payoff function for agent i may be known. However, in many settings, it may be desirable and feasible to estimate these payoff functions. Under (A3)(ii), we assume researchers have access to a random sample of scalar payoffs for agent i along with corresponding states and actions. We propose estimating the payoff function using CWGB and denote this estimate as $\widehat{\pi}_i(\widetilde{\mathbf{s}}_t, \widetilde{\mathbf{a}}_t)$, where again, $\widetilde{\mathbf{s}}_t$ and $\widetilde{\mathbf{a}}_t$ represent the dimension-reduced state and action vectors selected by CWGB, keeping in mind that the selected state variables may be different from those selected by CWGB to produce the opponent strategy function estimates.

Under some circumstances, such as in the entry game application we study in Section **??**, the law of motion is deterministic and need not be estimated. In settings where the law of motion must be estimated, the outcomes $(\mathbf{s}_{t+1})$ will be high-dimensional,

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[15]If feasible, in some contexts it may be desirable to estimate separate strategy function models for each feasible action, i.e. $\widehat{\sigma}_j(A_{jt} = a_{jt}|\widetilde{\mathbf{s}}_t)$ for $a_{jt} \in \mathcal{A}_{jt}$. We employ this estimation strategy in our entry game application, described in Section **??**.

[16]This includes, e.g., the recently proposed gradient boosted feature selection algorithm of Zheng *et al.* (2014). We note that the implementation of this algorithm requires large datasets, i.e. those where the number of observations is much larger than the number of regressors.

making the estimation of the law of motion infeasible or at least computationally burdensome. We therefore propose estimating only the evolution of the state variables collected across all dimension-reduced states selected by the CWGB estimation processes for all opponent strategy functions and the payoff function. We abuse the notation of this state vector by also denoting it as $\widetilde{\mathbf{s}}_t = (s_{1t}, ..., s_{Mt})$, where M is the total number of state variables retained across all CWGB-estimated opponent strategy and payoff function models. This restricts attention only to those state variables selected under the CWGB selection criteria for all other estimands of interest, rather than the state variables that comprise the original state vector $\mathbf{s}_t$. If the action vector is also high-dimensional, we use the dimension-reduced action vector $\widetilde{\mathbf{a}}_t$ selected in the payoff function estimation process. Using (A3)(iii) we assume researchers have access to a random sample of these state and action variables. Estimation of the law of motion using the retained state and action variables can proceed flexibly and the exact estimator used depends on the application and on the nature of the state variables. We propose estimating a separate model for each outcome state variable included in $\widetilde{\mathbf{s}}_{t+1}$. These estimated models are denoted as $\widehat{f}_k\left(\widetilde{\mathbf{s}}_t, \widetilde{\mathbf{a}}_t\right)$ for each $k = 1, ..., M$. If s_{kt+1} is continuous, $\widehat{f}_k\left(\widetilde{\mathbf{s}}_t, \widetilde{\mathbf{a}}_t\right)$ can be estimated using linear regressions, which generates models that takes the form $s_{kt+1} = \widehat{f}_k\left(\widetilde{\mathbf{s}}_t, \widetilde{\mathbf{a}}_t\right) + \widehat{m}_t$ for $k = 1, ..., M$, where $\widehat{m}_t$ is a residual. If s_{kt+1} is discrete and it's support is binary $0, 1$, then a parametric or semiparametric estimator of the probability of this state transition as a function of $\widetilde{\mathbf{s}}_t$ and $\widetilde{\mathbf{a}}_t$ can be used (for example, a probit model or again, OLS). If s_{kt+1} is discrete and its support is categorical, then an estimator for categorical variables can be used (for example, the multinomial logit).

Initial Strategy for Agent (Step 2)

The second step involves fixing an initial strategy for the agent, i.e., choosing the potentially suboptimal policy function for player i, i.e. $\overline{\sigma}_i$. In practice, this policy function can be any optimal or suboptimal policy, including previously proposed strategy that represents the highest payoffs researchers or game players have been able to find in practice. For example, if we were studying a game such as multi-player Texas Hold'em, we might start with the counterfactual regret minimization strategy recently proposed by Bowling *et al.* (2015). Regardless of the choice of $\overline{\sigma}_i$, Algorithm 2.2.1 is designed to weakly improve upon this strategy. However, a particularly suboptimal choice for $\overline{\sigma}_i$ may slow the convergence of our one-step improvements in subsequent iterations.

Simulating Play (Step 3)

We simulate play for the game using $\widehat{\sigma}_j\left(A_{jt} = a_{jt}|\widetilde{\mathbf{s}}_t\right)$ for all $j \in -i$, the law of motion, the payoff function, and $\overline{\sigma}_i$. We describe the case where both the law of motion and period return functions are estimated since it is straightforward to implement what follows when these functions are known and deterministic. Our simulation focuses only on the state variables selected across all CWGB-estimated models for opponent strategies and the period return function, i.e. $\widetilde{\mathbf{s}}_t$ as introduced in Section 2.2.2. Denote simulated variables with the superscript $*$. First, we generate an initial state $\widetilde{\mathbf{s}}_1^*$. This can be done by either randomly selecting a state from the support of $\widetilde{\mathbf{s}}_1$ or by restricting attention to particular "focal" states. For example, in an industry game, focal states of interest might include the current state of the industry or states likely to arise under certain policy proposals. We then generate period $t = 1$ actions. For competitors, we choose actions $\mathbf{a}_{-i1}^*$ by drawing upon the estimated probability models generated by opponent strategies $\widehat{\sigma}_j\left(A_{jt} = a_{jt}|\widetilde{\mathbf{s}}_t\right)$ for each $j \in -i$. For the agent, we choose actions a_{i1}^* by using the fixed agent strategy $\overline{\sigma}_i$ generally while randomly permuting a deviation to this action in some simulation runs or time periods. Given choices for a_{i1}^* and $\mathbf{a}_{-i1}^*$, and also given $\mathbf{s}_1^*$, we draw upon the estimated law of motion models $\widehat{f}_k\left(\widetilde{\mathbf{s}}_1^*, \widetilde{\mathbf{a}}_1^*\right)$ for $k = 1, ..., M$ to generate $\mathbf{s}_2^*$. We draw $\widetilde{s}_{k2}^*$ from these models in two ways, depending upon whether $\widetilde{s}_{k2}$ is discrete or continuous. For discrete state variables, $\widehat{f}_k\left(.\right)$ is a probability distribution, and we draw upon this probability distribution to choose $\widetilde{s}_{k2}^*$.

For continuous state variables, $\widehat{f}_k\left(.\right)$ is a linear regression model. We use this linear regression model to generate a prediction for the next period state variable, which represents it's mean value. We then draw upon the empirical distribution of estimated residuals generated by our original sample (see Section 2.2.2) to select a residual to add to the model prediction. This gives $\widetilde{s}^*_{k2} = \widehat{f}_k\left(\widetilde{\mathbf{s}}^*_t, \widetilde{\mathbf{a}}^*_t\right) + \widehat{m}^*_t$. We choose each a^*_{it}, $\mathbf{a}^*_{-it}$, and $\widetilde{\mathbf{s}}^*_{t+1}$ for $t = 2, ..., T$ similarly by randomly deviating from $\overline{\sigma}_i$, and also by drawing upon $\widehat{\sigma}_j\left(.\right)$ and $\widehat{f}\left(.\right)$, respectively. This simulation sequence produces data used to estimate the choice-specific value of a one-period deviation from $\overline{\sigma}_i$. In all time periods, we compute payoffs and generate the simulated sums for each $t = 1, ..., T$:

$$V_i\left(\widetilde{\mathbf{s}}^*_{lt}; a^*_{ilt}; \overline{\sigma}_i\right) = \sum_{\tau=t}^{T} \left(\beta\right)^{\tau-t} \pi_i\left(\widetilde{\mathbf{s}}^*_{l\tau}, \widetilde{\mathbf{a}}^*_{l\tau}\right) \tag{2.3}$$

The simulated sums represent the discounted payoffs of choice a^*_{ilt}, given that the agent plays $\overline{\sigma}_i$, each opponent $j \in -i$ plays according to $\widehat{\sigma}_j\left(.\right)$, and the law of motion evolves as dictated by $\widehat{f}_k\left(.\right)$ for $k = 1, ..., M$. These simulated sums provide us with outcome variables for estimation of the choice-specific value functions in Step 4.

The low-dimensionality of each $\widetilde{\mathbf{s}}_t$ greatly reduces the simulation burden in two ways. First, the simulation only needs to reach points in the support of each $\widetilde{\mathbf{s}}_t$, rather than all points in the full support of $\mathbf{s}_t$, which is computationally infeasible. Second, reducing the number of regressors may lead to more reliable estimates of $\widehat{\sigma}_j\left(.\right)$, and $\widehat{f}_k\left(.\right)$ due to a variety of potential statistical issues encountered in settings where the number of regressors is large. When the number of regressors is large, researchers often find in practice that many of these regressors are highly multicollinear, and in the context of collinear regressors, out-of-sample prediction is often maximized using a relatively small number of regressors. A large number of regressors may also cause identification issues using conventional models. Good estimates of these models lead to better predictions, which in turn allow the simulation to reliably search across the space of state variables that are strategically likely to arise when forming data for the choice-specific value function estimates. This in turn generates more reliable estimates of the choice-specific value functions, which leads to better improvements in Step 5.

The simulation process provides us with a sample of simulated data of the form:

$$\left\{V_i\left(\widetilde{\mathbf{s}}_{lt}^{*}, a_{ilt}^{*}; \overline{\sigma}_i\right), \widetilde{\mathbf{s}}_{lt}^{*}, a_{ilt}^{*}\right\}_{l=1,t=1}^{L,T}$$

for player i. We use this simulated data to estimate the choice-specific value function for agent i in the next step.

Estimating Choice-Specific Value Function (Step 4)

If there is smoothness in the value function, this allows us to pool information from across our simulations in Step 3 to reduce variance in our estimator. Note that the simulated choice specific value function will be equal to the choice specific value function plus a random error due to simulation. If we have an unbiased estimator, adding error to the dependent variable of a regression does not result in a biased estimator.

We propose pooling the simulated data $\left\{V_i\left(\widetilde{\mathbf{s}}_{lt}^{*}, a_{ilt}^{*}; \overline{\sigma}_i\right), \widetilde{\mathbf{s}}_{lt}^{*}, a_{ilt}^{*}\right\}_{l=1,t=1}^{L,T}$ over time and estimating separate choice-specific value functions for each action $a_{it} \in A_{it}$ using linear regressions (with intercepts), where each $V_i\left(\widetilde{\mathbf{s}}_{lt}^{*}, a_{ilt}^{*}; \overline{\sigma}_i\right)$ is the outcome variable and $\widetilde{\mathbf{s}}_{lt}^{*}$ are the regressors. We denote each estimated model as $\widehat{V}_i\left(\widetilde{\mathbf{s}}_t, a_{it}; \overline{\sigma}_i\right)$.

One-Step Improvement Policy (Step 5)

We generate a one-step improvement policy for player i, denoted as $\widehat{\sigma}_i^1$, which represents policy function which maximizes the estimated choice-specific value function in the corresponding period t conditional on $\overline{\sigma}_i$, i.e. we seek the policy function vector $\widehat{\sigma}_i^1$[17] such that, for all $t = 1, ..., T-1$:

[17] As with the other policy functions, we abuse notation by suppressing the dependence of $\widehat{\sigma}_i^1$ on the corresponding states.

$$\widehat{\sigma}_i^1 \equiv \left\{ \sigma_i : \widetilde{S}_t \to \mathcal{A}_{it} \;\middle|\; \begin{array}{c} \sigma_i = \arg\max_{a_{it} \in \mathcal{A}_{it}} \left\{ \widehat{V}_i \left(\widetilde{\mathbf{s}}_t, a_{it}; \overline{\sigma}_i \right) \right\} \\ \text{for all } \widetilde{\mathbf{s}}_t \in \mathcal{S}_t \end{array} \right\} \tag{2.4}$$

Each $\widehat{\sigma}_i^1$ is "greedy" in that it searches only for the action choices that maximize the estimated choice-specific value function in the current period conditional on the agent's fixed strategy $\overline{\sigma}_i$, rather than the actions that maximize the value of choices across all time periods. Once $\widehat{\sigma}_i^1$ is obtained, this strategy vector can be used to generate $\overline{\sigma}_i$ in the following iteration, repeating Algorithm 2.2.1 again to obtain a second-step improvement $\widehat{\sigma}_i^2$, and so forth until a suitable stopping rule is met.

2.3 Conclusion

This chapter develops a method for deriving policy function improvements for a single agent in high-dimensional Markov dynamic optimization problems and in particular dynamic games. The approach has two attributes that make it useful for deriving policies in realistic game settings. The first is that we impose no equilibrium restrictions on opponent behavior and instead estimate opponent strategies directly from data on past game play. This allows us to accommodate a richer set of opponent strategies than equilibrium assumptions would imply. A second is that we use a Machine Learning method to estimate opponent strategies and, if needed, the payoff function for a reference agent and the law of motion. This method makes estimation of the agent's choice-specific value function feasible in high-dimensional settings. As a consequence of estimation, the estimator reduces the dimension of the state space in a data-driven manner. Data-driven dimension-reduction proceeds by choosing the state variables that minimize the loss associated with predicting the outcomes of interest according to a fixed metric, making the estimates low-dimensional approximations of the original functions. In the next chapter, we show that our functions of interest are well-approximated by these low-dimensional representations.

Chapter 3

IMPROVING POLICY FUNCTIONS IN HIGH-DIMENSIONAL DYNAMIC GAMES: AN ENTRY GAME EXAMPLE

3.1 Introduction

In this chapter, we consider the problem of computing a one-step improvement policy for a single retailer in the game considered in Holmes (2011). He considers the decision by chain store retailers of where to locate physical stores. We add to his model the decision of where to locate distribution centers as well. In our game, there are 227 physical locations in the United States and two rival retailers, which each seek to maximize nation-wide profits over seven years by choosing locations for distribution centers and stores.

This game is complicated for several reasons. First, store location decisions generate both own firm and competitor firm spillovers. On the one hand, for a given firm, clustering stores in locations near distribution centers lowers distribution costs. On the other hand, it also cannibalizes own store revenues, since consumers substitute between nearby stores. For the same reason, nearby competitor stores lower revenues for a given store. Second, the game is complicated because it is dynamic, since we make distribution center and store decisions irreversible. This forces firms to consider strategies such as spatial preemption, whereby firm entry in earlier time periods influences the profitability of these locations in future time periods.

