

TESTIMONY OF

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BEFORE THE

**COMMITTEE ON PUBLIC
WORKS AND TRANSPORTATION**

U.S. HOUSE OF REPRESENTATIVES

SEPTEMBER 19, 1989

Good Morning!

The state of competition in the domestic airline industry has been a topic of particular interest to Secretary Skinner. As I'm sure you are aware, the Secretary formed a task force to study the many facets of this matter and produce policy recommendations this year. The approach of the task force has been to divide up the work into manageable topics covering: industry and route structure, pricing, airport and air traffic system capacity, airline marketing and distribution practices -- primarily Computer Reservation Systems -- regional carriers, international competition, and ultimately an econometric model of the domestic industry. The work on the various studies is being reviewed by representatives of other interested government agencies such as the Justice Department, the Federal Trade Commission, and the Council of Economic Advisors. The studies are in various stages of completion but several are well along in the review process. We plan to have our study completed well before the end of the year.

Thus it is important that my remarks today not be misinterpreted. I am not here to express any Departmental "findings" with respect to competition. The complete picture must await the conclusion of our study and I'm sure Secretary Skinner will express any Departmental views with you at that time. Nonetheless, given the timing of this hearing, I can report to you this morning on the preliminary results of two sections of the overall study -- industry

structure, and airport and airways capacity. Previous studies by the GAO and others have focused attention on specific problem areas -- primarily pricing and service at concentrated connecting hubs. The Department's approach has been to step back and take a broader view -- to study not just concentrated hubs but service and price competition at all domestic points and in all types of domestic markets. The objective has been to produce an overall assessment of the state of competition in the domestic airline industry against which our own analyses of problem areas could be judged in context.

For the structure and pricing sections we wanted a comprehensive review of the voluminous data available, but to make such a review manageable, we focused the analysis on three years: 1988, the most recent for which data were available, 1984, a period when many carriers were operating and industry concentration was low, and 1979, the first year of deregulation when carrier route systems were essentially the same as before deregulation. The airport and airways capacity analysis was managed by the FAA which made extensive use of its own data resources as well data from a comprehensive survey of airport capacity conducted by the Airport Operators Council, International.

Turning first to the factual results of the structure study:

INDUSTRY AND ROUTE STRUCTURE

Much of the concern over the competitiveness of the airline industry has focused on the reduction in the number of airlines in recent years and the increase in the number of airports dominated by one or two carriers. To be sure, increases in concentration at both the industry level and at many large hubs have been substantial.

-- In 1988, the top ten airlines accounted for 94 percent of total domestic revenue passenger miles, compared with 78 percent in 1984, and 85 percent in 1979.

-- In 1988, 90 percent of the industry's traffic (i.e., revenue passenger miles) was accounted for by only eight carriers, compared with 15 carriers in 1984 and 11 carriers in 1979.

-- The FAA classifies airports by size into large hub, medium hub, small hub and nonhub categories. At six large hub airports in 1988, 75 percent or more of the aircraft departures were by a single carrier. No large hub was as concentrated in 1984 or 1979.

-- In 1988, at almost half of the nation's 27 large hub airports, 50 percent or more of the departures were by a single carrier compared with only three such hub airports in 1984, and one in 1979.

-- In 1988, two carriers controlled 50 percent or more of the departures at 20 of the 27 large hubs, compared with nine such hubs in 1984, and eight in 1979.

These kinds of figures, by themselves, are anything but encouraging, but they tell only part of the story. While concentration has generally gone up at larger airports, the reverse is true at many smaller airports.

-- In 1979 only nine small hub airports had four or more carriers competing for the local market.* By 1988 there were 32 (out of 57) small hubs with four or more competing carriers.

-- No nonhub airport had more than three competitors in 1979 and only 29 had three competitors. By 1988 23 nonhubs had four or more competitors and 57 had three competitors.

* For study purposes a competitor was defined as a carrier with at least 10 percent of the seat capacity at an airport.

A more meaningful measure of concentration is the level of competitive service at the city-pair level. After all, passengers travel between cities and airlines compete on a city-pair basis. City pairs represent the traditional market examined in airline competition studies and anti-trust analysis. In 1988 there were over 5,000 city-pair markets receiving single plane service and nearly 2,500 receiving non-stop service. On a city-pair market basis, concentration in 1988 was very similar to that in 1984, and markedly lower than that in 1979.

