STATEMENT OF FEDERICO PEÑA
SECRETARY OF TRANSPORTATION
BEFORE THE
HOUSE PUBLIC WORKS AND TRANSPORTATION COMMITTEE,
SUBCOMMITTEE ON AVIATION
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Mr. Chairman, Members of the Subcommittee, I appreciate this opportunity to be here today to discuss the international aviation policy of the Department of Transportation. The last time that the Department crafted a written statement of international aviation policy was 16 years ago during the Carter Administration. We are finalizing a new policy statement, making this a well-chosen time for today's discussion. I know that Committee Members realize that this is a complex subject that combines economics, politics, domestic and international law, bilateral agreements and foreign policy. Numerous, often conflicting interests are involved.

That is why I would like to begin by setting out some basic facts and trends that we at the Department of Transportation see as shaping the international aviation industry and the context of international policy-making:

- first, the <u>global market environment</u>, including the growing international aviation market, regional differences, the transformation of U.S. airlines, U.S. airline performance in overseas markets, and the globalization of the industry;
- second, the <u>external factors shaping aviation industry growth</u>, including the bilateral regulatory system, the investment regime, and infrastructure constraints;
- Third, the <u>outlook or vision</u> of the future we see evolving and which

we seek to influence;

- Fourth, specific concrete steps that the Department of Transportation is taking to provide more aviation opportunities for U.S. airlines, cities and the American public; and
- Fifth, the role and impact of the use of code-sharing.

THE GLOBAL MARKET ENVIRONMENT

The growing international aviation market

Total worldwide international travel has been growing at the healthy rate of 7 percent per year -- more than doubling in the last 10 years -- and U.S. airlines have shared in this significantly. Indeed, U.S. carriers' international traffic has grown at a remarkable 9.5 percent per year for the last 10 years -- about twice the growth rate of the U.S. home market. International traffic now accounts for 25 percent of our airlines' business, up from 18 percent a decade ago. All forecasts show that international travel growth will continue to outpace growth at home, as our domestic aviation market matures and less-developed foreign markets surge.

One reason why overseas travel is likely to outpace domestic growth for years to come is that North Americans now travel by air more than 15 times more per capita, per year than Asians do and three times more than Europeans. This gap can only close as other economies around the world grow and their people travel more by air. Even as the gap narrows, though, U.S. international travel is expected to continue to grow twice as fast as domestic traffic over the next 10 years, rising more than 80 percent by the year 2003.

Our airlines know where the greatest growth opportunities are, and are determined to be major players in the dynamic global marketplace.

Regional differences

As the world market grows, it is important to analyze growth prospects by geographic region to see where the greatest opportunities lie. A decade ago, almost half of U.S. carriers' international revenues were earned over the Atlantic. Europe was our largest revenue market. That has changed dramatically. Last year the Pacific region generated 46 percent of our airlines' international aviation business and the Atlantic just 37 percent. Both regions have grown significantly, but Asia is now clearly more valuable to our industry's growth.

I should point out here that our carriers' international profits and losses are even more varied than their growth rates. Last year, U.S. passenger/cargo combination carriers reported an overall $392 million operating loss internationally. But their Pacific and Latin operations were slightly profitable. All of the reported losses were in the Atlantic, and one airline incurred most of them.

U.S. all-cargo carriers lost money in all three regions, with the heaviest losses in the Atlantic.

The primary factor driving the growth and profitability of global air travel is economic activity -- here in the United States and around the world. Airlines are extremely sensitive to the business cycle -- suffering severely during the recent recession and hopefully now returning to profitability as recovery takes hold. As Dr. Laura Tyson, Chair of the Council of Economic Advisers, said when she and I presented the Clinton

Administration's Aviation Initiative three months ago, "A strong economy will be the best medicine for what ails the aerospace complex."

As the U.S. economy continues to improve and other economies resume growth, airline activity is bound to increase. Strategic planning now, focusing on those markets with the greatest potential, will reap rich benefits in the future.

Two other major factors that shape our international aviation sector are: our domestic airline experience of competition and the world's international regulatory system.

