

STATEMENT OF JEFFREY N. SHANE
ASSISTANT SECRETARY OF TRANSPORTATION
FOR POLICY AND INTERNATIONAL AFFAIRS
BEFORE THE
AVIATION SUBCOMMITTEE OF THE SENATE COMMITTEE
ON COMMERCE, SCIENCE, AND TRANSPORTATION
CONCERNING U.S. AVIATION POLICY
SEPTEMBER 11, 1991

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE, I AM PLEASED TO HAVE THIS OPPORTUNITY TO APPEAR BEFORE YOU TO COMMENT ON THE CURRENT STATE OF THE AIRLINE INDUSTRY.

AS A RESULT OF A NUMBER OF RECENT INTERNATIONAL ROUTE SALES AND BANKRUPTCY FILINGS, SOME HAVE EXPRESSED A CONCERN ABOUT THE CONTINUING COMPETITIVENESS OF THE AIRLINE INDUSTRY. WE AT THE DEPARTMENT UNDERSTAND THAT CONCERN.

AS YOU KNOW, THE DEPARTMENT HAS STUDIED CAREFULLY THE COMPETITIVENESS OF THE U.S. AIRLINE INDUSTRY. AS I TESTIFIED LAST APRIL, AT SECRETARY SKINNER'S DIRECTION WE UNDERTOOK A COMPREHENSIVE ASSESSMENT OF THE STATE OF COMPETITION IN THE INDUSTRY, WHICH WAS RELEASED EARLY LAST YEAR. THAT STUDY PRESENTED COMPELLING EVIDENCE OF THE VERY COMPETITIVE STRUCTURE OF THE INDUSTRY. BUT THE INDUSTRY STRUCTURE HAS CONTINUED TO EVOLVE, AND, AS A CONSEQUENCE, WE HAVE CONTINUED TO EVALUATE ITS COMPETITIVENESS.

THE U.S. AIRLINE INDUSTRY'S FINANCIAL CONDITION HAS DETERIORATED DURING THE PAST YEAR. IN CALENDAR YEAR 1990, THE INDUSTRY INCURRED LOSSES OF \$3.9 BILLION. MOST OF THE LOSSES OCCURRED DURING THE FOURTH QUARTER. IN THAT ONE QUARTER THE INDUSTRY LOST APPROXIMATELY \$3.5 BILLION, WHICH

EXCEEDED PROFITS EARNED DURING THE ENTIRE SIX-YEAR PERIOD FROM 1984 THROUGH 1989. SINCE LATE LAST YEAR FOUR LARGE CARRIERS HAVE FILED FOR BANKRUPTCY -- CONTINENTAL, PAN AMERICAN, MIDWAY, AND AMERICA WEST. ANOTHER CARRIER -- EASTERN -- CEASED OPERATIONS ON JANUARY 19, 1991, AND NOW A LARGE PORTION OF PAN AMERICAN IS BEING SOLD. THERE IS CERTAINLY REASON FOR CONCERN, THEREFORE, ABOUT THE IMMEDIATE FINANCIAL HEALTH OF THE INDUSTRY.

IN LOOKING TO THE FUTURE, HOWEVER, WE MUST FIRST ASSESS THE REASONS BEHIND THIS RECENT POOR PERFORMANCE. WE ARE CONVINCED THAT THE INDUSTRY'S LONGER-TERM VIABILITY IS PROMISING, THAT VIGOROUS COMPETITION WILL CONTINUE TO PRODUCE QUALITY SERVICE AT LOW PRICES, AND THAT DIRECT GOVERNMENT EFFORTS TO REREGULATE OR EVEN TO INTERVENE IN THE WAYS PROPOSED IN S.1628, WOULD BE A MAJOR MISTAKE. DEREGULATION IS NOT THE CAUSE OF THE INDUSTRY'S CURRENT FINANCIAL CONDITION AND GOVERNMENT INTERVENTION IS NOT THE CURE. RATHER, RECENT LOSSES ARE PRIMARILY ATTRIBUTABLE TO FACTORS THAT EITHER NO LONGER EXIST OR ARE GREATLY DIMINISHED.

