TESTIMONY OF

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ON AVIATION

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Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to appear before you to comment on S.1741, the "Airline Competition Enhancement Act of 1989".

This legislation is a response to growing criticism of airline fares and a widespread belief that the airline industry has become concentrated and uncompetitive. A lot of work and thought went into it, obviously, and the sponsors are to be commended for focusing national attention on this critical issue. As you know, Secretary Skinner had similar concerns last year and asked his staff to undertake a comprehensive assessment of the state of competition in the domestic airline industry. The result was a multi-volume report issued in February. Although the report took over nine months to complete, I think it was well worth the wait, because it gave the Department of Transportation a much better understanding of the complex ways in which the airline industry has changed over the more than ten years since deregulation.

I would like to go over some of the more significant findings in the study, because they bear directly on the issues addressed in S.1741.

One of the most publicized changes has been the initial increase and subsequent decrease in the number of airlines operating since deregulation began (Chart 1). Between 1978 and 1984, the number of carriers operating large aircraft expanded from 30 to 38; the industry then consolidated through mergers and acquisitions so that, in 1988, 29 remained. In 1978, 13 airlines carried 90 percent of the traffic; the number increased to 16 in 1984 but then dropped so that today, after the merger in 1989 of Piedmont into USAir, 8 carriers account for 90 percent of the industry's revenue passenger miles.

One major reason the number of carriers has declined in recent years is because a fundamental change has taken place in the way carriers operate. All major domestic carriers developed hub and spoke networks to replace the linear route structures which had grown up under regulation. Hub and spoke networks have affected air travel in several important ways. First, the increase in number of flights to cities of all sizes, but particularly larger cities, has been dramatic (Chart 2). Second, small cities receive more frequent and more conveniently timed flights than previously, and many small or rural communities receive service to connecting hubs from more than one major airline or their code-sharing affiliate.

This provides travelers to and from many small communities with a choice of airlines and one-stop routings to most major destinations. The acid test of whether service is better under hub and spoke systems is whether passengers use it. Between 1984 and 1988, 61 percent of all airports, the vast majority of which serve small communities, showed traffic increases.

The hub at Charlotte, N.C., provides an illustration of how service increases when a connecting hub is created (Chart 3). In 1979, Charlotte had nonstop service to 32 communities, 8 of which were small cities and 7 of which could be classified as small or rural communities. By 1989 Charlotte received nonstop service to 73 communities; the number of small cities served was doubled to 16; and the number of rural and small communities served was more than tripled to 23. Charlotte is only one of more than 20 new connecting hub complexes which have developed in the past 6 to 8 years. The nation now has 25 hub airports, whereas in 1978 we had 5.

The only effective way of assessing the state of airline competition is by examining city-pair markets, the markets traditionally examined in airline competition studies and anti-trust analyses (Chart 4). The expansion of airline service networks that I have just described has resulted in an increase in the number of air carriers competing for passengers in a majority of city-pair markets. In 1988, more than 55 percent of passenger trips took place in city-pair markets served by three or more competing air carriers (each having at least 10 percent of the traffic), up from 28 percent in 1979. It is probably not an overstatement to say that in 1988 the airline industry structure was generally more competitive where it counts -- in city-pair markets -- than at any time in its history. The lesson to be learned is that you can't infer less intercarrier service competition between cities just because there are fewer carriers operating nationally.

As a further illustration of how the industry structure has become increasingly competitive, a look at actual passenger travel in one relatively small market -- Albany, New York-Minneapolis-St. Paul, Minnesota -- is helpful (Chart 5). In 1979 travelers between Albany and Minneapolis relied on connecting service offered by just two carriers -- USAir through Buffalo and American through Chicago. By 1988 air travel between these two cities had increased by 41 percent and two additional competing carriers had entered the market -- United, with service over Chicago, and Northwest, with service over its Detroit hub. (USAir's service is now provided over its Pittsburgh hub.)

As you know, each hubbing carrier enjoys a substantial advantage at its hub. Each additional spoke strengthens a hub by providing a new destination for the other spokes. This leads naturally to one airline providing most of the flights at its chosen connecting hub. Since flights into the hub city carry both passengers travelling between spoke cities and passengers destined for the hub city, the hubbing airline can provide more service than local passengers alone would justify. Other airlines generally cannot match the service of the hubbing airline or achieve its load factors into its hub city. As a result, direct nonstop competition into these connecting hubs is generally limited to markets involving the connecting hub of another air carrier. On the other hand, each connecting hub network competes for traffic in many markets by providing convenient one-stop service alternatives. These alternatives are less attractive to time sensitive travelers in short distance markets, but increasingly attractive as market distance increases.