-- In 1979, almost 70 percent of all passengers traveled in city-pair markets where a single carrier accounted for 50 percent or more of total passengers, compared with about 50 percent of all passengers in both 1984, and 1988.

-- In 1988, more than half of the passengers traveled in markets with three or more competing airlines, compared with only about 25 percent in 1979. (For purposes of the study we defined a competing airline as one which carried at least 10 percent of the traffic in a market.) (See Chart 1)

-- The number of markets receiving nonstop service from two or more carriers was higher in 1988 than in 1979 but lower than in 1984. The total number of markets with nonstop service has not declined since 1984.

-- The number of markets receiving competitive single-plane service in 1988 was 25 percent higher than in 1979 and about the same as 1984.

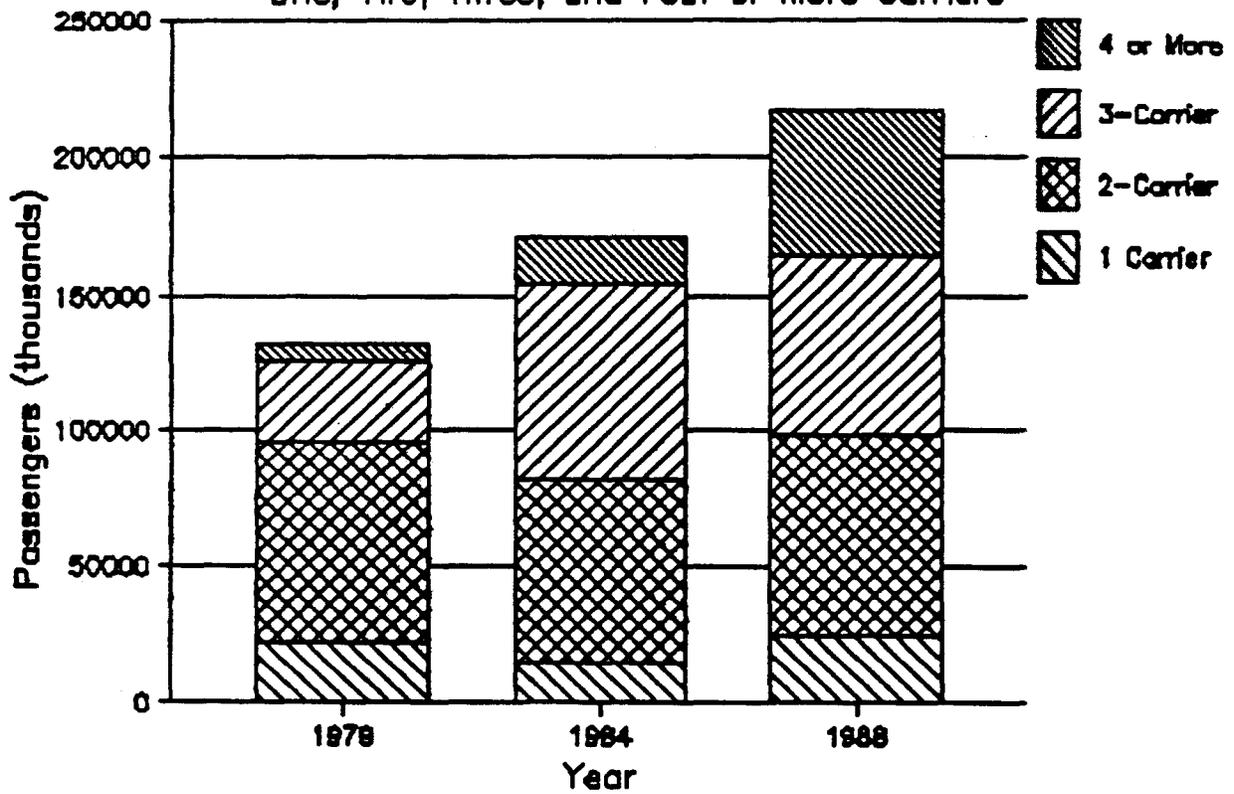
The question thus is: how can we have such great increases in concentration at the national level and at the larger hubs and, at the same time, much less concentration in individual city-pair markets? This apparent contradiction is explained by the geographic expansion of the major carriers and the integration of many new points they serve through hub and spoke networks.