The game we consider involve a large number of state variables. Thus, it is infeasible Using conventional methods to estimate opponent strategies, the law of motion, and the choice-specific value function. In our spatial location game, one way to enumerate the current state is to define it as a vector of indicator variables representing the national network of distribution center and store locations for both firms. This results in a state vector that contains 1817 variables and achieves an average cardinality in each time period on the order of 10^{85}.[1] Although this enumeration allows us to characterize opponent strategies, the law of motion, and choice-specific value functions of this game as completely non-parametric functions of the state variables, it is potentially computationally wasteful and generates three estimation issues. First, the large cardinality of the state vector makes it unlikely that these models are identified. Second, if they are identified, they are often inefficiently estimated since there are usually very few observations for any given permutation of the state vector. Moreover, when estimating the choice-specific value function, remedying these issues by increasing the scale of the simulation is computationally infeasible. Third, when the number of regressors is large, researchers often find in practice that many of these regressors are highly multicollinear, and in the context of collinear regressors, out-of-sample predictive accuracy under most norms is often maximized using a relatively small number of regressors. To the extent that some state variables are relatively unimportant, these estimation and computational issues motivate the use of well-specified approximations. However,

[1] $1817 = 227 * 2$ (own distribution center indicators for two merchandise classes) + $227 * 2$ (own store indicators for two types of stores) + $227 * 2$ (opponent distribution center indicators for two merchandise classes) + $227 * 2$ (opponent store indicators for two types of stores) + 1 (location-specific population variable). The state space cardinality for the second time period is calculated as follows. In each time period, we constrain the number of distribution centers and stores that each firm can open, and at the start of the game (in the first time period), we allocate firm facilities randomly as described in the Appendix. Only locations not currently occupied by firm i facilities of the same type are feasible. In the first time period, the number of feasible locations for placing facilities of each type in the second time period include: 220, 226, 211, and 203, and among available locations, each firm chooses 4 distribution centers and 8 stores of each type. The order of the resulting cardinality of the state space in the second period (only including the cardinality of the state attributable to firm i facilities; also not including the cardinality of the population variable) is the product of the possible combinations of distribution centers and store locations of each type, i.e. $\binom{220}{4} * \binom{226}{4} * \binom{211}{8} * \binom{203}{8} \approx 10^7 * 10^7 * 10^{13} * 10^{13} = 10^{43}$. The cardinality of the state attributable to firm $-i$ facilities is calculated in a similar manner, and the total cardinality of the state (not considering the population variable) is the product of the cardinality attributable to firm i and $-i$ facilities. State space cardinality calculations attributable to firm i facilities for all time periods are available in the Appendix.

in high-dimensional settings, it is often difficult to know *a priori* which state variables are important.

Using our algorithm developed in Chapter 2, we derive a one-step improvement policy for a hypothetical retailer and show that our algorithm generates a 289 percent improvement over a strategy designed to approximate the actual facility location patterns of Wal-Mart.

The rest of the chapter proceeds as follows. Section 2 describes the institutional background and data. Section 3 presents the game model. Section 4 details the policy function improvement. Section 5 describes the results. Section 6 concludes.

3.2 Institutional Background and Data

According to the U.S. Census, U.S. retail sales in 2012 totaled $4.87 trillion, representing 30 percent of nominal U.S. GDP. The largest retailer, Wal-Mart, dominates retail trade, with sales accounting for 7 percent of the U.S. total in 2012.[2] Wal-Mart is not only the largest global retailer, it is also the largest company by total revenues of any kind in the world.[3] Notwithstanding their importance in the global economy, there has been a relative scarcity of papers in the literature studying chain store retailers in a way that explicitly models the multi-store dimension of chain store networks, primarily due to modeling difficulties.[4]

Wal-Mart, along with other large chain store retailers such as Target, Costco or K-mart, operate large networks of physical store and distribution center locations around the world and compete in several product lines, including general merchandise and groceries, and via several store types, including regular stores, supercenters, and discount

[2]Total U.S. retail sales collected from the Annual Retail Trade Survey (1992-2012), available: http://www.census.gov/retail/. Wal-Mart share of retail sales collected from the National Retail Federation, Top 100 Retailers (2013), available: https://nrf.com/resources/top-retailers-list/top-100-retailers-2013.

[3]Fortune Global 500 list (2014), available: http://fortune.com/global500/.

[4]For recent exceptions, see Aguirregabiria and Vicentini (2014), Holmes (2011), Jia (2008), Ellickson, Houghton, and Timmins (2013), and Nishida (2014).

warehouse club stores. For example, by the end of 2014, Wal-Mart had 42 distribution centers and 4203 stores in the U.S., with each distribution center supporting from 90 to 100 stores within a 200-mile radius.[5]

In our illustration, we model a game similar to the one considered by Holmes (2011), who studies the physical store location decisions of Wal-Mart. Our game consists of two competing chain store retailers which seek to open a network of stores and distribution centers from the years $t = 2000, ..., 2006$ across a finite set of possible physical locations in the United States.[6] One location corresponds to a metropolitan statistical area (MSA) as defined by the U.S. Census Bureau and is indexed by $l = 1, ..., L$ with support $\mathcal{L}$ and $L = 227$ possible locations.[7] We extend the game in Holmes (2011) by modeling the decision of where to locate distribution centers as well as stores. Each firm sells both food and general merchandise and can open two types of distribution centers–food and general merchandise–and two types of stores–supercenters and regular stores. Supercenters sell both food and general merchandise and are supplied by both types of distribution centers, while regular stores sell only general merchandise and are supplied only by general merchandise distribution centers.[8]

At a given time period t, each firm i will have stores and distribution centers in a subset of locations, observes the facility network of the competitor as well as the current population of each MSA, and decides in which locations to open new distribution

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[5]The total number of stores figure excludes Wal-Mart's 632 Sam's Club discount warehouse club stores.

[6]Throughout the chapter, we use the notation $t = 2000, ..., 2006$ and $t = 1, ..., T$ with $T = 7$ interchangeably.

[7]Census Bureau, County Business Patterns, Metropolitan Statistical Areas, 1998 to 2012. Available at: http://www.census.gov/econ/cbp/. All raw data used in this chapter, which includes a list of MSA's used, is available from: http://abv8.me/4bL.

[8]Additionally, each firm operates import distribution centers located around the country, where each import distribution center supplies both food and general merchandise distribution centers. We abstract away from decisions regarding import distribution center placement, fixing and making identical the number and location of import distribution centers for both firms. Specifically, we place import distribution centers for each competitor in the locations in our sample closest to the actual import distribution center locations of Wal-Mart during the same time period. See the Appendix for details.

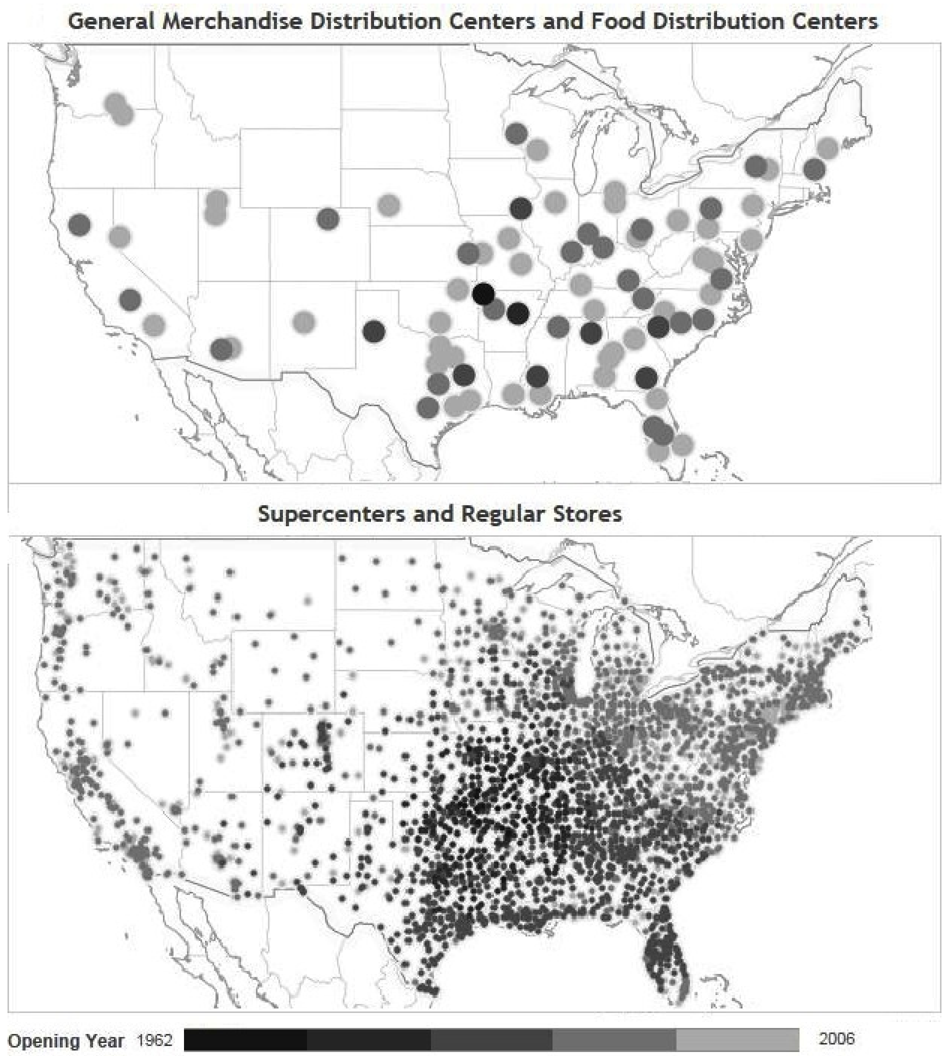

Figure 3.1: Wal-Mart Distribution Center and Store Diffusion Map (1962 to 2006)

centers and stores in period $t+1$. We collect MSA population and population density data from the US Census Bureau.[9] As in Holmes (2011), we focus on location decisions

[9]Our population density measure is constructed using MSA population divided by MSA land area by square miles in 2010, both collected from the U.S. Census Bureau. Population data by MSA was obtained from the Metropolitan Population Statistics, available: http://www.census.gov/population/metro/data/index.html. Land area in square miles by MSA in 2010 was obtained from the Patterns of Metropolitan and Micropolitan Population Change: 2000 to 2010, available: http://www.census.gov/population/metro/data/pop_data.html.

and abstract away from the decision of how many facilities to open in each period. Instead, we constrain each competitor to open the same number of distribution centers of each category actually opened by Wal-Mart annually in the United States from 2000 to 2006, with the exact locations and opening dates collected from data made publicly available by an operational logistics consulting firm.[10] We also constrain each competitor to open two supercenters for each newly opened food distribution center and two regular stores for each newly opened general merchandise distribution center.[11] Finally, we use the distribution center data to endow our competitor with a location strategy meant to approximate Wal-Mart's actual expansion patterns as documented by Holmes (2011), which involved opening a store in a relatively central location in the U.S., opening additional stores in a pattern that radiated from this central location out, and never placing a store in a far-off location and filling the gap in between. This pattern is illustrated in Figure 3.1.[12]

3.3 Game Model

In this section, we adapt our theoretical game model developed in Section 2.2.1 to the chain store entry game characterized in Section 3.2.

State. Our state vector is comprised of indicator variables over facility placement decisions by firm i and firm $-i$ across all locations, as well as a location-specific characteristic (population), resulting in $K_s = 8L + 1 = 1817$ variables. For example, the first L indicator variables take a value of 1 if firm i has placed a general merchandise distribution center in location l, 0 otherwise. The next L indicators work similarly with respect to firm i food distribution centers, and so forth for firm i regular stores

[10] This included thirty food distribution centers and fifteen general merchandise distribution centers. Wal-Mart distribution center locations with opening dates were obtained from MWPVL International, available: http://www.mwpvl.com/html/walmart.html. We also provide a list in the Appendix.

[11] This results in a total of sixty supercenters and thirty regular stores opened over the course of the game by each firm.

[12] Data prepared by Holmes (2011), available: http://www.econ.umn.edu/~holmes/data/WalMart/.

and supercenters. Similarly, the final $4L$ indicators represent facility placements by firm $-i$. Finally, we include a discrete variable representing the population for a given location l.

Actions. As introduced in Section 3.2, we force each competitor to open a pre-specified aggregate number of distribution centers and stores in each period.[13] The set of feasible locations is constrained by the period t state, since for a given facility type q, firm i can open at most one facility per location.[14] Further, we restrict firms to open at most one own store of any kind in each MSA, with firms each choosing regular stores prior to supercenters in period t. Given these constraints and also given the designated number of aggregate facility openings in each period, at time t, firm i chooses a vector of feasible actions (locations) $\mathbf{a}_{it}$ with $K_a = 4L = 908$. This action vector is comprised of indicator variables over facility placement choices by firm i across all locations. For example, the first L indicator variables take a value of 1 if firm i chooses to place a general merchandise distribution center in location l at time $t+1$, 0 otherwise. Similarly, the remaining $3L$ indicator variables represent placement decisions for food distribution centers, regular stores, and supercenters, respectively. We assume that once opened, distribution centers and stores are never closed. As documented by Holmes (2011), Wal-Mart rarely closes stores and distribution centers once opened, making this assumption a reasonable approximation for large chain store retailers.[15]

Law of Motion. Since we assume the state is comprised of only the current network of facilities and populations, rather than their entire history, this game is

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[13] We force firms to open the following number of facilities in each period (food distribution centers, general merchandise distribution centers, regular stores, and supercenters): $(4,4,8,8)$ in $t = 2000$, $(5,2,4,10)$ in $t = 2001$, $(6,1,2,12)$ in $t = 2002$, $(2,3,6,4)$ in $t = 2003$, $(3,3,6,6)$ in $t = 2004$, and $(3,1,2,6)$ in $t = 2005$. Note that these vectors each represent facility openings for the next period, e.g. $(4,4,8,8)$ in $t = 2000$ designates the number of openings to be realized in $t = 2001$.

[14] See the Appendix for details.

[15] Also see MWPVL International's list of Wal-Mart distribution center openings and closing for additional support for this assertion, available from: http://www.mwpvl.com/html/walmart.html.

Markov. Since we assume that all players have perfect foresight with respect to MSA-level population, the law of motion is a deterministic mapping from the current state and the current actions taken by players i and $-i$ to the state in period $t+1$.

Strategies. The policy function for each agent maps the current state to location choices in the following period. The probabilities induced by the strategy of opponent $-i$ are also defined as before, since our agent i does not observe the period t location choices of opponent player $-i$ until time period $t+1$.[16]

Period Return. The period t payoffs for firm i represents operating profits for location l. In this game, operating profits are parametric and deterministic functions of the current location-specific state and are similar to the operating profits specified by Holmes (2011). Since customers substitute demand among nearby stores, operating profits in a given location are a function of both own and competitor facility presence in nearby locations. They are also a function of location-specific variable costs, distribution costs, population, and population density. For simplicity of exposition, we ignore the separate contribution of population density in the period return when defining the state and instead use population as the lone non-indicator location-specific characteristic of interest. The Appendix provides the details of our profit specification.

Choice-Specific Value Function. The choice-specific value function for agent i in this game is a "local" facility and choice-specific value function, which is defined as the period t location-specific discounted expected operating profits of opening facility $q \in \{f, g, r, sc\}$ in location l for firm i, where f represents food distribution centers, g represents general merchandise distribution centers, r represents regular stores, and sc represents supercenters. We denote this facility-specific choice-specific value function

[16] Since in our illustration our state is "location-specific" in that it includes only the population of a particular location l (rather than the vector of populations across all locations), we ignore the effect of populations across locations on opponent strategies. Although this is likely a misspecification, we define the state in this way to take advantage of cross-sectional differences in location populations when estimating the choice-specific value function, rather than relying only on across-time variation. We show in our Results section that our state is well-approximated by our specification. In practice, researchers with access to large datasets might include the entire vector of populations or other location-specific characteristics in the state.

as $V_i\left(\mathbf{s}_t, a_{ilt}^q; \overline{\sigma}_i\right)$, where a_{ilt}^q replaces the action vector $\mathbf{a}_{it}$ and represents the decision by firm i of whether to locate facility q in location l, 0 otherwise. We focus on facility and location-specific value functions in order to take advantage of cross-sectional differences in value when estimating the choice-specific value function in the next section. The choice-specific value function is also conditional on a set of profit parameters, which is a dependence we suppress to simplify the notation. Details regarding all parameters are presented in the Appendix.[17]

3.4 Policy Function Improvement

We adapt our algorithm to derive a one-step improvement policy over a benchmark strategy in our chain store entry game.