THE PERSIAN GULF CRISIS RADICALLY AFFECTED BOTH COSTS AND DEMAND. THE INCREASE IN JET FUEL COSTS AFTER IRAQ INVADED KUWAIT LAST AUGUST WERE STAGGERING. BETWEEN AUGUST AND JANUARY FUEL COST INCREASES ADDED \$3 BILLION TO AIRLINE INDUSTRY COSTS. WITHOUT THE INCREASE IN THIS SINGLE COST COMPONENT, 1990 WOULD HAVE BEEN A MODEST LOSS YEAR INSTEAD OF THE WORST FINANCIAL LOSS YEAR EVER IN THE AIRLINE INDUSTRY.

BUT THE EFFECTS OF THE PERSIAN GULF CRISIS DID NOT STOP WITH HIGHER FUEL COSTS. THE WAR AND THE ASSOCIATED FEAR OF TERRORIST ACTIVITY HAD A DEVASTATING EFFECT ON TRAFFIC IN JANUARY AND FEBRUARY 1991, WHICH WAS DOWN FROM THE PREVIOUS YEAR BY 27 PERCENT AND 20 PERCENT, RESPECTIVELY. THE INDUSTRY'S RECENT TRAFFIC EXPERIENCE HAS BEEN FURTHER ERODED BY THE SLUMP IN THE U.S. ECONOMY. DOMESTIC TRAFFIC WAS DOWN ALMOST 9 PERCENT IN MARCH, AND 5 PERCENT IN APRIL OVER THE SAME MONTHS LAST YEAR. ON THE OTHER HAND, COMPARED WITH LAST YEAR, MAY 1991 INTERNATIONAL TRAFFIC WAS UP, AND DOMESTIC TRAFFIC HAD ALMOST TOTALLY RECOVERED. BY JULY CARRIERS WERE REPORTING SLIGHTLY MORE TOTAL TRAFFIC THAN THEY CARRIED LAST JULY.

DEREGULATION HAS OF COURSE PLAYED A ROLE IN INDIVIDUAL AIRLINES' FINANCIAL PERFORMANCE AS THE INDUSTRY HAS WORKED ITS WAY THROUGH THE TRANSITION FROM A REGULATED ENVIRONMENT. NOT ALL AIRLINES HAVE ADAPTED SUCCESSFULLY.

WHY ARE WE OPTIMISTIC ABOUT THE INDUSTRY'S FUTURE? FIRST, MOST OF THE RECORD LOSSES EXPERIENCED DURING 1990 WERE BORNE BY ONLY THREE CARRIERS. THE BALANCE OF THE INDUSTRY, IN OTHER WORDS, DID A CREDITABLE JOB OF DEALING WITH THE VERY DIFFICULT CIRCUMSTANCES THAT IT CONFRONTED. SECOND, THE RECENT LOSSES REPRESENT A DRAMATIC DOWNTURN FOR THE U.S. AIRLINE INDUSTRY, WHICH OPERATED AT A PROFIT IN FIVE OF THE SIX YEARS FROM 1984 THROUGH 1989, EXCLUDING THE EXTRAORDINARY LOSSES OF BANKRUPT BRANIFF IN 1989. IN FACT, EXCLUDING PAN AMERICAN, WHICH HAS STRUGGLED FINANCIALLY FOR MANY YEARS, THE INDUSTRY OPERATED AT A PROFIT FOR ALL SIX YEARS FROM 1984 THROUGH 1989, AND A MAJORITY OF LARGE CARRIERS THAT OPERATE TODAY CONSISTENTLY EARNED PROFITS AFTER THE INITIAL DEREGULATION

SHAKEOUT IN THE EARLY 1980'S. BY THE FIRST CALENDAR QUARTER OF 1991 THE INDUSTRY LOSSES WERE TRIMMED TO \$1.2 BILLION, AND EARLY INDICATIONS ARE THAT OPERATIONS FOR THE SECOND QUARTER WERE NEARLY PROFITABLE. THIRD, AND VERY IMPORTANTLY, THE EVIDENCE CONTINUES TO SHOW THAT THE INDUSTRY STRUCTURE CONTINUES TO BE VERY COMPETITIVE.