While we have fewer carriers, most have experienced considerable growth and several have enjoyed phenomenal growth as they expanded the scope of their operations from a regional to a national basis. In 1988, the 10 largest carriers served all or nearly all of the 27 large hubs, and twice as many medium hubs and almost three times as many small hubs as they did in 1979. This development stems in part from an attempt to control traffic through hubbing.

Hubbing provides a strong incentive for carriers to expand geographically because they can cross-connect passengers at their hubs only if they provide service to the passengers' ultimate destinations. For example, when Piedmont elected to establish a hubbing center at Charlotte it was a "regional" carrier with a service pattern focused mainly in the East. For Charlotte to succeed as a hubbing center, Piedmont had to, and did, expand service to major cities nationwide. Most other major carriers have matched this expansion of ocean to ocean and border to border

CHART 1

PASSENGER TRAVEL BY COMPETITIVE STATUS One, Two, Three, and Four or More Carriers



route systems. So, while hubbing has resulted in high levels of concentration at connecting hubs, it has also greatly expanded the numbers of competitors in city-pair markets.

Simply measuring service concentration at a particular airport does not reflect the ways a hub-and-spoke operation at a concentrated hub airport intensifies service competition. Usually, airport concentration statistics do not distinguish between local passengers that travel to and from the hubbing airport and connecting passengers that move across the hub between other points. Most passengers at a hubbing airport fall into the latter category and they are typically able to enjoy competitive service from other carriers, often many other carriers, who offer connecting service from the same origins to the same ultimate destinations over different connecting hubs. For these passengers, the fact that a particular connecting hub is dominated by a single carrier is of no consequence from the standpoint of enjoying access to competitive airline service.

There is an often expressed concern about hubbing as an operational strategy in that it produces a dominant service to smaller spoke cities where the hubbing carrier may be able to control both service and price. However, smaller points are, in

fact, the greater beneficiaries of the hub-and-spoke system of operation. A small airport like Akron, Ohio, was in 1988 a monopoly spoke that was linked to Piedmont's connecting hub at Dayton. However, Akron was also a monopoly spoke for six other connecting hubs, contributing to the dominance of one carrier at each of those hubs. Nevertheless, Akron has available hundreds of connections to many points as a result of being a spoke city to each of these hubs and, obviously, when Akron passengers move beyond one of the connecting hubs, many competitive alternatives are typically available. Most Akron passengers, in fact, do move beyond these connecting hubs. This is an example of how the hubbing process is a case of good news and bad news -- it simultaneously increases concentration at a connecting hub and creates competitive alternatives for passengers moving beyond the connecting hubs.

As a consequence, while point concentration overall is much more intense now than before hubbing proliferated, the competitive opportunities at smaller points have significantly increased. In 1979, one half of the passenger enplanements at small hub airports were at points where one carrier had the majority of traffic. By 1988, only 20 percent of small hub passenger enplanements were at airports where one carrier had the majority of the local market.

For nonhub airports the percent of enplanements at points where one carrier had the majority of traffic dropped from 90 percent in 1979 to 80 percent in 1988.

Unfortunately, however, not all of the news is good. While much of the increased hub concentration has resulted from adding service to new, smaller spoke points, not all concentration at connecting hubs is the result of new service. Concentration also results from decreased competition. In city-pair markets involving at least one concentrated hub very little nonstop competition now exists from carriers that do not hub at either end point of the city pair.

While non-hubbing carriers have sometimes been replaced by new hubbing carriers, they often have not. The result is fewer non-stop competitors in a number of large city-pair markets involving at least one concentrated connecting hub. Even where a non-hubbing carrier has been replaced by a hubbing carrier this process causes concern because it seems to have locked in the carriers that will offer nonstop service in these large markets.

