STATEMENT OF FRANKLIN K. WILLIS, DEPUTY ASSISTANT SECRETARY FOR POLICY AND INTERNATIONAL AFFAIRS, DEPARTMENT OF TRANSPORTATION, BEFORE THE SUBCOMMITTEE ON AVIATION OF THE HOUSE PUBLIC WORKS AND TRANSPORTATION COMMITTEE, CONCERNING THE PERFORMANCE OF THE AVIATION INDUSTRY UNDER DEREGULATION, JUNE 9, 1983

Chairman Mineta and Members of the Subcommittee:

I am pleased to be here today to present the Department of Transportation's assessment of the aviation industry under deregulation. I will discuss the aspects of industry performance that are the subject of today's hearing -- industry financial performance, fares, airline costs, the structure of the industry, service to cities of all sizes, employment, and the needs of the travelling public. We will be prepared to address other issues, including legislation, at your later hearings.

Let me begin with the bad news about the industry's performance. For a number of reasons -- rising fuel prices, the recession, the air traffic controllers' strike -- the air carrier industry is just now emerging from what has surely been its most difficult financial period. The airlines have suffered three consecutive years of operating losses. Overall industry losses in 1982 were the worst in history, approaching $800 million -- and would have been much larger were it not for the sale of tax benefits.

There was, as might be expected, a considerable range of experience among the individual companies. As a group, the largest air carriers -- the majors -- suffered most. Among the eleven largest carriers, only one was solidly profitable in 1982. While most of the national carriers remained profitable in 1982, earnings slipped from the record levels of 1981 and some experienced serious losses. Among new entrant carriers, most failed to reach profitability by 1982; however, early losses are normally to be expected in any new enterprise.

As a result of the losses of the past three years, several major carriers and national carriers are having severe financial problems. Some, including Braniff and Altair, went bankrupt.

How many of these financial problems should we attribute to deregulation? I believe almost none. As the carriers themselves and almost every industry analyst will tell you, the root of the problem has been the economy, not airline deregulation. We are just now coming out of the longest economic downturn since the Depression and certainly the least favorable economic climate the modern airline industry has ever faced. Traditionally, airlines make a lot of money when the economy is prospering, and lose a lot when the economy is bad. The weak economy caused business to cut back on travel at the same time that consumers reduced vacation trips. The result was serious overcapacity throughout much of the airline industry. Rather than ground their equipment, on which they had to bear fixed costs anyway, carriers decided to introduce discount and promotional air fares to retain or increase ridership. These discount fares undoubtedly stimulated some additional travel. Nevertheless there was an absolute year-to-year decline in revenues in 1982 -- a first for the majors -- despite a 3.4 percent increase in traffic.

High interest rates and inflation also contributed to poor industry performance. Interest rates skyrocketed at a time when many carriers needed to replace equipment with more fuel-efficient planes. Carriers that were committed to replacement paid a stiff price when they became locked into high interest rates. Other carriers which had put off capital investment were forced to continue operating less fuel-efficient aircraft. Some carriers had labor contracts with built-in wage escalators which, during the high inflation of the late 70's, caused labor costs to rise rapidly.

Two other factors added to carrier problems since 1978. Drastic increases in fuel prices in 1979 had carriers scrambling to realign routes, or replace fuel-inefficient aircraft, or adjust fares to cover higher costs. On top of all this, and in the midst of efforts to restructure routes, the industry was forced to adjust to scheduling constraints brought on by the air traffic controller strike in 1981.

Given the combined impact of these factors, it is a tribute to the industry -- management and labor both -- that the necessary adjustments were made and that the long-term outlook for the industry is healthy. Airlines simply could not have made these adjustments without the flexibility provided by deregulation. Even the best-intentioned government regulators could not have responded as promptly and effectively to these shocks to the system as the airlines did themselves. Had the industry still been regulated, needed route realignments would have been delayed, as would speedy adjustments in fare structures. Instead, airlines were able to respond quickly to the opportunity to create more efficient networks, and competition for travellers and shippers has given consumers a wide variety of discount fares at the same time.