Opponent Strategies and the Law of Motion (Step 1). In our illustration, we do not estimate models corresponding to opponent strategies. Instead, we force the competitor to open distribution centers in the exact locations and at the exact times chosen by Wal-Mart from 2000 to 2006, placing stores in the MSA's closest to these

[17]There are two primary differences between the model developed in Section 2.2.1 and the model implied by our chain store game. The first difference is the timing of actions. In the chain store application, in period t, agents decide on store locations in period $t+1$. This makes the time t period return deterministic, since all player actions have already been realized. The second difference is that the law of motion is deterministic, since the state is comprised of indicators over location choices, and period t actions deterministically determine period $t+1$ location choices. Also, we assume perfect foresight by all competitors on the population variable, which represents the only variable in the state vector that is not a location indicator. As in Section 2.2.2, we assume that $\epsilon_{it} = 0$ for $t = 1, ..., T$ for our reference agent. As a result, the choice-specific value function for the value of placing facility q in location l in our chain store entry game for the reference agent i takes the form:

$$V_i\left(\mathbf{s}_t; a_{ilt}^q, \overline{\sigma}_i\right) = \pi_i\left(\mathbf{s}_t\right) + \beta \mathbb{E}_{\mathbf{S}_{t+1}}\left[V_i(\mathbf{s}_{t+1}; \overline{\sigma}_i) | \mathbf{s}_t, \mathbf{a}_{it}\left(a_{ilt}^q\right)\right] \tag{3.1}$$

where,

$$\mathbb{E}_{\mathbf{S}_{t+1}}\left[V_i(\mathbf{s}_{t+1}; \overline{\sigma}_i) | \mathbf{s}_t, \mathbf{a}_{it}\left(a_{ilt}^q\right)\right] = \sum_{\mathbf{a}_{-tt} \in \mathcal{A}_{-it}} V_i(\mathbf{s}_{t+1}\left(\mathbf{s}_t, \mathbf{a}_{it}\left(a_{ilt}^q\right), \mathbf{a}_{-it}\right); \overline{\sigma}_i) \sigma_{-i}\left(\mathbf{a}_{-it} | \mathbf{s}_t\right)$$

where the randomness in $\mathbf{S}_{t+1}$ is due only to the randomness in the opponent's strategy $\sigma_{-i}\left(\mathbf{a}_{-it} | \mathbf{s}_t\right)$, the notation $\mathbf{a}_{it}\left(a_{ilt}^q\right)$ indicates that facility choices by agent i across all locations at time t are conditional on the facility and location-specific choice a_{ilt}^q, and the notation $\mathbf{s}_{t+1}\left(\mathbf{s}_t, \mathbf{a}_{it}\left(a_{ilt}^q\right), \mathbf{a}_{-it}\right)$ indicates that $\mathbf{s}_{t+1}$ is conditional on $\mathbf{s}_t$, $\mathbf{a}_{it}\left(a_{ilt}^q\right)$, and $\mathbf{a}_{-it}$.

distribution centers. Specifically, for $\widehat{\sigma}_{-i}$ for all simulations, we force our competitor to place food and general merchandise distribution centers in the MSA's in our sample closest to the exact locations of newly opened Wal-Mart distribution centers of each kind during the years 2000 to 2006, as detailed in Appendix Tables B.1 and B.2. We then open regular stores in the two closest feasible MSA's to each newly opened firm i general merchandise distribution center. After making this decision, we determine the closest firm i general merchandise distribution center to each newly opened firm i food distribution center and open supercenters in the two feasible MSA's closest to the centroid of each of these distribution center pairs. Additionally, we do not estimate a law of motion, since it is deterministic in our example. We also do not estimate the payoff function for agent i, since we assume that it is known.

Initial Strategy for Agent (Step 2). In our illustration, for the first-step policy improvement, we choose distribution center locations randomly over all remaining MSA's not currently occupied by an own-firm general merchandise or food distribution center, respectively (the number chosen per period is constrained as previously described). We then open regular stores and supercenters in the closest feasible MSA's to these distribution centers exactly as described for the competitor. For second-step policy improvements and beyond, we use the previous step's improvement strategy as the fixed agent strategy.

Simulating Play (Step 3). We simulate play for the game using the opponent's strategy as described in Step 1, the law of motion, and $\overline{\sigma}_i$. We generate an initial state $\mathbf{s}_1^*$ by 1) for the agent, randomly placing distribution centers around the country and placing stores in the MSA's closest to these distribution centers, and 2) for the competitor, placing distribution centers in the exact locations chosen by Wal-Mart in the year 2000 and placing stores in the MSA's closest to these distribution centers. This results in seven food distribution centers, one general merchandise distribution center, two regular stores, and fourteen supercenters allocated in the initial state ($t =$ 2000). In all specifications, store placement proceeds as follows. We open regular stores in the two closest feasible MSA's to each newly opened firm i general merchandise distribution center. After making this decision, we determine the closest firm i general merchandise distribution center to each newly opened firm i food distribution center and open supercenters in the two feasible MSA's closest to the centroid of each of these distribution center pairs. We then generate period $t = 1$ actions. For the competitor, we choose locations $\mathbf{a}^*_{-i1}$ according to the opponent strategy from Step 1. For the agent, we choose a subset of facility locations using the fixed agent strategy $\overline{\sigma}_i$, and the remaining facilities randomly, i.e. by choosing $a^{q*}_{il1} = 1$ or $a^{q*}_{il1} = 0$ for each facility $q \in \{f, g, r, sc\}$ and each location $l = 1, ..., L$ by drawing from a uniform random variable. For example, in $t = 2000$, of the 8 supercenters agent i must choose to enter in $t = 2001$, we choose 6 using $\overline{\sigma}_i$ and 2 randomly (i.e., we place supercenters in the two feasible locations with the highest random draws). These choices specify the state in period $t = 2$, i.e. $\mathbf{s}^*_2$. We choose each a^{q*}_{ilt} and $\mathbf{a}^*_{-it}$ for $t = 2, ..., T-1$ similarly using $\overline{\sigma}_i$, a subset of random location draws, and the opponent strategy. For each location l and period $t = 1, ..., T-1$, we calculate the expected profits generated by each choice $a^{q*}_{ilt} \in \{0, 1\}$, i.e. the simulated sums presented in definition 2.3, substituting a^{q*}_{ilt} for a^*_{ilt}. This provides us with a sample of simulated data of the form $\{V_i(\mathbf{s}^*_{lt}, a^{q*}_{ilt}; \overline{\sigma}_i), \mathbf{s}^*_{lt}, a^{q*}_{ilt}\}^{L,T}_{l=1,t=1}$ for firm i and each simulation run.

Estimating Choice-Specific Value Function (Step 4). We focus on eight estimands, $V_i(\mathbf{s}_t, a^q_{ilt}; \overline{\sigma}_i)$ for each $q \in \{f, g, r, sc\}$ and choice $a^q_{ilt} \in \{0, 1\}$. Defining the state as "location-specific" through the location-specific population variable allows us to exploit differences in value across locations when estimating the choice-specific value functions. This simplification is not necessary for implementing Algorithm 2.2.1 but greatly reduces the simulation burden, since each individual simulation effectively provides 227 sample observations rather than 1. We employ CWGB Algorithm 2.2.2, with outcomes $V_i(\mathbf{s}^*_{lt}, a^{q*}_{ilt}; \overline{\sigma}_i)$ and regressors $\mathbf{s}^*_{lt}$, and we pool observations across simulation runs, locations, and time. This estimation process produces eight models, denoted as $\widehat{V}_i(\widetilde{\mathbf{s}}_t, a^q_{ilt}; \overline{\sigma}_i)$ for $q \in \{f, g, r, sc\}$ and $a^q_{ilt} \in \{0, 1\}$, where we abuse notation by not acknowledging the potential differences in the dimension-reduced vectors $\widetilde{\mathbf{s}}_t$ across models, which need not include the same state variables.[18]

One-Step Improvement Policy (Step 5). To derive each $\widehat{\sigma}_i^1$, we first compute the difference in the CWGB estimated local choice and facility-specific value functions between placing a facility q in location l versus not, i.e. $\widehat{V}_i\left(\widetilde{\mathbf{s}}_t, a_{ilt}^q = 1; \overline{\sigma}_i\right)$ $-\widehat{V}_i\left(\widetilde{\mathbf{s}}_t, a_{ilt}^q = 0; \overline{\sigma}_i\right)$, for each facility type $q \in \{f, g, r, sc\}$ and location $l = 1, ..., L$. Then, for each q, we rank these differences over all locations and choose the highest ranking locations to place the pre-specified number of new facilities allowed in each period. This algorithm for choosing facility locations over all time periods represents our one-step policy improvement policy $\widehat{\sigma}_i^1$.[19] A second-step policy improvement is obtained by using $\widehat{\sigma}_i^1$ to generate $\overline{\sigma}_i$, and repeating the steps of Algorithm 2.2.1.[20]

3.5 Results

The models resulting from using the CWGB procedure are presented in Table 3.1. Table 3.1 lists both the final coefficients associated with selected state variables in each model, and the proportion of CWGB iterations for which univariate models of these state variables resulted in the best fit (i.e. the selection frequency). For example, during the CWGB estimation process which generated the model for general merchandise distribution centers and $a_{ilt}^g = 1$, i.e. $\widehat{V}_i\left(\widetilde{\mathbf{s}}_t, a_{ilt}^g = 1; \overline{\sigma}_i\right)$, univariate models of the population variable were selected in 53 percent of the iterations.

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[18]In our chain store entry game application, we estimate the choice-specific value function using CWGB rather than OLS, where OLS is proposed in Section 2.2.2. This is necessary because our state vector remains high-dimensional in this game, since we do not estimate opponent policy functions, our agent's payoff function is known, and the law of motion is deterministic. In settings where the policy functions of opponents and (if necessary) the agent's payoff function are estimated using CWGB, the CWGB estimator typically reduces the dimension of the state vector sufficiently, making further model selection unnecessary when estimating the choice-specific value function.

[19]We note that by choosing $\widehat{\sigma}_i^1$ in this way, we do not choose a true greedy maximum action vector $\mathbf{a}_{it}$ in each period t, since focusing on location and facility-specific choice-specific value functions effectively assumes that facilities in all other locations are chosen according to $\overline{\sigma}_i$. Nonetheless, we show in the next Section that $\widehat{\sigma}_i^1$ generates a substantial improvement in our illustration.

[20]Our code for implementing the chain store application is available at: http://abv8.me/4g8.

Choice-Specifc Value Function	$\widehat{V}_i(a^g_{ilt}=1)$	$\widehat{V}_i(a^g_{ilt}=0)$	$\widehat{V}_i(a^f_{ilt}=1)$	$\widehat{V}_i(a^f_{ilt}=0)$	$\widehat{V}_i(a^r_{ilt}=1)$	$\widehat{V}_i(a^r_{ilt}=0)$	$\widehat{V}_i(a^{sc}_{ilt}=1)$	$\widehat{V}_i(a^{sc}_{ilt}=0)$
Population	1.64×10^{1}	1.42×10^{1}	1.93×10^{1}	1.42×10^{1}	1.18×10^{1}	1.42×10^{1}	1.95×10^{1}	1.42×10^{1}
	(0.530)	(0.526)	(0.526)	(0.526)	(0.531)	(0.526)	(0.533)	(0.526)
Own Entry Regstore Allentown, PA	-1.69×10^{7}		-1.53×10^{7}		-2.09×10^{6}		-7.81×10^{6}	
	(0.113)		(0.072)		(0.058)		(0.053)	
Own Entry Regstore Boulder, CO	-4.85×10^{6}		-4.23×10^{6}				-2.37×10^{6}	
	(0.061)		(0.065)				(0.064)	
Own Entry Regstore Hartford, CT	-8.70×10^{6}		-6.39×10^{6}		-1.15×10^{6}		-3.57×10^{6}	
	(0.051)		(0.059)		(0.054)		(0.059)	
Own Entry Regstore Kansas City, MO	-1.55×10^{7}		-5.42×10^{6}		-2.13×10^{6}		-3.54×10^{6}	
	(0.049)		(0.026)		(0.045)		(0.035)	
Own Entry Regstore San Francisco, CA	-1.08×10^{7}				-1.77×10^{6}		-1.11×10^{6}	
	(0.196)				(0.159)		(0.079)	
Own Entry Regstore Augusta, GA			-1.48×10^{7}		-3.57×10^{6}		-9.28×10^{6}	
			(0.252)		(0.153)		(0.177)	
Rival Entry Regstore Albany, GA		-8.47×10^{6}		-8.47×10^{6}		-8.48×10^{6}		-8.47×10^{6}
		(0.302)		(0.303)		(0.303)		(0.302)
Rival Entry GM Dist Clarksville, TN		-1.34×10^{6}		-1.35×10^{6}		-1.35×10^{6}		-1.34×10^{6}
		(0.032)		(0.033)		(0.033)		(0.032)
Rival Entry GM Dist Columbia, MO		-5.09×10^{5}		-5.05×10^{5}		-5.06×10^{5}		-5.05×10^{5}
		(0.015)		(0.015)		(0.015)		(0.015)
Rival Entry GM Dist Cumberland, MD		-1.35×10^{6}		-1.35×10^{6}		-1.35×10^{6}		-1.35×10^{6}
		(0.050)		(0.050)		(0.050)		(0.050)
Rival Entry GM Dist Dover, DE		-1.81×10^{6}		-1.80×10^{6}		-1.80×10^{6}		-1.81×10^{6}
		(0.051)		(0.050)		(0.050)		(0.051)
Rival Entry GM Dist Hickory, NC		-9.74×10^{5}		-9.65×10^{5}		-9.66×10^{5}		-9.74×10^{5}
		(0.024)		(0.023)		(0.023)		(0.024)
Constant	4.12×10^{7}	9.37×10^{6}	3.11×10^{7}	9.37×10^{6}	6.24×10^{6}	9.38×10^{6}	1.72×10^{7}	9.37×10^{6}

Note: Selection frequencies are shown in parentheses. Results are based on 1000 simulation runs. We use *glmboost* function in *mboost* package in R with linear base-learners, a squared-error loss function used for observation-weighting, 1000 iterations per boosted regression model, and a step size of 0.01. The covariate *Own Entry Regstore City, State* represents own-firm regular store entry in the listed MSA; similarly, *Rival Entry Regstore City, State* represents competitor regular store entry in the listed MSA, and *Rival Entry GM Dist City, State* represents competitor general merchandise distribution center entry in the listed MSA.

Table 3.1: Choice-Specific Value Function Estimates, Boosted Regression Models (Baseline Specification)

This table reveals three salient features of these models. The first is that the CWGB procedure *drastically* reduces the number of state variables for each model, from 1817 to an average of 7 variables. For example, one of the most parsimonious models estimated is that for regular stores with $a^r_{ilt} = 1$, i.e. $\widehat{V}_i\left(\widetilde{\mathbf{s}}_t, a^r_{ilt} = 1; \overline{\sigma}_i\right)$, which consists of a constant, the population covariate, and indicators for own regular store entry in five markets: Allentown, PA, Hartford, CT, Kansas City, MO, San Francisco, CA, and Augusta, GA. This reduces the average state space cardinality per time period from more than 10^{85} (not including population) to 32 (2^5) multiplied by the cardinality of the population variable.