WHILE DEREGULATION IS NOT TO BLAME FOR THE INDUSTRY'S CURRENT FINANCIAL CONDITION, THAT CONDITION AND THE POSSIBILITY THAT ADDITIONAL INDUSTRY CONSOLIDATION WILL OCCUR, LEAD TO THE CORE ISSUE OF THIS HEARING. HAS THE INDUSTRY BECOME SO CONCENTRATED THAT THE BENEFITS OF DEREGULATION ARE THREATENED? THE ANSWER IS AN EMPHATIC NO. THE OBJECTIVE EVIDENCE SIMPLY DOES NOT SHOW THAT COMPETITION IN THE AIRLINE INDUSTRY IS WEAKENING.

AS DEMONSTRATED IN THE DEPARTMENT'S COMPETITION STUDY RELEASED IN EARLY 1990, THE HUB-AND-SPOKE SYSTEM OF SERVICE THAT MOST CARRIERS NOW OPERATE IS A VERY EFFICIENT AND PROCOMPETITIVE WAY TO PROVIDE AIR TRANSPORTATION. HUBBING SYSTEMS SERVE SO MANY MARKETS NATIONWIDE THAT A RELATIVELY SMALL NUMBER OF CARRIERS CAN PROVIDE VERY COMPETITIVE SERVICE IN MOST CITY-PAIR MARKETS. THIS IS ILLUSTRATED BY OUR STUDY WHICH SHOWS THAT BETWEEN 1984 AND 1988, WHEN INDUSTRY CONCENTRATION GREATLY INCREASED, COMPETITION IN CITY-PAIR MARKETS ALSO GREATLY INCREASED, AS THE FEWER CARRIERS EXPANDED THEIR SERVICE COVERAGE TO MANY ADDITIONAL CITIES. IT IS CLEAR THAT THE SHIFT TO HUB AND SPOKE SERVICE HAS PROVIDED GREATER FREQUENCY, CONVENIENCE AND TRAVEL OPTIONS TO THE PUBLIC THAN WERE AVAILABLE UNDER THE POINT-TO-POINT OR LINEAR ROUTE STRUCTURES THAT CHARACTERIZED AIR TRAVEL BEFORE DEREGULATION. TODAY, ONE OUT OF EVERY

TWO PASSENGER TRIPS OCCURS IN MARKETS WITH THREE OR MORE COMPETITORS, UP DRAMATICALLY FROM 1979, WHEN LESS THAN ONE OUT OF FOUR TRIPS WERE IN SUCH COMPETITIVE MARKETS. IN FACT, ONE OUT OF EVERY FIVE TRIPS TODAY IS IN MARKETS WITH FOUR COMPETITORS, COMPARED WITH LESS THAN ONE OUT OF 25 IN 1979. MOREOVER, THE MOST RECENT DATA DO NOT JUST SHOW THAT COMPETITION CONTINUES TO BE INTENSE, THEY SHOW THAT THE NUMBER OF MARKETS SERVED BY THREE OR MORE CARRIERS HAS INCREASED AS CARRIERS CONTINUE TO DEVELOP THEIR HUB-AND-SPOKE NETWORKS.

OUR ANALYSIS DEMONSTRATES QUITE CLEARLY THAT THE DOMESTIC AIRLINE INDUSTRY STRUCTURE THAT HAS EVOLVED UNDER DEREGULATION IS FUNDAMENTALLY MORE COMPETITIVE THAN AT ANY TIME IN THE PAST IN SPITE OF THE DECLINE IN THE NUMBER OF AIRLINES OPERATING NATIONALLY.

OUR CONTINUING ANALYSIS OF FARES CONFIRMS THE FUNDAMENTALLY COMPETITIVE NATURE OF THE DOMESTIC AIRLINE INDUSTRY. WHAT I HAVE DESCRIBED AS INCREASING COMPETITIVENESS IS REFLECTED IN THE CONTINUED DECLINE IN DOMESTIC FARES. OUR STUDY SHOWED THAT AFTER 1981, FOLLOWING AN INCREASE IN AIR FARES CAUSED BY AN ENORMOUS INCREASE IN THE COST OF JET FUEL, AVERAGE AIR FARES ADJUSTED FOR INFLATION HAD DECLINED BY 26 PERCENT BY 1988. THROUGH THE FIRST QUARTER OF 1991 THAT REAL FARE DECLINE NOW TOTALS 31 PERCENT. AS IT STANDS NOW, INFLATION ADJUSTED DOMESTIC AIR FARES ARE LOWER THAN AT ANY TIME IN HISTORY.