We believe the financial prospects of the air carrier industry are improving, for several reasons. Fuel costs have declined, the economy is improving, traffic appears to be rebounding, and overall costs hopefully have stabilized now that we have inflation under control. 1983 will still be a tough year financially for the carriers. Nonetheless, with continuing improvements in the economy, I think we will have turned the corner on a very difficult period for the airlines.

The major changes in industry structure since deregulation have been the growth of the nationals and regionals and the entry of new carriers. Some of this growth came at the expense of the former trunk carriers. Although they retain a major share of the market, the former trunks' share of domestic revenue passenger miles has fallen from about 87 percent of the total domestic revenue passenger miles in 1978 to around 80 percent last year.

New entrants have been successful in carving out markets for themselves, partly by replacing service dropped by existing carriers and partly by stimulating new air travel. In the first three years after the passage of the 1978 Act, the market share of new entrant airlines rose from 3.6 to 7.7 percent. The primary spur for this structural change has been their lower fares, which are made possible by lower costs and greater efficiency. New entrants generally have significantly lower operating costs than carriers which were operating prior to 1978. This is due to lower wage scales, more flexible work rules, and the lack of various other pre-existing restrictions which hamper pre-deregulation carriers. Thus, they have stimulated travel through aggressive and innovative pricing approaches.

Regional and commuter carriers have also grown since deregulation. This growth continued even during the recent downturn in the economy. Regional/commuter passenger traffic grew by 20 percent last year; revenue passenger miles by 26 percent; and air cargo by 11 percent.

With respect to employment, all the factors which I mentioned earlier -- rising fuel prices, the recession, and the air traffic controllers' strike -- have had their effect on the airlines' workforce. Nonetheless, between October 1978 and October 1982, overall industry employment hardly changed, showing a slight decline of 3,000 full-time jobs from a level of 321,600 to 318,300. Within these overall aggregates, however, there were some significant shifts in the location of jobs among the various sectors of the industry and individual carriers as the industry moved to adapt to the depressed economy and the new competitive environment brought about by deregulation. For example, in the four years between October 1978 and October 1982 employment among the eleven majors declined by about 24,000 while the smaller national and regional carriers increased their full-time jobs by some 21,000. Although it seems clear to me that the strongest influence on industry employment during this period has been the weak demand that accompanied the recession, the truly significant thing is that the industry under deregulation has been able to respond and adapt, thereby sustaining employment levels in the face of that recession.

Airline unions have testified before the Subcommittee that such aggregate numbers do not tell the full story in terms of shifts in the location of jobs as well as in long term declines in employment among some of the more troubled of the majors. There is substance to this observation. Any industry undergoing structural change experiences disruptions among both union and management employees. It is the Department's belief that the downturn in the business climate has had the most significant influence over total airline employment levels, not the Deregulation Act. In addition, although there have been some disruptions in the airline workforce, the present average compensation for the airline employee is 70 percent higher than the average compensation in other U.S. industries.

Deregulation is having a significant impact on costs and productivity, although much of this impact is masked by economic conditions. There have been five areas in which deregulation has introduced opportunities for increased efficiency and, thereby, lower costs. First, deregulation permitted carriers to improve equipment utilization by realigning routes and rescheduling flights. Second, by realigning routes, carriers have been able to improve load factors, thereby reducing the average cost per passenger. Third, under regulation fares were generally kept high and carriers competed by offering high quality service -- often a more costly service than passengers wanted to pay for; with deregulation, carriers adjusted services to meet market demand, thereby lowering costs. Fourth, new carriers entered the business with significantly lower costs, in some cases offering "no-frills" service and in other cases offering standard service at lower fares. Fifth, as a result of the competition, labor and management cooperated to improve productivity and efficiency.