The second and related feature is that all models draw from a relatively small subset of the original 1816 own and competitor facility presence indicators. It is also interesting to observe which MSA indicators comprise this subset, which is made up primarily of indicators associated with medium-sized MSA's in our sample scattered across the country. What explains this pattern is that in the simulated data used for estimation, even across many simulations, only a subset of MSA's are occupied by firm facilities. Among those occupied, occasionally, the agent experiences either heavy gains or heavy losses, which are compounded over time, since we do not allow firms to close facilities once they are opened. These particularly successful or painful facility placements tend to produce univariate models that explain levels of the choice-specific value function well, which results in their selection by the CWGB procedure, typically across several models. For example, a series of particularly heavy losses were sustained by the agent as a result of placing a regular store in Augusta, GA, which induced the CWGB procedure to choose this indicator at a high frequency–25 percent, 15 percent, and 18 percent of iterations–across three different models, with each model associating this indicator with a large negative coefficient. As a result, our one-step improvement policy $\widehat{\sigma}^1_i$ tended to avoid placing distribution centers and stores in this location.

The third salient feature apparent from Table 3.1 is that population is the state variable selected most consistently across all CWGB models.

Model	CWGB 1 (baseline)	CWGB 2 (high-urban-penalty)	CWGB 3 (high-dist-cost)
Revenue (millions of $)			
Agent, One-Step Improvement	244.23	244.09	245.87
Agent, Random Choice	53.79	53.67	54.64
Competitor	62.14	62.15	62.47
Operating Income (millions of $)			
Agent, One-Step Improvement	18.44	18.29	17.91
Agent, Random Choice	3.26	3.09	2.78
Competitor	4.40	4.25	4.01
Operating Margin			
Agent, One-Step Improvement	7.55%	7.49%	7.28%
Agent, Random Choice	6.07%	5.77%	5.08%
Competitor	7.09%	6.83%	6.42%
Variable Cost Labor (millions of $)			
Agent, One-Step Improvement	21.28	21.26	21.42
Agent, Random Choice	5.64	5.62	5.73
Competitor	5.91	5.91	5.93
Variable Cost Land (millions of $)			
Agent, One-Step Improvement	0.20	0.20	0.20
Agent, Random Choice	0.05	0.05	0.05
Competitor	0.04	0.04	0.04
Variable Cost Other (millions of $)			
Agent, One-Step Improvement	17.23	17.21	17.33
Agent, Random Choice	4.78	4.76	4.84
Competitor	5.16	5.16	5.18
Import Distribution Cost (millions of $)			
Agent, One-Step Improvement	0.79	0.80	1.21
Agent, Random Choice	0.74	0.73	1.10
Competitor	0.56	0.56	0.85
Domestic Distribution Cost (millions of $)			
Agent, One-Step Improvement	0.60	0.56	0.84
Agent, Random Choice	0.37	0.37	0.55
Competitor	0.28	0.28	0.42
Urban Cost Penalty (millions of $)			
Agent, One-Step Improvement	0.34	0.51	0.34
Agent, Random Choice	0.32	0.48	0.32
Competitor	0.32	0.48	0.32

Note: Results are based on 1000 simulation runs for each specification.
The parameter values for each specification are available in the Appendix.

Table 3.2: Simulation Results by Specification (Per-Store Average)

Population is selected with a frequency of roughly 53 percent in each model, while facility presence indicator variables are selected at much smaller rates.[21]

For a variety of parameter specifications, Table 3.2 compares per-store revenues, operating income, margins, and costs, averaged over all time periods and simulations, for three strategies: 1) the one-step improvement policy for the agent, 2) a random choice agent strategy, where distribution centers and stores are chosen as specified for $\overline{\sigma}_i$ (in all time periods $t, ..., T-1$), and 3) the competitor's strategy (benchmark). The three parameter specifications correspond to three scenarios: a baseline specification, a high penalty for urban locations, and high distribution costs.[22] As shown in this table when comparing revenues, in the baseline scenario, the one-step improvement policy outperforms the random choice strategy by 354 percent. Similarly, it outperforms the competitor's strategy by 293 percent. In the high urban penalty and high distribution cost specifications, the one-step improvement policy outperforms the random choice strategy by 355 percent and 350 percent, respectively, and the competitor strategy by 293 percent and 294 percent, respectively. The relative returns of the one-step improvement policies seem fairly invariant to the parameter specifications, which is understandable since each is constructed using a choice-specific value function estimated under each respective parameter specification. The one-step improvement policies appear to adjust the agent's behavior accordingly in response to these parameter changes.

Table 3.3 provides a comparison of per-store revenues, operating income, margins, and costs by revenue type and strategy, averaged over all time periods and simulations

[21]For comparison, in the Appendix (Table B.5), we estimate OLS models of the choice-specific value functions of interest by using only the state variables selected by the corresponding boosted regression model from Table 3.1. Overall, the post selection OLS models have similar coefficients to the boosted regression models.

[22]The parameter values in the baseline specification were chosen to calibrate competitor per-store returns to those actually received by Wal-Mart in the U.S. during the same time period. The high urban penalty and high distribution cost specifications were chosen to explore the sensitivity of the relative returns generated by our one-step improvement policy to these parameters.

Statistic	One-Step Improvement	Random Choice	Competitor	Wal-Mart (2005)
Revenue (millions of $)				
All Goods	244.23	53.79	62.14	60.88
General Merchandise	119.19	30.81	36.61	–
Food	180.71	33.13	36.89	–
Operating Income (millions of $)				
All Goods	18.44	3.26	4.40	4.49
General Merchandise	8.46	1.64	2.43	–
Food	14.43	2.34	2.85	–
Operating Margin (millions of $)				
All Goods	7.55%	6.07%	7.09%	7.38%
General Merchandise	7.10%	5.33%	6.64%	–
Food	7.99%	7.05%	7.73%	–
Import Distribution Cost (millions of $)				
All Goods	0.79	0.74	0.56	–
General Merchandise	0.55	0.43	0.30	–
Food	0.35	0.44	0.38	–
Domestic Distribution Cost (millions of $)				
All Goods	0.60	0.37	0.28	–
General Merchandise	0.51	0.28	0.21	–
Food	0.13	0.12	0.10	–
Variable Costs and Urban Penalty (millions of $)				
Labor Cost, All Goods	21.28	5.64	5.91	–
Land Cost, All Goods	0.20	0.05	0.04	–
Other Cost, All Goods	17.23	4.78	5.16	–
Urban Cost Penalty, All Goods	0.34	0.32	0.32	–
MSA Population				
Population (millions)	2.39	0.84	1.01	–
Population Density (Population/Square Miles)	528	296	264	–

Note: Results are based on 1000 simulation runs. The baseline specification parameter values are in the Appendix.

Table 3.3: Simulation Results by Merchandise Type (Baseline Specification, Per-Store Average)

in the baseline scenario, and compares these to Wal-Mart's revenue and operating income figures for 2005. The competitor's strategy generates average operating income per store (of both types) of $4.40 million, which is similar to that actually generated by

Wal-Mart in 2005 of $4.49 million, and larger than the of the random choice strategy, which generates $3.26 million. The one-step improvement policy does much better, with an operating income per store of over $18 million, corresponding to revenues per store of $244 million, versus $62 million for the competitor and $54 million for the random choice strategy. Moreover, the one-step improvement policy achieves a slightly higher operating margin than the other two strategies: 7.55 percent versus 7.09 percent for the competitor and 6.07 percent for the random choice strategy. One reason for the success of the improvement strategy appears to be that it targets higher population areas than the other strategies, which generates higher revenues in our simulation. Specifically, it targets MSA's with an average population of 2.39 million versus 0.84 million for the random choice strategy and 1.01 million for the competitor. That the average population of competitor locations is relatively small is understandable, since the competitor progresses as Wal-Mart did, placing distribution centers and stores primarily in the Midwest and radiating out towards the east coast, while the improvement strategy searches for value-improving locations for distribution centers and stores in a less restricted manner across the country.

These facility placement pattern differences are visually detectable in Figure 3.2, which shows distribution center and store location patterns for the agent and the competitor in a representative simulation, with the agent using the one-step improvement policy. As shown in these figures, the agent scatters distribution centers and stores across the population dense MSA's in the United States, while the competitor has a concentration of distribution centers and stores primarily in the Midwest and east coast. By the end of 2006, the agent has a strong presence on the West coast with eight facilities in California, while the competitor only opens four facilities in this region. Although visually these pattern differences seem subtle, they generate large differences in revenues and operating income, as highlighted by Table 3.3.

Finally, we generate additional policy improvements after the first one-step policy improvement by randomly deviating from each one-step policy improvement and

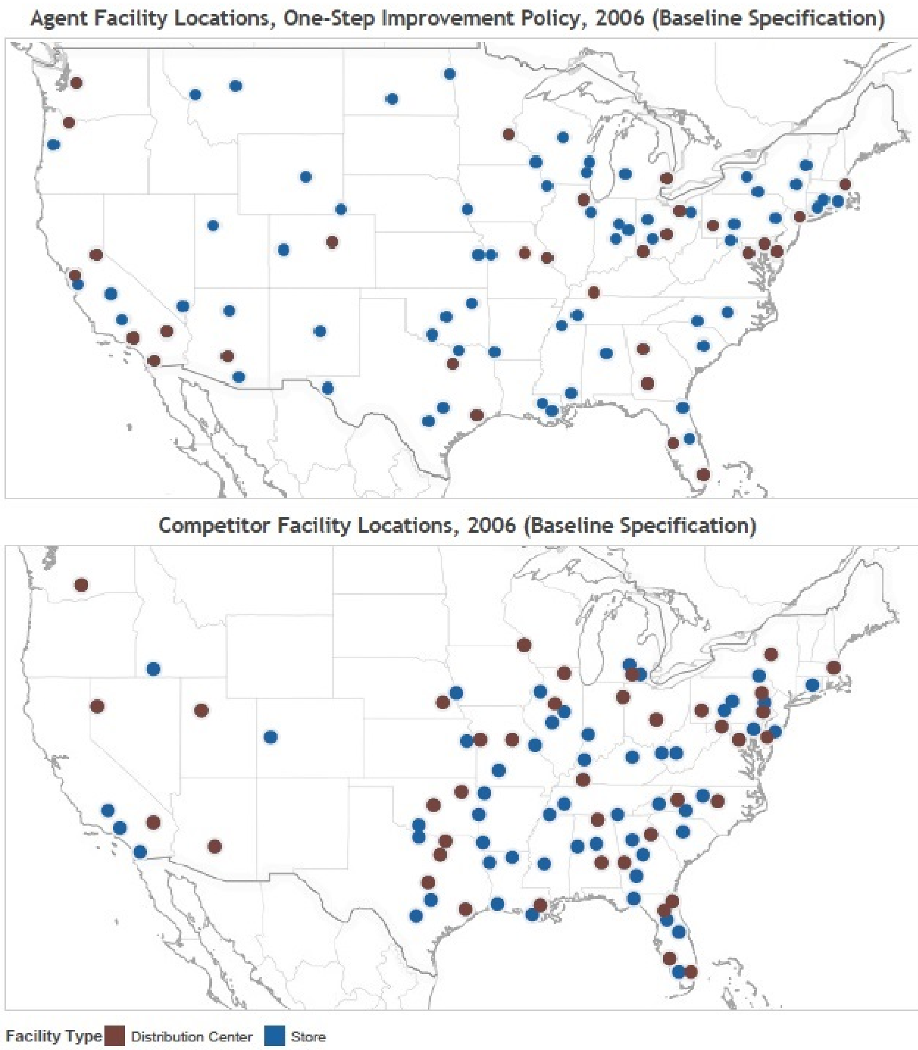
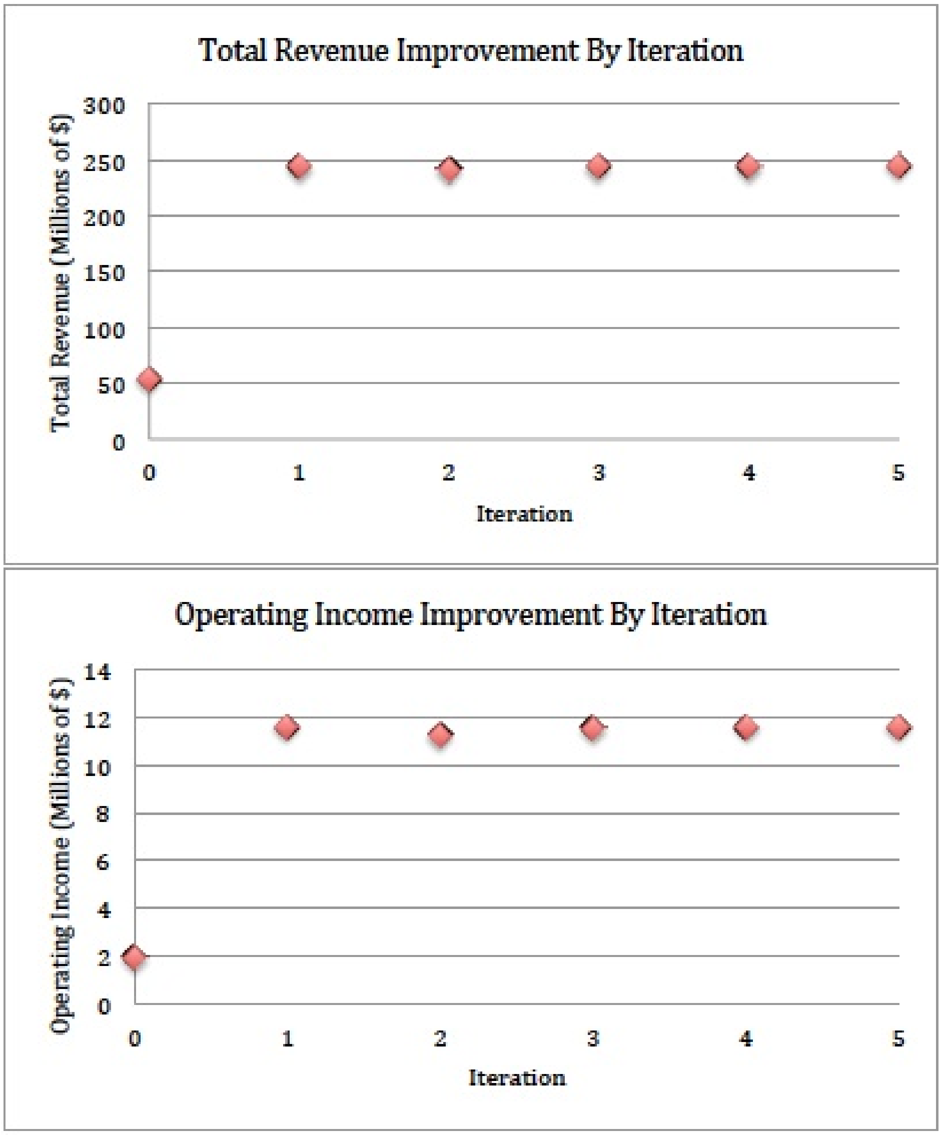


Figure 3.2: Simulation Results Representative Simulation (2000 to 2006)

otherwise repeating the steps of Algorithm 2.2.1. As shown in Figure 3.3, the first one-step policy improvement generates almost all gains in payoffs, and all subsequent policy improvements generate returns very close to the first one-step policy improvement. For example, using the baseline specification, while the first one-step policy improvement generates total revenues per store for the agent of \$244.44 million, up from the total revenues per store generated by the random choice strategy of \$53.61 million, the second through fifth-step policy improvements generate total revenues per



Note: Training samples based on 500 simulation runs. Test samples based on one simulation run. Iteration 0 represents return from random facility strategy. Iterations 1 to 5 trained using one-step policy improvements upon strategy of previous iteration. All iterations use baseline parameter specification.