WE ARE ALSO SEEING EVIDENCE THAT ONE OF THE LIMITED COMPETITIVE PROBLEMS WE DISCOVERED IN OUR COMPETITION STUDY, HIGHER FARES AT HUBS DOMINATED BY ONE OR TWO AIRLINES, IS LESSENING. PASSENGERS AT THE 8 MOST

CONCENTRATED HUB AIRPORTS DOMINATED BY A SINGLE CARRIER PAID FARES IN 1988 WHICH WERE 19 PERCENT HIGHER THAN AT OTHER AIRPORTS. HOWEVER, THE "FARE PREMIUM" AT THESE 8 AIRPORTS WAS EVEN HIGHER IN 1984 (23 PERCENT) AND SUBSEQUENT CALCULATIONS FOR 1989 SHOW A CONTINUED DECLINE TO 12 PERCENT. THE DECLINE IN FARE PREMIUMS AT CONCENTRATED HUB AIRPORTS REFLECTS THE INCREASING COMPETITIVENESS OF MAJOR AIRLINE NETWORKS AS THEY GROW AND MATURE AND MAKE INROADS IN EACH OTHERS' MAJOR MARKETS. ALSO, COMPANIES ARE APPARENTLY INCREASINGLY REQUIRING THEIR EMPLOYEES TO SEEK OUT DISCOUNT TRAVEL AND CONSUMERS ARE BECOMING MORE SOPHISTICATED IN SEEKING OUT LOW FARES. ATA REPORTS THAT THE PROPORTION OF PASSENGERS FLYING ON DISCOUNT FARES HAS NOW REACHED 96 PERCENT. STILL ANOTHER EXPLANATION IS THAT AT A NUMBER OF IMPORTANT HUBS, SOUTHWEST AIRLINES, A GROWING, LOW-COST AIRLINE THAT SPECIALIZES IN HIGH FREQUENCY, SHORT-HAUL SERVICE, IS DEMONSTRATING IN MARKET AFTER MARKET THAT IT IS POSSIBLE FOR A CARRIER WITH THE RIGHT TYPE OF OPERATION TO COMPETE EFFECTIVELY FOR LOCAL TRAFFIC AT COMPETITOR-DOMINATED CONNECTING HUBS. SO THE MARKETPLACE SEEMS TO BE REACTING SUCCESSFULLY EVEN TO THE LIMITED PROBLEM OF HIGHER FARES AT HUB AIRPORTS.

IN SPITE OF THE CLEAR EVIDENCE OF THE CONTINUING COMPETITIVENESS OF THE AIRLINE INDUSTRY, CRITICS CONTINUE TO LOOK FOR PROBLEMS. AMERICA WEST AIRLINES RECENTLY CIRCULATED A STUDY WHICH PURPORTS TO SHOW THAT THE "BIG THREE" CARRIERS -- AMERICAN, DELTA AND UNITED -- ARE CONSISTENTLY ABLE TO COLLECT HIGHER AVERAGE FARES THAN OTHER CARRIERS BECAUSE OF THEIR DOMINANT MARKET POWER, WHICH AMERICA WEST ATTRIBUTES PRIMARILY TO THOSE CARRIERS' COMPUTER RESERVATIONS SYSTEMS, AND TO THE USE OF FREQUENT FLYER PROGRAMS AND TRAVEL AGENT COMMISSION OVERRIDES.

THE PICTURE PAINTED BY AMERICA WEST -- THAT ONLY THE LARGE CARRIERS THAT SERVE THE LARGEST NUMBER OF MARKETS CAN CHARGE FARE PREMIUMS BY VIRTUE OF THEIR MARKET POWER AND, IN TURN, ONLY THEY CAN ACHIEVE PROFITS -- IS FLAWED FOR TWO REASONS. FIRST, WE DUPLICATED ITS MODEL AND FOUND THAT IT WAS NOT STATISTICALLY RELIABLE BECAUSE IT TOTALLY IGNORES IMPORTANT FACTORS THAT AFFECT FARE LEVEL SUCH AS TYPE OF MARKET (BUSINESS VERSUS PLEASURE), THE COST OF SERVICE, AND MARKET DENSITY. WHEN WE ADJUSTED FOR JUST THE FIRST OF THESE -- TYPE OF MARKET -- THE STATISTICAL RELIABILITY OF THE MODEL IMPROVED DRAMATICALLY AND SHOWED THAT UNITED, WHICH BY AMERICA WEST'S MEASURES SHOULD BE MORE DOMINANT THAN ANY CARRIER EXCEPT, PERHAPS, AMERICAN, DOES NOT EXACT FARE PREMIUMS. INDEED, UNITED CHARGES PRICES THAT ARE WITHIN THE RANGE OF THOSE CHARGED BY MUCH SMALLER CARRIERS.