Carriers have also instituted major changes in their pricing policy. Some have adopted a wide variety of restricted discounts, while others have charged unrestricted low fares. Some carriers have expanded off-peak discounts, charging lower fares during times of low demand. The effect of these pricing changes has been beneficial for industry productivity, as discounts have helped bolster lagging demand and improve load factors overall, while off-peak pricing differentials have helped to balance out loads throughout the day and the week. With more balanced passenger loads, carriers have been able to achieve better utilization of both equipment and labor. Equally as important as the effect on productivity, this change in pricing practices has given consumers a far wider choice in fares -- particularly low fares -- than they had under regulation.

Of course this period has also seen the development of "fare wars," particularly deep discount pricing in the high density transcontinental markets, which may have contributed to the industry's financial problems. This must be balanced against the invaluable flexibility that the carriers have been able to exercise in adjusting their fares freely as changing market, supply and cost circumstances warranted. In my opinion, the proposed cure of re-regulation would be no solution. It would be far preferable to let competition continue while the emerging economic recovery takes over to restore demand and improve yields.

Some have asserted that deregulation has permitted inequities to arise in pricing on low-density and short-haul routes, compared to, for example, the high-density transcontinental markets. Such pricing, however, is simply a reflection of actual airline cost differentials. The CAB's recent evaluation of deregulation, Competition and the Airlines, shows that the real inequity in fares occurred prior to deregulation, when the CAB mandated fares in many short-haul markets that were actually below the cost of service, while also setting fares above costs in markets of more than 400 miles. Since deregulation, carriers have the freedom to institute pricing that better reflects the actual cost of operation on a specific route. The CAB's analysis shows that cost per available seat mile falls rapidly with the distance of the route operated. In 1981, the average operating cost per revenue passenger mile, at 60 percent load factors, was more than three times as high for smaller aircraft (DC-9-30) on 200-mile routes, as for large aircraft (B-747) on 2500-mile routes.

The differential in airline operating costs increases further if the market is very thin. It is essential that carriers have the flexibility to tailor equipment and schedules to fit the short-haul, thin routes in order to keep costs and fares at a reasonable level. I believe it is a tribute to the industry that they have achieved efficiencies which have enabled them to hold the rate of increase in average airline fares below that of the Consumer Price Index, despite extraordinary cost pressures.

The Committee also indicated an interest in looking at service to cities of different sizes. There have been two main changes in this area. Between May 1978 and May 1983, the number of departures has increased at large hubs by 15.7 percent, at medium hubs by 22.5 percent, and at small hubs by 12.4 percent, while departures dropped at nonhubs by 2.8 percent. The losses at nonhubs are accounted for by decreased flights from nonhubs to small hubs and other nonhubs, while service from nonhubs to large and medium hubs is up significantly. In general, these changes reflect carrier efforts to establish efficient networks by concentrating on hub-and-spoke operations. Now, although nonhubs have had a small decrease in total departures, their increased service to medium and large hubs provides them better overall access to air transportation through a multitude of connecting opportunities at large and medium hub airports.

The Essential Air Service (EAS) program ensures that all communities receiving certificated air service prior to 1978 will continue to be served through 1988. This contrasts with the period 1960 - 1976, when service to 173 communities was dropped by certificated airlines. Although EAS has permitted major carriers to withdraw from communities, they have been replaced by smaller carriers. These replacement carriers have usually been able to provide more frequent service through use of smaller aircraft more suited to the traffic and service needs. In fact, in the 74 communities where the majors and nationals dropped service since deregulation, total departures increased by 26 percent, due to increased operations by regional and commuter airlines.

The final item the Committee wished to consider in these hearings is "meeting the needs of the travelling public." Deregulation has given the travelling public a much broader range of choices, choices that it never had before. Today it is the public's needs and demands which are the driving force in industry decisions. The industry has responded extremely well to customer demand under very trying economic conditions, by re-aligning routes and schedules, by introducing "no-frills" service to supplement premium service, by adjusting fares to reflect cost differentials, and by introducing a wide variety of fare options.

In summary, I believe a compelling case for deregulation is being made in the marketplace. The best evidence I can present for continuing along this course is the fact that there is no cry in the commercial airline industry nor among its users for a return to extensive government regulation. Secretary Dole has asked me to convey to the Committee her own strong and personal commitment to airline deregulation. We believe there should be no turning back.