Figure 3.3: Multi-step Policy Improvement

store of between $244.43 and $244.60 million. Similarly, while the first one-step policy improvement generates operating income per store of $11.55 million, up from the operating income per store generated by the random choice strategy of $1.94 million, the second through fifth-step policy improvements generate operating income per store of between \$11.23 million and \$11.55 million.

3.6 Conclusion

We use the method developed in Chapter 2 to derive policy function improvements for a single retailer in a dynamic spatial competition game among two chain store retailers similar to the one considered by Holmes (2011). This game involves location choices for stores and distribution centers over a finite number of time periods. This game becomes high-dimensional primarily because location choices involve complementarities across locations. For example, clustering own stores closer together can lower distribution costs but also can cannibalize own store revenues, since consumers substitute demand between nearby stores. For the same reason, nearby competitor stores lower revenues for a given store. Since we characterize the state as a vector enumerating the current network of stores and distribution centers for both competitors, the cardinality of the state becomes extremely large (on the order of $> 10^{85}$ per time period), even given a relatively small number of possible locations (227). We derive an improvement policy and show that this policy generates a nearly 300 percent improvement over a strategy designed to approximate Wal-Mart's actual facility placement during the same time period (2000 to 2006).

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Appendices

Appendix 1

CHAPTER 1 APPENDIX

A.1 First Stage: Demand Estimation

In this section, we elaborate on the discussion of Section 1.5.2, which introduces the estimation procedure for demand parameters. As previously introduced, assume we have access to a vector of instrumental variables I_{mt} such that the expectation of the vector of unobserved product characteristics conditional on these instruments is zero, i.e.

$$E\left[\xi_{mt}|I_{mt}\right]=0$$

for all m and t. These moment conditions imply:

$$E\left[h\left(I_{mt}\right)\xi_{mt}\right]=0$$

for all m and t and any function $h\left(.\right)$.

One issue with these conditions is that they are a function of the unobserved product attributes, which must be computed. To do so, we use the contraction mapping algorithm of Berry and Jia (2010). Recall each carrier's market share demand function specified in Section 1.3.3. This expression provides a vector of closed-form expressions for the market share of each product in market m at time t, which we denote as $\mathbf{ms}_{mt}\left(\mathbf{x}_{mt},\mathbf{p}_{mt},\xi_{mt};\theta^{d}_{rt}\right)$. Notice that for each market, we obtain a vector of realized market shares for each product, defined as $\mathbf{ms}_{mt}\equiv\left(ms_{1mt},...ms_{J_{mt}mt}\right)$ where ms_{jmt} represents the realized market share for product j, which we set equal to the vector of market share equations, such that

$$\mathbf{ms}_{mt} = \mathbf{ms}_{mt}\left(\mathbf{x}_{mt}, \mathbf{p}_{mt}, \xi_{mt}; \theta_{rt}^{d}\right) \tag{A.1}$$

for all m and t. The right hand side of equation A.1 gives us a closed-form solution for market shares up to the unknown parameters θ_{rt}^{d}, which must be estimated. For a given value of the parameter vector θ_{rt}^{d} and for a given realized vector of market shares, we can invert A.1 to solve for the vector of unobserved product characteristics in market m at time t, i.e.

$$\xi_{mt} = \mathbf{ms}_{mt}^{-1}\left(\mathbf{x}_{mt}, \mathbf{p}_{mt}, \mathbf{s}_{mt}; \theta_{rt}^{d}\right)$$

This leads to the following estimation algorithm for θ_{rt}^{d}, where we denote the estimate as $\widehat{\theta}_{rt}^{d}$. Let ξ_{jmt}^{g} denote the unobserved product attribute for product j, market m, time t, and contraction-mapping iteration g.

Algorithm A.1.1 *Estimating $\widehat{\theta}_{rt}^{d}$ as in Berry and Jia (2010) for a given time period t.*

1. *Choose a candidate parameter value θ_{rt}^{d}*

2. *Solve for ξ_{mt} using $\xi_{mt} = \mathbf{ms}_{mt}^{-1}\left(\mathbf{x}_{mt}, \mathbf{p}_{mt}, \mathbf{ms}_{mt}; \theta_{rt}^{d}\right)$*

3. *Contraction Mapping. Set $\xi_{jmt}^{0} = \xi_{jmt}$ for all j,m. Set $g = 1$.*

   (a) *Set $\xi_{jmt}^{g} = \xi_{jmt}^{g-1} + \lambda_t \left[\ln\left(s_{jmt}\right) - \ln\left(ms_{jmt}\left(\mathbf{x}_{mt}, \mathbf{p}_{mt}, \xi_{mt}^{g-1}; \theta_{rt}^{d}\right)\right)\right]$ for all j and m, where $\xi_{mt}^{g-1} = \left(\xi_{1mt}^{g-1}, ..., \xi_{J_{mt}mt}^{g-1}\right)$.*

   (b) *Set $g = g + 1$ and repeat until the difference between each ξ_{jmt}^{g} and ξ_{jmt}^{g-1} is sufficiently small according to a desired tolerance level. Denote the final iteration as $g = G$.*

4. *Compute the empirical GMM moment function:*

$$GMM\left(\xi^G_{mt}, \theta^d_{rt}\right) = \frac{1}{K}\sum_{m=1}^{K}\left[h\left(z_{mt}\right)\xi^G_{mt}\left(\mathbf{x}_{mt}, \mathbf{p}_{mt}, \mathbf{ms}_{mt}; \theta^d_{rt}\right)\right]$$

5. *Repeat steps* 1 *to* 4 *and find the candidate parameter value* θ^d_{rt} *such that*

$$\widehat{\theta}^d_{rt} \equiv \arg\min_{\theta^d_{rt}} \left|GMM\left(\xi_{mt}, \theta^d_{rt}\right)\right|$$

A.2 First Stage: Marginal Costs

In this section, we partly restate and expand upon the discussion of the Berry and Jia (2010) algorithm for estimating the marginal cost specification, as introduced in Section 1.5.2. We invert the system of equations in 1.8 using the estimated demand parameters $\widehat{\theta}^d_{rt}$ to solve for equilibrium product price markups, i.e.

$$\begin{bmatrix} p_{1mt} - mc_{1mt} \\ ... \\ p_{J_m mt} - mc_{J_m mt} \end{bmatrix} = \widehat{\mathbf{P}}^{-1} \begin{bmatrix} 0 \\ ... \\ 0 \end{bmatrix} \tag{A.2}$$

where

$$\widehat{\mathbf{P}} \equiv \begin{bmatrix} 1 & ms_{1mt}\left(\mathbf{x}_{mt}, \mathbf{p}_{mt}, \xi_{mt}; \widehat{\theta}^d_{rt}\right) & \frac{\partial ms_{1mt}\left(\mathbf{x}_{mt}, \mathbf{p}_{mt}, \xi_{mt}; \widehat{\theta}^d_{rt}\right)}{\partial p_{1mt}} & ... & \frac{\partial ms_{J_{mt}mt}\left(\mathbf{x}_{mt}, \mathbf{p}_{mt}, \xi_{mt}; \widehat{\theta}^d_{rt}\right)}{\partial p_{1mt}} \\ ... & & & & \\ 1 & s_{J_{mt}mt}\left(\mathbf{x}_{mt}, \mathbf{p}_{mt}, \xi_{mt}; \widehat{\theta}^d_{rt}\right) & \frac{\partial ms_{1mt}\left(\mathbf{x}_{mt}, \mathbf{p}_{mt}, \xi_{mt}; \widehat{\theta}^d_{rt}\right)}{\partial p_{J_{mt}mt}} & ... & \frac{\partial ms_{J_{mt}mt}\left(\mathbf{x}_{mt}, \mathbf{p}_{mt}, \xi_{mt}; \widehat{\theta}^d_{rt}\right)}{\partial p_{J_{mt}mt}} \end{bmatrix}$$

Since prices are observed, rearranging A.2 gives us marginal costs:

$$\begin{bmatrix} mc_{1mt} \\ ... \\ mc_{J_m mt} \end{bmatrix} = \begin{bmatrix} p_{1mt} \\ ... \\ p_{J_m mt} \end{bmatrix} - \widehat{\mathbf{P}}^{-1} \begin{bmatrix} 0 \\ ... \\ 0 \end{bmatrix} \tag{A.3}$$

As with demand side unobservables, cost-side unobservables are computed using the contraction mapping algorithm of Berry and Jia (2010). We assume we have access to a vector of instrumental variables I_{mt} such that the expectation of the vector of cost-side unobservables conditional on these instruments is zero, i.e.

$$E\left[\omega_{mt}|I_{mt}\right]=0$$

for all m and t. These moment conditions imply:

$$E\left[h\left(I_{mt}\right)\omega_{mt}\right]=0$$

for all m and t and any function $h\left(.\right)$.

As with demand unobservables, for a given time period t, we solve for cost-side unobservables ω_{jmt} and form moments for estimation that take the form $E\left(h\left(z_{mt}\right)\omega_{mt}\left(\mathbf{x}_{mt},\mathbf{p}_{mt},\mathbf{ms}_{mt},\widehat{\theta}^{d}_{rt},\theta^{mc}_{rt}\right)\right)=0.$

A.3 Fixed, Entry, and Exit Costs

We propose the following linear model for the fixed and entry costs of carrier f operating in segment c:

$$\begin{aligned}
C_{fc} = \gamma_0 &+ \gamma_1\mathbb{1}\{EntryOrigAirport\}_{fc} + \gamma_2\mathbb{1}\{EntryDestAirport\}_{fc} \\
&+ \gamma_3\mathbb{1}\{ExitOrigAirport\}_{fc} + \gamma_4\mathbb{1}\{ExitDestAirport\}_{fc} \\
&+ \gamma_5\mathbb{1}\{EntrySegment\}_{fc} + \gamma_6\mathbb{1}\{ExitSegment\}_{fc} + \\
&+ \gamma_7 OrigShare_{fc} + \gamma_8 DestShare_{fc} \\
&+ \gamma_9\mathbb{1}\{HighCapacityLevel\}_{fc} + \gamma_{10}\mathbb{1}\{MediumCapacityLevel\}_{jc} \\
&+ \gamma_{11}\mathbb{1}\{LowCapacityLevel\}_{fc} + \epsilon.
\end{aligned}$$

where $\mathbb{1}\{.\}$ represents the indicator function, *EntryOrigAirport*, *EntryDestAirport*, *ExitOrigAirport*, and *ExitDestAirport* represent entry and exit by carrier f into and out of the origin and destination airport for segment c, *EntrySegment* and

ExitSegment represent entry and exit by carrier f into and out of segment c, and *OrigShare* and *DestShare* represent carrier fs share of flights at the origin and destination airports of segment c. *HighCapacityLevel*, *MediumCapacityLevel* and *LowCapacityLevel* are defined by the terciles of the distribution of flights for all segments and all carriers. This cost function can be estimated by the inequality estimator proposed by Bajari, Benkard, and Levin (2007). The specification is inspired by those for fixed and entry costs in the context of dynamic, strategic, airline competition proposed by Benkard, Bodoh-Creed, and Lazarev (2010) and Snider (2009).

A.4 Miscellaneous

We provide the list of low cost carriers used to compute the share of enplaned passengers from 1995 to 2014 departing or arriving at Minneapolis, St. Paul airport, using T100 segment data, available from the Department of Transportation (Bureau of Transportation Statistics). The list comes from the historical list of lcc's published by IACO (2014), for which this source provided an IATA code. The list of lcc's we use, with IATA code in parentheses, includes: Access Air (ZA), Air South (KKB), Air Tran Airways (FL), Allegiant Air (G4), ATA Airlines (TZ), Eastwind Airlines (W9), Frontier Airlines (F9), Go! (YV), Independence Air (DH), JetBlue Airways (B6), Kiwi International Airlines (KP), Midway Airlines (ML), Midwest Airlines (YX), National Airlines (N7), New York Air (NY), Pacific Southwest Airlines (PS), People Express (PE), Pro Air (P9), Reno Air (QQ), Skybus Airlines (SX), SkyValue USA (XP), Southwest Airlines (WN), Spirit Airlines (NK), Sun Country Airlines (SY), Tower Air (FF), USA 3000 (U5), ValueJet (J7), Vanguard (NJ), Virgin America (VX), and Western Pacific (W7).

Carrier	Hubs
American	Dallas Fort Worth, Los Angeles, Miami, Chicago O'Hare, San Francisco
Alaska	Seattle-Tacoma, Portland
JetBlue	Boston Logan, John F. Kennedy (New York, NY)
Continental	Cleveland Hopkins International Airport, Newark Liberty, George Bush Intercontinental Airport (Houston, TX)
Delta	Hartsfield-Jackson Atlanta, Cincinnati/Northern Kentucky, Salt Lake City
Northwest	Detroit, Minneapolis-St. Paul
US Airways	McCarran (Las Vegas, NV), Phoenix Sky Harbor, Charlotte Douglas, Ronald Reagan Washington National, Philadelphia, Pittsburgh
United	Denver, Chicago O'Hare, San Francisco

Note: This list represents a snapshot of primary hubs maintained during 2007. We combine the primary hubs of America West Airlines (Las Vegas, NV and Phoenix, AZ) with those of US Airways to reflect the merger of these carriers in 2005.