How have these structural and service changes affected price? In the 10 years since deregulation, air fares, adjusted for inflation, have continued their long-term historic decline (Chart 6). After 1981, following an increase in air fares caused by an enormous increase in the cost of jet fuel, air fares declined by 26 percent (adjusted for inflation). From 1984 to 1988 the decline was 15 percent. In this more recent period, cities of all sizes had fare declines, but small cities benefited the most.

Over the period of deregulation average fares have closely tracked average costs. However, compared to what fares would be if based on the formula used by the CAB when fares were regulated, short-haul fares are now relatively higher than long-haul fares. But, since the CAB policy was to set fares below cost for short trips and above costs for long trips, this shift was to be expected and is consistent with a competitively determined, cost related fare structure.

Our study showed that the presence of competition in city-pair markets does affect price. Among the 3,675 markets in 1988 with at least ten passengers per day in each direction, 698 were dominated by a single carrier and fares in these single-carrier markets were 14 percent higher than in competitive markets. These single carrier markets account for about 10 percent of domestic revenue passenger miles.

We also studied pricing at concentrated hubs by analyzing fares at the eight most concentrated hubs, where one airline had more than 75 percent of passenger enplanements (Chart 7). We found that fares at these hubs were on average 18.7 percent higher than in similar markets for other airports. We accounted for differences in the size of markets and distance of markets in calculating this hub premium, which is the main reason our result is lower than the General Accounting Office estimate of last June. We found that fare premiums at these eight hubs were greatest for travel between large cities within the range of 250 to 1,000 miles of the hub. Traffic in the high fare markets at these eight hubs represents 4.1 percent of domestic revenue passenger miles. We see no regulatory alternatives which would address this limited situation without doing more harm than good.

We studied other areas as well. Our study analyzed airline marketing systems including computer reservation systems (CRS), travel agencies and frequent flyer programs. We concluded that the basic features of CRS industry structure are unchanged over the past few years, and entry into the CRS industry remains difficult. There are, however, two promising CRS developments. First is the diversification of ownership of three of the four reservations systems. To the extent that these systems are owned by more than one airline and are operated as separate profit centers, managers' incentives and abilities to use these systems to thwart airline competition are reduced. Second is the enhanced ability of these systems to provide real time information on the flights of participating airlines which could, potentially, reduce the need for travel agents to use the locally dominant air carrier's reservation system. The Department has rules restricting the airlines owning CRS's from using their control of the systems to prejudice their competitors. The Department is currently considering whether to readopt or amend those rules, now scheduled to expire at the end of this year.

The travel agency industry has grown dramatically under deregulation. Before deregulation travel agents booked 51 percent of U.S. airline passenger sales compared to 81 percent in 1988, and the number of agency locations has grown from 14,800 to over 35,000. Travel agencies are a relatively inexpensive means for marketing airline services; without the agency system each carrier would have to create its own distribution network, an arrangement that would be considerably more costly. The agency system is still evolving, and travel agencies have been developing new services for clients, including services that can significantly lower travel costs.

Frequent flyer programs are a form of discount directed toward the most lucrative segment of airline traffic -- the full fare business flyer. These programs probably make a contribution to airline efficiency by using awards so as to fill seats that otherwise would have been flown empty. Pursuit of frequent flyer rewards by company employees can lead to distorted purchasing decisions by business travelers, but corporations are adopting control measures that they believe are reducing these problems. Also, most frequent flyers belong to more than one program, thus helping to promote competition among carriers.

A separate section of the study covering regional airlines found that the number of airports served by this carrier group increased by 25 percent between 1978 and 1988 and the number of passengers carried by the regionals more than tripled. Most regional airline service is marketed on a code sharing basis with a major airline which provides greater coordination between carrier flight schedules, allows shared boarding and baggage facilities, simplifies ticketing, and permits passengers of regional air carriers to participate in frequent flyer programs offered by major carriers. Most regional travel markets are competitive. Of the top 300 regional markets in 1988, our study found that 212 were served by two or more air carriers, and in another 24 markets regional airlines compete with major air carriers.

The impact of international air service on domestic competition was also studied. We found that international operations are a growing source of revenue and profits and are important to the financial strength of the individual domestic carriers. The introduction of new gateways and additional opportunities for international travel has resulted in substantial increases in traffic and has altered traffic flows, with more passengers traveling on-line and fewer making interline connections between domestic and international sectors.