Other things being equal, expansion can be expected to involve the least risk for a carrier where that carrier already has a

significant degree of concentration, and the most risk where another carrier already has a significant degree of concentration. This consideration is fundamental but profoundly important, because it would seem to encourage carriers to continue to expand by extending their dominance (i.e., entering new city-pair markets to and from their already-dominant hubs), or creating new areas of dominance, rather than by competing at other carriers' hubs. This strategy which seems to prevail among the carriers operating today strongly suggests that new entry in already concentrated city-pair markets will likely be the exception rather than the rule, and increases the prospect that the existing competitors will not compete vigorously over time, as discussed earlier.

AIRPORT AND AIRWAYS CAPACITY

As Secretary Skinner has noted many times, when we deregulated competition in the airline industry, we apparently forgot to deregulate capacity. No major new airport has been built in this country since 1974. While traffic has roughly doubled since deregulation, airport capacity has remained stagnant. For competition to truly flourish, we must have added capacity and remove any barrier to entry.

Four airports are, as you know, governed by the High Density Rule which allocates specific landing and takeoff slots to specific airlines. Allowing new entry presents a serious problem for any allocation program. To enter these markets, new entrants must depend on the vagaries of the occasional lottery of available slots, in which they enjoy some preference, or must purchase or lease slots from current holders. While this slot market has been effective in facilitating schedule adjustments for incumbent carriers, it has not been a particularly effective mechanism for encouraging new entry. The Secretary is well aware of the imperfections in the current rules governing slot usage and has directed the Department and the FAA to develop ideas for changing those rules to create more opportunities for new competition at the High Density Rule airports.

Enroute air traffic control delay was also studied as a potential source of barrier to entry. While certain enroute sectors may be congested there is generally adequate airspace capacity within existing and planned air traffic control systems. Moreover, the cost of any delay is spread equally among those using the system and no discriminatory treatment is given new entrants. Thus, we see no barrier to entry associated with enroute airspace capacity.

Since ground side facilities are an important factor in providing air transport services, we are also considering whether they are a possible barrier to entry. In analyzing this, we relied heavily on surveys conducted by the Airport Operator Council International (AOCI) in 1982 and 1989. These surveys show that gate availability is a problem, that is, a barrier to entry, in both the short and long term. For example, of the 25 responding airports to the 1989 survey, 15 indicated that no gates could be made available within 90 days. Of the rest, only four airports indicated that five or more gates could be had within that period; five gates appear to be the minimum needed to operate a small hubbing type of service.

In the longer term, the lead time for construction of permanent gates is well over two years, and certain provisions in the

existing contractual arrangements between airport authorities and its current airline tenants, such as "Majority in Interest" clauses,* can delay or prevent construction of new facilities. Moreover, subleasing of existing facilities is often not a real solution to the need for groundside gates. In any case, if a new entrant had to go through an incumbent to obtain its groundside facilities, it is likely that its costs would be substantially higher than the lessor's own cost, and the sublet facility would not be as attractive as those the incumbent retains. Thus, a barrier would exist even if subleasing were a common practice.

Significant work on the overall evaluation of competition is still to be completed. We are finalizing a comprehensive pricing analysis that includes a larger data base than previous studies. Evaluating the effect of computer reservation systems on airline competition is also a particularly important component of this effort. Also, CRS rules must by law be reviewed and the Department just commenced a rulemaking proceeding to determine whether the rules should be modified.

* Majority in interest clauses give the airline tenants the right to approve certain airport decisions involving items such as capital improvements, expansions, added debt, and new bond issues.

As you know, the Department has endeavored to promote competition whenever the opportunity to do so comes along. The Secretary wrote the Attorney General on two occasions; first opposing the sale of gates at Philadelphia by Eastern to USAir and again in opposition to the merger of American and Delta's computer reservation systems. The Department of Justice subsequently announced its opposition to both transactions and they did not take place. The Secretary has also taken an active interest regarding leveraged buyouts and the control of U.S. airlines through foreign investment and has emphasized the Department's role in insuring that the transfer of international route authority does not result in less competition and reduced service benefits. We will continue to monitor closely the activities of the Eastern bankruptcy for competitive implication.

The study of industry competition initiated by Secretary Skinner is very broad. Secretary Skinner is committed to doing everything he can to preserve and enhance competition in our deregulated environment. I will be happy to now answer your questions.