Table A.1: List of Hubs

Merger	Announcement	Regulatory Approval (U.S.)	Shareholder Approval	Merger Legal Close	Single Operating Certificate (FAA)	Single Passenger Reservation System
American West and US Airways	May 19, 2005	Sept 16, 2005	Sept 13, 2005	Sept 27, 2005	Sept 26, 2007	Mar 4, 2007
Delta and Northwest	Apr 14, 2008	Oct 29, 2008	Sept 26, 2008	Oct 28, 2008	Dec 31, 2009	Jan 31, 2010
United and Continental	May 3, 2010	Aug 27, 2010	Sept 17, 2010	Oct 1, 2010	Nov 30, 2011	Mar 5, 2012
Southwest and AirTran	Sept 27, 2010	Apr 26, 2011	Mar 23, 2011	May 2, 2011	Mar 1, 2012	Not Complete
American and US Airways	Feb 14, 2013	Nov 12, 2013	June 12, 2013	Dec 9, 2013	Apr 8, 2015	Not Complete

Table A.2: Timeline of Merger Events

Table A.3: List of Southwest Flight Segments Unentered in 2008q1

Quarter Entered	Segments List
2008q2	Birmingham to Spokane, Boise to Southwest Florida, El Paso to Omaha, Spokane to Jacksonville, Spokane to Tulsa, Orlando to Palm Beach, Omaha to Tulsa, Palm Beach to Reno, Portland to Southwest Florida
2008q3	Boise to Jacksonville, Boise to Tulsa, Denver to Omaha, Oklahoma City to Southwest Florida
2008q4	Southwest Florida to Tulsa
2009q1	Albuquerque to Minneapolis-St. Paul, Albany to Minneapolis-St. Paul, Austin to Minneapolis-St. Paul, Hartford to Minneapolis-St. Paul, Birmingham to Minneapolis-St. Paul, Nashville to Minneapolis-St. Paul, Nashville to St. Louis, Boston to Minneapolis-St. Paul, Buffalo to Minneapolis-St. Paul, Los Angeles to Minneapolis-St. Paul, Washington DC to Minneapolis- St. Paul, Cleveland to Minneapolis-St. Paul, Columbus to Minneapolis-St. Paul, Dallas to Minneapolis-St. Paul, Denver to Minneapolis-St. Paul, Detroit to Minneapolis-St. Paul, El Paso to Minneapolis-St. Paul, El Paso to Palm Beach, Miami to Minneapolis-St. Paul, Houston to Minneapolis-St. Paul, Indianapolis to Minneapolis-St. Paul, Jacksonville to Minneapolis-St. Paul, Las Vegas to Minneapolis-St. Paul, Kansas City to Minneapolis-St. Paul, Orlando to Minneapolis-St. Paul, Chicago to Minneapolis-St. Paul, Minneapolis-St. Paul to New Orleans, Minneapolis-St. Paul to San Francisco, Minneapolis-St. Paul to Oklahoma City, Minneapolis-St. Paul to Norfolk, Minneapolis-St. Paul to Palm Beach, Minneapolis-St. Paul to Portland, Minneapolis-St. Paul to Philadelphia, Minneapolis-St. Paul to Phoenix, Minneapolis-St. Paul to Pittsburgh, Minneapolis-St. Paul to Raleigh-Durham, Minneapolis-St. Paul to Reno, Minneapolis-St. Paul to Southwest Florida, Minneapolis-St. Paul to San Diego Minneapolis-St. Paul to San Antonio, Minneapolis-St. Paul to Louisville, Minneapolis- St. Paul to Seattle, Minneapolis-St. Paul to Salt Lake City, Minneapolis-St. Paul to Sacramento, Minneapolis-St. Paul to St. Louis, Minneapolis-St. Paul to Tampa, Minneapolis-St. Paul to Tulsa, Minneapolis-St. Paul to Tucson, Palm Beach to Tucson
2009q2	Albuquerque to New York, Albany to Honolulu, Birmingham to New York, Nashville to New York, Washington DC to New York, Cleveland to New York, Columbus to New York, Dallas to New York, Denver to New York, Detroit to New York, New York to Miami, New York to Houston, New York to Orlando, New York to Norfolk, New York to Palm Beach, New York to Raleigh-Durham, New York to San Diego, New York to Tampa, Oklahoma City to Palm Beach
2009q3	Boise to New York, Boise to Minneapolis-St. Paul, Boston to New York, Buffalo to New York, El Paso to New York, New York to Jacksonville, New York to Minneapolis-St. Paul, New York to Pittsburgh, New York to Reno, New York to

	Southwest Florida, New York to Salt Lake City, Spokane to Minneapolis-St. Paul
2009q4	Albuquerque to Milwaukee, Albany to Milwaukee, Austin to Milwaukee, Hartford to Milwaukee, Birmingham to Milwaukee, Nashville to Milwaukee, Boise to Milwaukee, Boston toMilwaukee, Buffalo to Milwaukee, Los Angeles to Milwaukee, Washington DC to Milwaukee, Columbus to Milwaukee, Dallas to Milwaukee, Denver to Milwaukee, El Paso to Milwaukee, Miami to Milwaukee, Spokane to Milwaukee, Houston to Milwaukee, Jacksonville to Milwaukee, Las Vegas to Milwaukee, Kansas City to Milwaukee, Orlando to Milwaukee, Milwaukee to New Orleans, Milwaukee to San Francisco, Milwaukee to Oklahoma City, Milwaukee to Norfolk, Milwaukee to Palm Beach, Milwaukee to Portland, Milwaukee to Phoenix, Milwaukee to Pittsburgh, Milwaukee to Raleigh-Durham, Milwaukee to Reno, Milwaukee to Southwest Florida, Milwaukee to San Diego, Milwaukee to San Antonio, Milwaukee to Seattle, Milwaukee to Salt Lake City, Milwaukee to Sacramento, Milwaukee to St. Louis, Milwaukee to Tampa, Milwaukee to Tulsa, Milwaukee to Tucson
2010q1	Cleveland to Philadelphia, New York to Milwaukee, Jacksonville to Orlando, Portland to Seattle
2010q2	New York to Spokane, Spokane to Palm Beach, Milwaukee to Louisville, Palm Beach to Tulsa
2010q3	Buffalo to Cleveland
2010q4	Cleveland to Milwaukee, Detroit to Pittsburgh
2011q1	Buffalo to Detroit, Columbus to Louisville
2011q2	Spokane to Southwest Florida
2011q3	Milwaukee to Omaha, Milwaukee to Philadelphia
2011q4	Albany to Boston, Columbus to Indianapolis
2012q1	Albuquerque to Atlanta, Albany to Atlanta, Atlanta to Austin, Atlanta to Hartford, Atlanta to Boise, Atlanta to Boston, Atlanta to Buffalo, Atlanta to Los Angeles, Atlanta to Washington DC, Atlanta to Cleveland, Atlanta to Dallas, Atlanta to Denver, Atlanta to Detroit, Atlanta to El Paso, Atlanta to New York, Atlanta to Spokane, Atlanta to Houston, Atlanta to Las Vegas, Atlanta to Kansas City, Atlanta to Chicago, Atlanta to Minneapolis-St. Paul, Atlanta to San Francisco, Atlanta to Oklahoma City, Atlanta to Omaha, Atlanta to Norfolk, Atlanta to Portland, Atlanta to Philadelphia, Atlanta to, Atlanta to Reno, Atlanta to San Diego, Atlanta to San Antonio, Atlanta to Louisville, Atlanta to Seattle, Atlanta to Salt Lake City, Atlanta to Sacramento, Atlanta to Tulsa, Atlanta to Tucson
2012q2	Atlanta to Columbus, Atlanta to Milwaukee, Atlanta to New Orleans, Atlanta to Pittsburgh, Atlanta to St. Louis
2012q3	Atlanta to Indianapolis, Atlanta to Orlando, Atlanta to Tampa
2012q4	Atlanta to Miami, Atlanta to Jacksonville, Atlanta to Raleigh-Durham, Atlanta to Southwest Florida, Columbus to Pittsburgh, Detroit to Milwaukee, Milwaukee to Minneapolis-St. Paul, San Francisco to Sacramento
2013q1	Albany to Charlotte, Albany to San Juan, Atlanta to Palm Beach, Austin to

	Charlotte, Austin to San Juan, Hartford to San Juan, Boston to Charlotte, Boston to San Juan, Buffalo to Charlotte, Los Angeles to San Diego, Washington DC to Charlotte, Washington DC to San Juan, Charlotte to Norfolk, Charlotte to Pittsburgh, Kansas City to Omaha, Minneapolis-St. Paul to Omaha, Norfolk to San Juan, Raleigh-Durham to San Juan, San Juan to Tampa
2013q2	Albuquerque to Charlotte, Albuquerque to San Juan, Atlanta to Charlotte, Atlanta to Memphis, Atlanta to San Juan, Austin to Memphis, Hartford to Charlotte, Birmingham to San Juan, Nashville to Charlotte, Nashville to San Juan, Boston to Memphis, Buffalo to San Juan, Los Angeles to Charlotte, Los Angeles to Memphis, Los Angeles to San Juan, Washington DC to Memphis, Cleveland to Charlotte, Cleveland to San Juan, Charlotte to Columbus, Charlotte to Dallas, Charlotte to Denver, Charlotte to Detroit, Charlotte to El Paso, Charlotte to Miami, Charlotte to Spokane, Charlotte to Houston, Charlotte to Indianapolis, Charlotte to Las Vegas, Charlotte to Kansas City, Charlotte to Orlando, Charlotte to Chicago, Charlotte to Milwaukee, Charlotte to Minneapolis-St. Paul, Charlotte to New Orleans, Charlotte to San Francisco, Charlotte to Oklahoma City, Charlotte to Omaha, Charlotte to Palm Beach, Charlotte to Portland, Charlotte to Phoenix, Charlotte to Reno, Charlotte to San Diego, Charlotte to San Antonio, Charlotte to Louisville, Charlotte to Seattle, Charlotte to San Juan, Charlotte to Salt Lake City, Charlotte to Sacramento, Charlotte to St. Louis, Charlotte to Tampa, Charlotte to Tulsa, Charlotte to Tucson, Columbus to San Juan, Dallas to San Juan, Denver to Memphis, Denver to San Juan, Detroit to San Juan, El Paso to San Juan, New York to Memphis, New York to San Juan, Miami to San Juan, Houston to Memphis, Houston to San Juan, Indianapolis to San Juan, Jacksonville to San Juan, Las Vegas to Memphis, Las Vegas to San Juan, Kansas City to San Juan, Orlando to Memphis, Orlando to San Juan, Chicago to Memphis, Chicago to San Juan, Memphis to San Francisco, Memphis to Norfolk, Memphis to Raleigh-Durham, Memphis to Seattle, Milwaukee to San Juan, Minneapolis-St. Paul to San Juan, New Orleans to San Juan, San Francisco to San Juan, Oklahoma City to San Juan, Omaha to San Juan, Portland to San Juan, Philadelphia to San Juan, Phoenix to San Juan, Pittsburgh to San Juan, San Diego to San Juan, San Antonio to San Juan, Louisville to San Juan, Seattle to San Juan, San Juan to Salt Lake City, San Juan to Sacramento, San Juan to St. Louis, San Juan to Tulsa
2013q3	Albuquerque to Memphis, Albany to Memphis, Hartford to Memphis, Boise to Memphis, Buffalo to Memphis, Cleveland to Memphis, Charlotte to Philadelphia, Charlotte to Southwest Florida, Columbus to Memphis, Detroit to Memphis, Jacksonville to Memphis, Kansas City to Memphis, Memphis to Milwaukee, Memphis to Minneapolis-St. Paul, Memphis to New Orleans, Memphis to Omaha, Memphis to Portland, Memphis to Philadelphia, Memphis to Phoenix, Memphis to Pittsburgh, Memphis to San Diego, Memphis to San Antonio, Memphis to Salt Lake City, Memphis to Sacramento, Reno to San Juan

2013q4	Charlotte to Memphis, Dallas to Memphis, El Paso to Memphis, Miami to Memphis, Memphis to Oklahoma City, Memphis to Reno, Memphis to Southwest Florida, Memphis to Louisville, Memphis to San Juan, Memphis to St. Louis, Memphis to Tampa, Memphis to Tucson, Reno to Sacramento
2014q1	Birmingham to Charlotte, Boise to San Juan, Buffalo to Philadelphia, Charlotte to New York, Spokane to San Juan, Memphis to Palm Beach, Southwest Florida to San Juan
2014q2	Boise to Charlotte, Boise to Palm Beach, Spokane to Memphis
2014q3	Atlanta to Nashville, Palm Beach to San Juan
2014q4	Indianapolis to Memphis, Indianapolis to Milwaukee

Value of Defense (Millions of $)	Min.	1st Qu.	Median	Mean	3rd Qu.	Max.
Markets That Southwest Never Entered						
Merger Change	-25.67	6.11	22.45	27.56	45.45	112.4
Unmerged	-3.4	6.16	14.74	16.56	24.39	56.03
Merged	-15.93	14.44	40.37	44.12	66.43	141.4
Southwest	-5.35	-1.73	-0.59	-0.58	0.65	4.46
Markets That Southwest Entered After 2008q1						
Merger Change	-22.07	1.64	13.66	17.93	32.38	97.9
Unmerged	-4.12	2.55	7.81	9.54	14.24	46.01
Merged	-15.75	5.72	19.6	27.47	49.84	129.1
Southwest	-6.06	-1.49	-0.26	-0.45	0.64	3.77

Table A.4: Distribution Summary, Value of Defense

CSA	Airport Code	CSA	Airport Code
Albuquerque	ABQ	*Orlando*	MCO
Albany	ALB	*Chicago*	ORD, MDW
Anchorage	ANC	*Memphis*	MEM
Atlanta	ATL	*Milwaukee*	MKE
Austin	AUS	*Minneapolis − St.Paul*	MSP
Hartford	BDL	*NewOrleans*	MSY
Birmingham	BHM	*SanFrancisco*	SFO, SJC, OAK
Nashville	BNA	*Kahului*	OGG
Boise	BOI	*OklahomaCity*	OKC
Boston	BOS, MHT, PVD	*Omaha*	OMA
Buffalo	BUF	*Norfolk*	ORF
LosAngeles	LAX, ONT, SNA, BUR	*PalmBeach*	PBI
WashingtonDC	IAD, DCA, BWI	*Portland*	PDX
Cleveland	CLE	*Philadelphia*	PHL
Charlotte	CLT	*Phoenix*	PHX
Columbus	CMH	*Pittsburgh*	PIT
Cincinnati	CVG	*Raleigh − Durham*	RDU
Dallas	DFW, DAL	*Reno*	RNO
Denver	DEN	*SouthwestFlorida*	RSW
Detroit	DTW	*SanDiego*	SAN
ElPaso	ELP	*SanAntonio*	SAT
NewYork	JFK, LGA, EWR	*Louisville*	SDF
Miami	MIA, FLL	*Seattle*	SEA
Spokane	GEG	*SanJuan*	SJU
Honolulu	HNL	*SaltLakeCity*	SLC
Houston	IAH, HOU	*Sacramento*	SMF
Indianapolis	IND	*St.Louis*	STL
Jacksonville	JAX	*Tampa*	TPA
LasVegas	LAS	*Tulsa*	TUL
KansasCity	MCI	*Tucson*	TUS

Table A.5: CSA Airport Correspondences

Variable	DL	Variable	DL
Total Capacity t		**Capacity Change t+1**	
El Paso San Diego	8.87e+6	New York Memphis	-4.36e+4
Spokane Philadelphia	2.58e+7	Spokane Salt Lake City	-4.36e+4
Honolulu Pittsburgh	2.50e+7	Orlando Memphis	-4.76e+4
Indianapolis Pittsburgh	8.46e+6	Minneapolis-St. Paul Tucson	-8.89e+4
Jacksonville Kahului	2.40e+7	New Orleans Salt Lake City	-8.89e+4
Jacksonville Louisville	9.15e+6	Albuquerque Cincinnati	-2.27e+5
Jacksonville Sacramento	9.34e+6	Philadelphia Salt Lake City	-7.34e+4
Las Vegas Palm Beach	9.24e+6	Salt Lake City Sacramento	-1.61e+4
Kansas City Tulsa	7.63e+6	Atlanta Denver	-2.60e+4
Anchorage El Paso	9.98e+6	Atlanta Chicago	-6.65e+6
Chicago San Juan	7.46e+6	Atlanta Norfolk	-1.84e+4
Milwaukee Palm Beach	1.92e+7	Atlanta Louisville	-7.76e+3
San Francisco Norfolk	2.64e+7	Atlanta St. Louis	-4.73e+3
Kahului Salt Lake City	1.63e+7	Atlanta Tulsa	-1.66e+4
Oklahoma City Raleigh-Durham	8.59e+6	Atlanta Tucson	-5.36e+4
Oklahoma City Seattle	8.96e+6	Hartford Cincinnati	-6.09e+4
Hartford Jacksonville	9.65e+6	Albuquerque Atlanta	-5.07e+4
Hartford Kahului	1.79e+7	Boston Cleveland	-1.16e+4
Washington DC Kahului	1.93e+7	Boston Cincinnati	-3.41e+3
Cleveland El Paso	9.94e+6	Los Angeles New Orleans	-5.34e+4
Columbus Reno	8.90e+6	Washington DC Cincinnati	-5.05e+3
Columbus Sacramento	9.04e+6	Cincinnati Indianapolis	-8.57e+3
Dallas San Juan	1.78e+7	Dallas Salt Lake City	-2.34e+4
		Denver Salt Lake City	-5.26e+3
Offset	5.58e+6	Detroit Norfolk	-1.49e+4
Entry t+1 Norfolk Tucson	7.99e+6	Detroit Pittsburgh	-1.47e+5
Entry t+1 Boise Washington DC	1.05e+7		