SECOND, IF YOU INCLUDE RESULTS FOR SOUTHWEST AIRLINES, WHICH AMERICA WEST IGNORED WHERE NECESSARY TO KEEP ITS INTENDED PICTURE INTACT, IT SHOWS THAT CARRIERS DO NOT HAVE TO BE LARGE AND CHARGE FARE PREMIUMS TO COMPETE SUCCESSFULLY AND EARN PROFITS. SOUTHWEST AIRLINES'S RESULTS ARE THE VERY OPPOSITE OF WHAT AMERICA WEST PURPORTS TO SHOW. SOUTHWEST DOES NOT CHARGE FARE PREMIUMS, BUT, INSTEAD, CHARGES MUCH LOWER PRICES THAN ANY OTHER CARRIER, SERVES ONE-FIFTH THE NUMBER OF MARKETS AS ANY OF THE BIG THREE, YET WAS BY FAR THE MOST PROFITABLE CARRIER IN TERMS OF OPERATING MARGIN, DURING THE PERIOD COVERED BY AMERICA WEST'S STUDY.

THE DOMESTIC AIRLINE SYSTEM TODAY IS EXTREMELY COMPLEX. INDIVIDUAL CARRIERS OPERATE INTRICATE OPERATIONAL NETWORKS AND COMPETITIVE PRICING

SCHEMES WHICH DEPEND UPON VERY COMPLEX YIELD MANAGEMENT SYSTEMS. GOVERNMENT INTERVENTION IN THIS VERY SUCCESSFUL SYSTEM IS SURE TO HAVE UNINTENDED CONSEQUENCES AND COULD WELL DO MORE HARM THAN GOOD. FOR THESE REASONS REGULATORY ACTIONS SHOULD NOT BE TAKEN ABSENT CLEAR EVIDENCE THAT COMPETITION WOULD BE SIGNIFICANTLY IMPROVED BY THOSE ACTIONS.

THE DEPARTMENT BELIEVES THAT IT HAS AMPLE TOOLS TO PREVENT COMPETITION FROM ERODING UNNECESSARILY WITHOUT IMPOSING ANY ADDITIONAL REGULATORY MEASURES. WE SUPPORTED ENACTMENT OF THE AVIATION SAFETY AND CAPACITY EXPANSION ACT OF 1990. THIS LEGISLATION, THROUGH PASSENGER FACILITY CHARGES, WILL ENSURE THAT AIRPORTS HAVE THE FINANCIAL RESOURCES THEY NEED TO FURNISH OPPORTUNITIES FOR ENHANCED COMPETITION AMONG AIR CARRIERS AS WELL AS EXPAND CAPACITY TO KEEP PACE WITH THE GROWING DEMAND FOR AIR TRAVEL. WE DO NOT WANT COMPETITION TO BE INHIBITED DUE TO THE LACK OF CAPACITY. WE WILL CONTINUE TO EXERCISE OUR REGULATORY RESPONSIBILITIES REGARDING ROUTE SALES AND OTHER ASSET TRANSFERS WITH AN EYE ON THE COMPETITIVE IMPLICATIONS. WE HAVE ISSUED AN NPRM ON OUR RULES GOVERNING CRSs. FINALLY, OUR RULEMAKING PROCEEDING AIMED AT MAKING IT EASIER FOR NEW ENTRANTS AND SMALL INCUMBENTS TO ENTER SLOT-CONTROLLED AIRPORTS HAS NOW BEEN ISSUED.

THANK YOU AGAIN FOR THIS OPPORTUNITY TO EXPRESS THE DEPARTMENT'S VIEWS. I WILL BE HAPPY TO ANSWER ANY QUESTIONS YOU MIGHT HAVE.