Finally, our study included a section on airport and air traffic impediments to competition. We found that delays resulting from airport and airway capacity restrictions are a serious concern, but in and of themselves do not prevent new carriers from gaining airport access because the "first come, first served" rule of handling traffic treats new entrants and incumbents the same. With regard to the four slot controlled airports -- O'Hare, La Guardia, Kennedy and Washington National -- inadequate capacity is an obstacle to expansion by incumbents and entry by new carriers. Reallocation of slots is now accomplished through a market-type process that allows slots to be transferred for any consideration. This "buy-sell rule" has been effective in providing for adjustments among incumbent carriers. However, the capacity shortage at these airports may well impede carriers from entering these markets.

We also found that a shortage of airport groundside facilities is a serious problem. According to a 1989 survey conducted by the Airport Operators Council International, 19 of the 30 large hub airports indicated that no gates could be made available within 90 days.

Let me turn now to the specific provisions of S.1741. Section 2 covers computer reservation systems and code sharing. As I noted earlier, the Department is well along in the rulemaking process to consider changes to its CRS regulations which expire at the end of 1990. Comments have been filed by 27 parties and the issues raised are very complex. Consequently, the Department will not be in a position to make substantial comments on CRS issues until the rule is done.

On the issue of outlawing code sharing our views are clear. Our study of structure and pricing in the industry and our review of regional airlines led us to conclude that code sharing has usually been a positive development, which has produced not only better service but also more competitive options for many smaller cities and rural communities.

Section 3 would give the Federal Trade Commission authority over deceptive and anti-competitive practices in the airline industry. This would duplicate the Department's authority under Section 411 of the Federal Aviation Act and, with respect to anti-competitive practices, would overlap both this Department and the Department of Justice's authority. We see no reason why this increase in overlapping authority would lead to better regulation or enforcement and consequently are opposed to this section.

Section 4 creates a presumption that a dominant air carrier at a concentrated hub airport has been engaged in unfair or deceptive practices or unfair methods of competition, and Section 5 authorizes the Secretary to move in district court for an injunction against those practices. Our study of the industry led us to conclude that the hub-and-spoke system of organizing routes has generally produced more and better service at the hubs and more competition in most domestic markets than would otherwise prevail. We, therefore, believe it would be unwise to simply presume guilt based on market share. The current antitrust laws provide a method for correcting monopolistic, unfair, or deceptive practices.

Section 6 allows the assessment of passenger facility charges (PFC's) at concentrated hub airports to be used for "security, capacity enhancement, and noise mitigation projects". We agree in concept with this section but see no reason to limit PFC's to certain airports. Our competition study and our national transportation policy review indicate the need to expand airport and airway capacity. For this reason the Department included in its proposed reauthorization legislation for the FAA a provision that will allow airports to collect a PFC of up to $3 per enplaning passenger which, in the first year, can be spent for purposes currently authorized under the Airport Improvement Program (AIP). Our proposal would also allow the Secretary, after the first year, to permit higher PFC's and permit their use for non-AIP eligible airport improvements that help eliminate air transportation system problems. I won't go into the many details of this proposal today. I would simply note that our proposal is more expansive than the PFC proposal in S.1741. We believe this new revenue source is necessary if we are to significantly progress toward meeting the growing needs of the air transportation system.

Section 7 would require the Department to revoke and reallocate all slots by periodic auction. While this may have the positive effect of generating more funds for airport development, it would not alter the fundamental problem at the four airports subject to the high density rule -- lack of capacity. Since the existing rule already provides a buy-sell mechanism, the Department is trying to determine whether this approach would change the way the potential users of the slots value them or whether that it would result in a more competitive outcome than currently exists. It may simply result in lower profits for carriers or higher fares for consumers.

The conclusions of our competition study reenforce the themes of the Administration's National Transportation Policy. Deregulation works; letting competition flourish in transportation markets brings benefits to the traveling public, to our nation's domestic economy and to our competitive position in the emerging global marketplace. Any effort to reregulate would do more harm than good. Instead we believe the emphasis should be placed on expanding airport and airway capcity so opportunities for introducing new service by new and existing carriers are not foreclosed. In areas where the Department now exercises some direct control and oversight, such as in the allocation of slots and CRS rules, any action we take will seek to promote competition. Actions we take in developing international policy and other related statutory responsibilities must take into consideration the impact on domestic competition. We would expect abuses of market power to be dealt with by enforcement of the nation's antitrust laws and will of course provide technical advice and data to support the Department of Justice in this objective.

Thank you Mr. Chairman for the opportunity to present the Department's views. I'll be happy to answer any questions the committee members might have.