Table A.6: Estimated Choice-Specific Value of Flight Capacity (Boosted Regression): Delta Airlines, 2008q2 (Full Set of Regressors)

Variable	NW	Variable	NW
Total Capacity t		**Capacity Change t+1**	
El Paso New Orleans	2.60e+7	New York Minneapolis-St. Paul	-4.08e+4
El Paso Omaha	6.78e+7	Indianapolis Minneapolis-St. Paul	-7.69e+4
Albany Southwest Florida	5.79e+7	Jacksonville Minneapolis-St. Paul	-1.78e+5
Spokane Memphis	6.04e+7	Memphis Milwaukee	-3.15e+5
Spokane San Antonio	2.45e+7	Memphis New Orleans	-1.75e+5
Spokane Sacramento	3.03e+7	Albuquerque Cincinnati	-3.57e+5
Honolulu New Orleans	9.57e+7	Atlanta Detroit	-8.70e+3
Honolulu Omaha	6.15e+7	Hartford Detroit	-6.24e+4
Honolulu Raleigh-Durham	3.52e+7	Hartford Houston	-1.02e+6
Memphis Southwest Florida	6.42e+7	Birmingham New York	-1.17e+5
Milwaukee San Juan	2.72e+7	Nashville Memphis	-1.19e+5
New Orleans Palm Beach	2.54e+7	Nashville Minneapolis-St. Paul	-1.09e+5
Anchorage Milwaukee	2.91e+7	Boston Indianapolis	-6.56e+4
Anchorage Oklahoma City	3.27e+7	Los Angeles Reno	-1.78e+5
Norfolk Reno	5.59e+7	Cleveland Memphis	-6.87e+4
Palm Beach Phoenix	6.85e+7	Albany Cleveland	-4.66e+5
Portland San Antonio	2.67e+7	Charlotte Minneapolis-St. Paul	-4.77e+4
Pittsburgh Reno	2.92e+7	Denver Memphis	-1.72e+5
Raleigh-Durham San Juan	3.05e+7		
San Diego Tulsa	9.69e+7	Offset	2.04e+7
Austin Buffalo	3.58e+7		
Austin Cincinnati	1.02e+8		
Austin Kahului	5.82e+7		
Hartford El Paso	3.16e+7		
Hartford San Diego	3.25e+7		
Hartford St. Louis	5.52e+7		
Birmingham San Francisco	6.20e+7		
Boise Memphis	5.43e+7		
Boston Kahului	1.15e+8		
Albuquerque San Juan	3.56e+7		
Buffalo Cleveland	7.12e+7		
Washington DC Kahului	3.65e+7		
Columbus San Antonio	2.70e+7		
El Paso Honolulu	3.17e+7		

Table A.7: Estimated Choice-Specific Value of Flight Capacity (Boosted Regression): Northwest Airlines, 2008q2 (Full Set of Regressors)

Variable	DLNW	Variable	DLNW
Total Capacity t		**Capacity Change t+1**	
Honolulu San Antonio	4.47e+5	Indianapolis Las Vegas	-2.44e+2
Jacksonville Southwest Florida	3.95e+5	Memphis Seattle	-3.62e+2
Kansas City Salt Lake City	2.76e+5	Minneapolis-St. Paul New Orleans	1.09e+4
Palm Beach San Juan	5.94e+5	Minneapolis-St. Paul Oklahoma City	1.32e+3
Austin Boise	5.72e+5	Minneapolis-St. Paul Pittsburgh	1.05e+3
Buffalo Salt Lake City	3.24e+6	Minneapolis-St. Paul Sacramento	1.76e+3
		Reno Tucson	-9.59e+4
Offset	3.47e+8	Atlanta Nashville	1.37e+2
Entry t+1 Nashville Pittsburgh	-3.94e+5	Atlanta Dallas	3.36e+1
Entry t+1 Boise Boston	4.30e+5	Atlanta Denver	8.68e+1
Entry t+1 Dallas Las Vegas	9.40e+5	Atlanta Las Vegas	-7.80e+1
		Albuquerque Minneapolis-St. Paul	2.94e+1
		Nashville Miami	-9.89e+1
		Buffalo Cincinnati	-4.70e+2
		Buffalo Detroit	-3.93e+2
		Buffalo Southwest Florida	-1.30e+5
		Los Angeles Denver	2.29e+3
		Los Angeles Honolulu	2.99e+2
		Cincinnati San Diego	-7.67e+2

Table A.8: Estimated Choice-Specific Value of Flight Capacity (Boosted Regression): Delta/Northwest Merged, 2008q2 (Full Set of Regressors)

Appendices

Appendix 2

CHAPTER 3 APPENDIX

B.1 Section 3.2 Details

Year	Wal-Mart Location	Competitor's Location
2000	LaGrange, GA	Columbus, GA
2001	Coldwater, MI	Jackson, MI
2001	Sanger, TX	Sherman, TX
2001	Spring Valley, IL	Peoria, IL
2001	St. James, MO	Columbia, MO
2002	Shelby, NC	Hickory, NC
2002	Tobyhanna, PA	Scranton, PA
2003	Hopkinsville, KY	Clarksville, TN
2004	Apple Valley, CA	Riverside, CA
2004	Smyrna, DE	Dover, DE
2004	St. Lucie County, FL	Miami, FL
2005	Grantsville, UT	Salt Lake City, UT
2005	Mount Crawford, VA	Cumberland, MD
2005	Sealy, TX	Houston, TX
2006	Alachua, FL	Gainesville, FL

Table B.1: General Merchandise Distribution Centers

Import Distribution Centers. During the 2000 to 2006 time period, Wal-Mart operated import distribution centers in Mira Loma, CA, Statesboro, GA, Elwood, IL, Baytown, TX, and Williamsburg, VA. See http://www.mwpvl.com/html/walmart.html for this list. For our simulation (over all time periods), we endow each firm with an import distribution center in each MSA in our sample physically closest to the above listed cities. These include [Wal-Mart's corresponding import distribution center location]: Riverside, CA [Mira Loma, CA], Savannah, GA [Statesboro, GA], Kankakee, IL [Elwood, IL], Houston, TX [Baytown, TX], and Washington, DC [Williamsburg, VA].

General Merchandise and Food Distribution Centers. We constrain each competitor to open the same number of general merchandise and food distribution centers in each period as actually opened by Wal-Mart. Additionally, we constrain the competitor to open general merchandise and food distribution centers in the MSA's in our sample closest to the actual distribution centers opened by Wal-Mart in the same period. Tables B.1 and B.2 present both the distribution centers opened by Wal-Mart, as well as the distribution center locations opened by the competitor in all simulations.

B.2 Section 3.3 Details

State Space Cardinality Calculation. Calculations for the cardinality of the part of the state space attributable to firm i are listed in Table B.3.

Constraints on firm location choices. For a given firm i, we allow each location l to accommodate up to four firm i facilities at one time: one import distribution center, one food distribution center, one general merchandise distribution center, and one store of either type. Symmetrically, the competitor firm can also place up to four facilities in the same location l, for a maximum number of eight facilities per location. We assume that neither firm can place two of its own stores (regardless of type) in one location. This approximates actual store placement patterns by big box retailers such as Wal-Mart well for small MSA's, which usually accommodate only one own-store at a time, but less so for larger MSA's, which might contain several own-stores. One additional constraint we impose is that in each period t, each firm chooses regular stores prior to choosing supercenters. Since we allow only one firm i store of any type per MSA, each firm's constrained set of possible supercenter locations are a function of period t regular store location choices.

Year	Wal-Mart Location	Competitor's Location
2000	Corinne, UT	Salt Lake City, UT
2000	Johnstown, NY	Utica-Rome, NY
2000	Monroe, GA	Athens, GA
2000	Opelika, AL	Columbus, GA
2000	Pauls Valley, OK	Oklahoma City, OK
2000	Terrell, TX	Dallas, TX
2000	Tomah, WI	LaCrosse, WI
2001	Auburn, IN	FortWayne, IN
2001	Harrisonville, MO	KansasCity, MO
2001	Robert, LA	New Orleans, LA
2001	Shelbyville, TN	Huntsville, AL
2002	Cleburne, TX	Dallas, TX
2002	Henderson, NC	Raleigh, NC
2002	MacClenny, FL	Jacksonville, FL
2002	Moberly, MO	Columbia, MO
2002	Washington Court House, OH	Columbus, OH
2003	Brundidge, AL	Montgomery, AL
2003	Casa Grande, AZ	Phoenix, AZ
2003	Gordonsville, VA	Washington, DC
2003	New Caney, TX	Houston, TX
2003	Platte, NE	Cheyenne, WY
2003	Wintersville (Steubenville), OH	Pittburgh, PA
2004	Fontana, CA	Riverside,CA
2004	Grandview, WA	Yakima,WA
2005	Arcadia, FL	PuntaGorda,FL
2005	Lewiston, ME	Boston,MA
2005	Ochelata, OK	Tulsa,OK
2006	Pottsville, PA	Reading,PA
2006	Sparks, NV	Reno,NV
2006	Sterling, IL	Rockford,IL
2007	Cheyenne, WY	Cheyenne,WY
2007	Gas City, IN	Muncie,IN

Table B.2: Food Distribution Centers

Year	2000	2001	2002	2003	2004	2005	2006	Total
Number of location decisions								
Regular Stores	2	8	4	2	6	6	2	30
Supercenters	14	8	10	12	4	6	6	60
Food DC	7	4	5	6	2	3	3	30
General Merchandise DC	1	4	2	1	3	3	1	15
Number of feasible locations								
Regular Stores	227	211	195	181	167	157	145	–
Supercenters	225	203	191	179	161	151	143	–
Food DC	227	220	216	211	205	203	200	–
General Merchandise DC	227	226	222	220	219	216	213	–
Number of possible combinations								
Regular Stores	$2.57{\times}10^{04}$	$8.52{\times}10^{13}$	$5.84{\times}10^{07}$	$1.63{\times}10^{04}$	$2.75{\times}10^{10}$	$1.89{\times}10^{10}$	$1.04{\times}10^{04}$	–
Supercenters	$6.47{\times}10^{21}$	$6.22{\times}10^{13}$	$1.40{\times}10^{16}$	$1.55{\times}10^{18}$	$2.70{\times}10^{07}$	$1.49{\times}10^{10}$	$1.07{\times}10^{10}$	–
Food DC	$5.61{\times}10^{12}$	$9.50{\times}10^{07}$	$3.74{\times}10^{09}$	$1.14{\times}10^{11}$	$2.09{\times}10^{04}$	$1.37{\times}10^{06}$	$1.31{\times}10^{06}$	–
General Merchandise DC	$2.27{\times}10^{02}$	$1.06{\times}10^{08}$	$2.45{\times}10^{04}$	$2.20{\times}10^{02}$	$1.73{\times}10^{06}$	$1.66{\times}10^{06}$	$2.13{\times}10^{02}$	–
State space cardinality	$2.11{\times}10^{41}$	$5.33{\times}10^{43}$	$7.51{\times}10^{37}$	$6.34{\times}10^{35}$	$2.68{\times}10^{28}$	$6.40{\times}10^{32}$	$3.12{\times}10^{22}$	–
Total number of possible terminal nodes (generated by state)					$2.86{\times}10^{242}$			
Average state space cardinality (over all time periods)					$7.64{\times}10^{42}$			

Note: The cardinality calculations represent the cardinality of the state attributable to firm i facilities only. The cardinality attributable to firm -i facilities is the same that attributable to firm i facilities. The total cardinality of the state is the product of the cardinality attributable to firm i facilities, firm -i facilities, and the population variable.

Table B.3: State Space Cardinality Calculation

Profit Specification. For a given firm i, sales revenues for a store in location l depend on the proximity of other firm i stores and firm $-i$ stores, where $-i$ denotes the competitor firm. Note that since we allow only one store of any kind per MSA, we can refer to a store by its location, i.e. we refer to a store in location l as store l. Let the portion of the state vector attributable to locations for food distribution centers (f), general merchandise distribution centers (g), regular stores (r), and supercenters (sc) be denoted as $\mathbf{s}_{it}^{f}$, $\mathbf{s}_{it}^{g}$,$\mathbf{s}_{it}^{r}$, and $\mathbf{s}_{it}^{sc}$, where each vector is of length L, and $\mathbf{s}_{it}^{q} \equiv (s_{1t}^{q}, ..., s_{Lt}^{q})$ for $q \in \{f, g, r, sc\}$. Also denote the population for location l at time t as pop_{lt}. For store l of firm i at time t, denote food revenues as $R_{ilt}^{f}\left(\mathbf{s}_{it}^{sc}, \mathbf{s}_{-it}^{sc}, pop_{lt}\right)$ and general merchandise revenues as $R_{ilt}^{g}\left(\mathbf{s}_{it}, \mathbf{s}_{-it}, pop_{lt}\right)$, where $\mathbf{s}_{it} \equiv \mathbb{I}\left(\mathbf{s}_{it}^{r} + \mathbf{s}_{it}^{sc} > 0\right)$ with support $\mathcal{S}_{it}$, $\mathbb{I}(.)$ represents the indicator function, each element of $\mathbf{s}_{it}$ is denoted as s_{ilt}, food revenues are a function of the proximity of supercenter locations for both firms, general merchandise revenues are a function of the proximity of store locations of both types for both firms, and both classes of revenue are a function location-specific population pop_{lt}.[1] Although we do not model consumer choice explicitly, our revenue specification implies that consumers view other own-stores and competitor-stores as substitutes for any given store.[2]

We assume that revenues are a function of the parameter vector $\vartheta_i = (\alpha_i, \delta_{i,-i}, \delta_{i,i})$ and specify total revenues for store l and firm i at time t in the following way:

$$R_{ilt}\left(\mathbf{s}_{it}^{sc}, \mathbf{s}_{-it}^{sc}, \mathbf{s}_{it}, \mathbf{s}_{-it}, pop_{lt}; \vartheta_i\right) = R_{ilt}^{f}\left(\mathbf{s}_{it}^{sc}, \mathbf{s}_{-it}^{sc}, pop_{lt}; \vartheta_i\right) + R_{ilt}^{g}\left(\mathbf{s}_{it}, \mathbf{s}_{-it}, pop_{lt}; \vartheta_i\right) \quad \text{(B.1)}$$

where,

[1] It is conceivable that close-proximity regular stores could cannibalize food revenues of a given supercenter store l to the extent that consumers buy food incidentally while shopping for general merchandise. In that case, a nearby regular store might attract the business of these consumers, who could refrain from making the incidental food purchases they might have made at supercenter store l. Because we expect this effect to be small, we model food revenues as conditional only on the presence of nearby supercenters.

[2] Holmes (2011) specifies revenue in a similar way but derives consumers' store substitution patterns from demand estimates obtained using data on Wal-Mart sales.

$$R^{f}_{ilt}\left(\mathbf{s}^{sc}_{it},\mathbf{s}^{sc}_{-it},pop_{lt};\vartheta_i\right)=$$
$$s^{sc}_{ilt}*\left[\alpha_i pop_{lt}\left(1+\delta_{i,-i}\sum_{m\neq l}\frac{s^{sc}_{-imt}}{d_{lm}}*\mathbb{I}\left\{d_{lm}\leq 60\right\}+\delta_{i,i}\sum_{m\neq l}\frac{s^{sc}_{imt}}{d_{lm}}*\mathbb{I}\left\{d_{lm}\leq 60\right\}\right)\right]$$

$$R^{g}_{ilt}\left(\mathbf{s}_{it},\mathbf{s}_{-it},pop_{lt};\vartheta_i\right)=$$
$$s_{ilt}*\left[\alpha_i pop_{lt}\left(1+\delta_{i,-i}\sum_{m\neq l}\frac{s_{-imt}}{d_{lm}}*\mathbb{I}\left\{d_{lm}\leq 60\right\}+\delta_{i,i}\sum_{m\neq l}\frac{s_{imt}}{d_{lm}}*\mathbb{I}\left\{d_{lm}\leq 60\right\}\right)\right]$$

In this specification, both classes of revenue depend on the proximity of own-stores and competitor-stores through the terms $\delta_{i,i}\sum_{m\neq l}\frac{s^{y}_{imt}}{d_{lm}}*\mathbb{I}\left\{d_{lm}\leq 60\right\}$ and $\delta_{i,-i}\sum_{m\neq l}\frac{s^{y}_{-imt}}{d_{lm}}*\mathbb{I}\left\{d_{lm}\leq 60\right\}$ for $y\in\{sc,\oslash\}$, respectively, where m indexes a location different from location l, and d_{lm} represents the distance from location l to a different location m. The parameters $\delta_{i,i}$ and $\delta_{i,-i}$ represent the average effect on revenues of close-proximity own-stores and competitor-stores, respectively. Since we assume that the parameters $\delta_{i,i}$ and $\delta_{i,-i}$ are negative, intuitively, these terms represent a deduction to revenues induced by own-stores or competitor-stores that are close in proximity to store l, since we assume that consumers view these stores as substitutes for store l. With respect to own-stores, this revenue substitution effect is deemed own-store "cannibalization," which is an important dimension of chain-store location decisions as documented by Holmes (2011) for the case of Wal-Mart. With respect to competitor stores, this effect reflects competition. The strength of the effect is weighted by d_{lm}, with stores in locations that are farther away from store l having a smaller effect on revenues than those that are close by. The indicators $\mathbb{I}\left\{d_{lm}\leq 60\right\}$ take a value of 1 if location m is closer than 60 miles away from location l, 0 otherwise, which imposes the assumption that stores located farther than 60 miles have no effect on store l revenues. This assumption is slightly unrealistic, but we impose it since our sample only includes 227 MSA's in the U.S., which means there are few MSA's within, for example, a

30 mile radius of any MSA in our sample. With more MSA's, this cutoff distance can be reduced. We assume that the parameters $\delta_{i,i}$ and $\delta_{i,-i}$ are the same across revenue categories to simplify the exposition. Both types of revenue are dependent on population at time t, x_{lt}, through a common scalar parameter α_i. Additionally, since regular stores don't sell food, $R^f_{ilt} = 0$ for all regular stores.

As in Holmes (2011), we abstract from price variation and assume each firm sets constant prices across all own-stores and time, which is motivated by simplicity and is not necessarily far from reality for a chain-store retailer like Wal-Mart, which is known to set prices according to an every-day-low-price strategy. Denoting μ as the proportion of sales revenue that is net of the cost of goods sold (COGS), then $\mu R^e_{ilt}(.)$ represents revenues net of COGS for firm i, store l, time t, and revenue type $e \in \{g, f\}$.

Firms incur three types of additional costs: 1) distribution costs attributable to store sales, 2) store-level variable costs, and store-level fixed costs. In order to sell a given set of goods in time period t at store l, as in Holmes (2011), we assume that each firm incurs distribution costs to deliver these goods from general merchandise or food distribution centers (or both for supercenters) to store l. In addition, we assume that firms incur distribution costs when transporting these goods from import distribution centers to either general merchandise or food distribution centers. We introduce these latter distribution costs in order to model location decisions for general merchandise and food distribution centers. Denote the distribution costs incurred by firm i to sell goods from store l at time t as DC_{ilt}, which take the form: $DC_{ilt} = \varsigma d^g_{lt} + \iota d^{imp}_{lgt} + \varsigma d^f_{lt} + \iota d^{imp}_{lft}$. Here, d^g_{lt} and d^f_{lt} represent the distance from store l to the nearest firm i general merchandise distribution center or food distribution center, respectively. In our game simulation, if store l is a regular store, we assume that it is supplied exclusively by the own-general merchandise distribution center in the MSA physically closest to store l. Similarly, if store l is a supercenter, it is supplied exclusively by the own-food distribution center and own-general merchandise distribution center in the MSA('s) closest to store l. Further, d^{imp}_{lgt} represents the distance between the general merchandise distribution center that supplies store l and the nearest import distribution center, while d_{lft}^{imp} represents the distance between the food distribution center that supplies store l (if store l is a supercenter) and the nearest import distribution center. We assume that distribution costs are a fixed proportion of these distances, captured by the parameters ς and ι, and interpret fixed distribution costs as the costs incurred to operate a truck over the course of one delivery of goods per day, aggregated over one year. This model approximates the daily truck delivery distribution model actually employed by Wal-Mart, as documented by Holmes (2011). Finally, if store l is a regular store, $\varsigma d_{lt}^{f} + \iota d_{lft}^{imp} = 0$ since regular stores do not sell food.

The remainder of our costs for both firms are specified almost exactly as in Holmes (2011) for the case of Wal-Mart, so we describe them succinctly and direct the interested reader to that work for additional description. Firms incur variable costs in the form of labor, land, and other costs (all costs not attributable to land or labor). Variable land costs are motivated by the store modification patterns of Wal-Mart, which frequently changes parking lot size, building size, and shelf space to accommodate changes in sales patterns. The quantity of labor, land, and other inputs needed are assumed to be a fixed proportion of total store revenues, such that for firm i, store l, and time t, $Labor_{ilt}^{e} = \nu^{Labor} R_{ilt}^{e}$, $Land_{ilt}^{e} = \nu^{Land} R_{ilt}^{e}$, and $Other_{ilt}^{e} = \nu^{Other} R_{ilt}^{e}$, for merchandise segment $e \in \{g, f\}$. The prices of land and labor per unit of input are represented by wages and rents specific to store l at time t, denoted as $wage_{lt}$ and $rent_{lt}$. We collect data on rents and wages for each time period and each MSA. We define rents as the median (per-MSA) residential home value per square-foot from Zillow, and wages as the annual retail sector payroll divided by the total number of employees (per-MSA), provided by the U.S. Census County Business Patterns dataset (MSA level).[3] The price of the other input is normalized to 1. We focus only on fixed costs that vary by location, since costs that are constant across locations do not matter for the decision

[3]The Zillow data is available from http://www.zillow.com/, and the Census data is available from http://www.census.gov/econ/cbp/.

of where to locate stores and distribution centers. As documented by Holmes (2011), there are disadvantages for big box retailers like Wal-Mart of locating stores in urban locations, including, for example, increased non big box retailer shopping options for consumers. The fixed-cost disadvantage of locating stores in urban locations is modeled as a as a function of the population density at time t of the location hosting store l, denoted as $Popden_{lt}$.[4] This function, $u\left(Popden_{lt}\right)$, is quadratic in logs, e.g.:

$$u\left(Popden_{lt}\right) = \omega_0 + \omega_1 \ln\left(Popden_{lt}\right) + \omega_2 \ln\left(Popden_{lt}\right)^2$$

Given this specification for revenues and costs, firm i operating profits for store l at time t take the following form:

$$\pi_i\left(\mathbf{s}_t\right) \approx \pi_{ilt} \equiv \left[\left[\psi^g_{ilt} - \varsigma d^g_{lt} - \iota d^{imp}_{lgt}\right] + \left[\psi^f_{ilt} - \varsigma d^f_{lt} - \iota d^{imp}_{lft}\right] - u\left(Popden_{lt}\right)\right] \tag{B.2}$$

where,

$$\psi^e_{ilt} = \mu R^e_{ilt} - Wage_{lt} Labor^e_{ilt} - Rent_{lt} Land^e_{ilt} - Other^e_{ilt} \text{ for merchandise segment } e \in \{g, f\}$$

If store l is a regular store, the profit component $\left[\psi^f_{ilt} - \varsigma d^f_{lt} - \iota d^{imp}_{lft}\right] = 0$, since regular stores sell only general merchandise. We assume that if firm i operates no store in location l at time t, then $\pi_{ilt} = 0$. Note that we use the $\approx$ notation to make clear that the we omit population density from the location-specific state described in Section 3.3 and instead only include location-specific population.

We define a discount factor β and set it to $\beta = 0.95$. We define an exogenous productivity parameter ρ that represents gradual increases in average sales per-store, motivated by gradual increases in average sales per-store experienced by Wal-Mart. [5] Profit parameter values for each specification are presented in Table B.4.

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[4] See Section 3.2 for details on our population density definition and data source.

[5] Unlike in Holmes (2011), for simplicity of exposition, we make the productivity parameter constant over time. One source of increases is an expansion in the variety of products for sale.

Model	Specification 1 (baseline)	Specification 2 (high-urban-penalty)	Specification 3 (high-dist-cost)
Revenue parameter α^g	60	60	60
Revenue parameter α^f	60	60	60
Revenue parameter $\delta_{(i,-i)}$	-0.5	-0.5	-0.5
Revenue parameter $\delta_{(i,i)}$	-0.5	-0.5	-0.5
Distribution cost parameters ς	1400	1400	2100
Distribution cost parameters ι	1400	1400	2100
Input parameters ν^{labor}	3.61	3.61	3.61
Input parameters ν^{land}	5×10^{-6}	5×10^{-6}	5×10^{-6}
Input parameters ν^{other}	0.07	0.07	0.07
Urban location quadratic cost parameter ω_0	0	0	0
Urban location quadratic cost parameter ω_1	20000	30000	20000
Urban location quadratic cost parameter ω_2	20000	30000	20000
Discount factor β	0.95	0.95	0.95
Productivity parameter ρ	1.07	1.07	1.07
Markup μ	0.24	0.24	0.24

Table B.4: CWGB Parameter Values by Specification

B.3 Section 3.5 Details

Table B.5 presents OLS models of the choice-specific value functions using state variables selected by the corresponding boosted regression models in Table 3.1 and simulation data generated under the baseline specification of parameters. Each column represents an OLS regression model of the indicated choice-specific value function run only on the state variables selected by the corrresponding boosted regression model. Some OLS variables return “NA” for variables that do not vary. Since the boosted model uses no intercept in its component individual univariate regressions, it returns a coefficient under these circumstances.

Choice-Specifc Value Function	$\widehat{V}_i(a^g_{ilt}=1)$	$\widehat{V}_i(a^g_{ilt}=0)$	$\widehat{V}_i(a^f_{ilt}=1)$	$\widehat{V}_i(a^f_{ilt}=0)$	$\widehat{V}_i(a^r_{ilt}=1)$	$\widehat{V}_i(a^r_{ilt}=0)$	$\widehat{V}_i(a^{sc}_{ilt}=1)$	$\widehat{V}_i(a^{sc}_{ilt}=0)$
Population	1.70×10^{1}***	1.48×10^{1}***	1.99×10^{1}***	1.48×10^{1}***	1.35×10^{1}***	1.48×10^{1}***	2.00×10^{1}***	1.48×10^{1}***
	(1.15×10^{0})	(1.76×10^{-2})	(8.53×10^{-1})	(1.76×10^{-2})	(5.99×10^{-1})	(1.76×10^{-2})	(5.99×10^{-1})	(1.76×10^{-2})
Own Entry Regstore Allentown, PA	-1.86×10^{7}		-1.38×10^{7}		-2.43×10^{6}		-7.22×10^{6}	
	(2.37×10^{7})		(1.26×10^{7})		(2.38×10^{6})		(6.51×10^{6})	
Own Entry Regstore Boulder, CO	-7.26×10^{6}		-6.26×10^{6}				-3.52×10^{6}	
	(1.91×10^{7})		(1.02×10^{7})				(5.26×10^{6})	
Own Entry Regstore Hartford, CT	-9.72×10^{6}		-6.68×10^{6}		-1.75×10^{6}		-3.73×10^{6}	
	(2.08×10^{7})		(1.08×10^{7})		(1.59×10^{6})		(5.56×10^{6})	
Own Entry Regstore Kansas City, MO	-1.33×10^{7}		-6.06×10^{6}		-1.89×10^{6}		-3.88×10^{6}	
	(2.37×10^{7})		(1.14×10^{7})		(2.11×10^{6})		(5.85×10^{6})	
Own Entry Regstore San Francisco, CA	NA				NA		NA	
	NA				NA		NA	
Own Entry Regstore Augusta, GA			-1.91×10^{7}		-3.10×10^{6}		-9.38×10^{6}	
			(1.51×10^{7})		(2.77×10^{6})		(7.76×10^{6})	
Rival Entry Regstore Albany, GA		NA		NA		NA		NA
		NA		NA		NA		NA
Rival Entry GM Dist Clarksville, TN		-1.44×10^{6}***		-1.44×10^{6}***		-1.44×10^{6}***		-1.44×10^{6}***
		(1.03×10^{5})		(1.03×10^{5})		(1.03×10^{5})		(1.03×10^{5})
Rival Entry GM Dist Columbia, MO		-5.54×10^{5}***		-5.50×10^{5}***		-5.51×10^{5}***		-5.50×10^{5}***
		(1.03×10^{5})		(1.03×10^{5})		(1.03×10^{5})		(1.03×10^{5})
Rival Entry GM Dist Cumberland, MD		-2.35×10^{6}***		-2.35×10^{6}***		-2.35×10^{6}***		-2.35×10^{6}***
		(1.03×10^{5})		(1.03×10^{5})		(1.03×10^{5})		(1.03×10^{5})
Rival Entry GM Dist Dover, DE		-1.98×10^{6}***		-1.98×10^{6}***		-1.98×10^{6}***		-1.98×10^{6}***
		(1.03×10^{5})		(1.03×10^{5})		(1.03×10^{5})		(1.03×10^{5})
Rival Entry GM Dist Hickory, NC		-1.03×10^{6}***		-1.03×10^{6}***		-1.03×10^{6}***		-1.03×10^{6}***
		(1.03×10^{5})		(1.03×10^{5})		(1.03×10^{5})		(1.03×10^{5})
Constant	2.77×10^{7}.	6.36×10^{3}	3.25×10^{7}**	5.08×10^{3}	2.27×10^{6}	4.31×10^{3}	1.48×10^{7}*	5.14×10^{3}
	(1.58×10^{7})	(7.43×10^{4})	(1.18×10^{7})	(7.43×10^{4})	(2.22×10^{6})	(7.43×10^{4})	(6.04×10^{6})	(7.43×10^{4})

Note: Standard errors are shown in parentheses. Significance levels are indicated by: '***' 0.001 '**' 0.01 '*' 0.05 '.' 0.1 ' ' 1. Results are based on 1000 simulation runs. The covariate *Own Entry Regstore City, State* represents own-firm regular store entry in the listed MSA; similarly, *Rival Entry Regstore City, State* represents competitor regular store entry in the listed MSA, and *Rival Entry GM Dist City, State* represents competitor general merchandise distribution center entry in the listed MSA.

Table B.5: Choice-Specific Value Function Estimates, OLS Models (Baseline Specification)