The Competitive Transformation of the U.S. airline industry

Fifteen years of intense competition has brought about a startling metamorphosis, not only in the U.S. home market but in the list of players in U.S. international aviation. Indeed, with the exception of Northwest Airlines, the largest U.S. international airlines today were all primarily or exclusively domestic not very long ago.

But these changes in the rankings of dominant international airlines have not created a static situation. Our biggest international carriers remain under enormous competitive pressure at home. A steady stream of new entrants and more rigorous enforcement of anti-trust laws by our Administration ensure this healthy competition. This sustained competitive pressure has made U.S. carriers highly efficient. Indeed, Mr. Chairman, U.S. carriers are ready to compete anywhere in the world. The problem is that the rest of the world is not ready to compete with them. Although the U.S. airline industry will continue to evolve, U.S. carriers will always be formidable competitors, and the fact that the identity of the U.S. players in particular markets may change over time will not alter our fundamental policy of promoting competition and opening up international markets.

U.S. airline performance vis-a-vis foreign competitors

The European Union's Comité des Sages recently pointed out that European airlines have operating costs 48 percent higher than major U.S. carriers -- before even factoring in our low-cost companies. This U.S. advantage extends beyond Europe to Asia and around the world. No wonder U.S. carriers' share of international traffic is growing.

In international markets involving the U.S., our carriers captured 47 percent of the traffic in 1986. Last year, they took a 54 percent share. The U.S. share has risen 7 points in 8 years. On a market-by-market basis, U.S. carriers convey 66 percent of the traffic to and from Japan, 62 percent to and from Germany and Canada, 70 percent to and from France and 44 percent to and from the United Kingdom.

Caught up as we sometimes are in day-to-day issues and disputes, we should bear in mind that the big picture of achievement in international aviation shows U.S. carriers doing very well indeed.

The trend towards globalization

The competitive quest now underway for better, more efficient access to as many international markets and passengers as possible, might best be summarized as the "globalization" of the airline industry. Airline strategies and initiatives have been driven in part by the logic of strong economic forces and the search for profit, but they have also been influenced by the character of the international regulatory system and other constraints.

Airlines are being impelled by the economic force of their customers' demand for improved service and their own search for higher growth. Demand for international air service is growing strongly -- hence, airlines want to tap this demand and enhance their competitive positions by gaining better access to as many markets and passengers in the most efficient ways they can.

Many airlines cannot achieve these goals by establishing new direct services with their own aircraft and marketing their services exclusively under their own names. It is not only regulatory constraints that inhibit them but the daunting costs that unilateral expansion on a global scale would entail. Given the presence of extensive, existing networks in all regions of the world, one of the most efficient, cost-effective ways to expand globally is to facilitate passenger movements between existing networks. This economic logic has fueled the ongoing wave of inter-airline investments, mergers, strategic alliances and code-sharing both within and across national borders.

The trend toward alliances gathered speed during the 1980's, as U.S. and foreign carriers around the world sought various degrees of strategic integration. Virtually all of the major U.S. international airlines have entered into marketing alliances with foreign carriers large and small. Several U.S. airlines have been involved in equity transactions. Similarly, investments or marketing alliances between foreign carriers have involved virtually all of the major carriers within Europe as well as many large and small airlines in other regions. Marketing alliances have been most common, but there have been a number of notable equity transactions

Some of these arrangements have ended and several far-reaching alliances have been proposed, but not consummated -- such as the KLM-British Airways bid for Sabena and the Alcazar project to merge KLM, SAS, Swissair and Austrian Airlines. But even if some alliances have proven temporary, and some deals have aborted, the participants have simply gone on to seek new partners. The trend remains.

It is also true that carriers' various corporate strategies have been strongly influenced by the regulatory environment and other externalities. Some alliances, for instance, may not have been created, or would have taken different forms, were it not for the limitations imposed by the restrictive bilateral system and other constraints.

EXTERNAL FACTORS SHAPING GROWTH

Unfortunately, Mr. Chairman, both the growth of international aviation and the ability of U.S. airlines to meet the demand for global air services have been severely inhibited by a number of economic and physical barriers to efficient airline operations. These barriers include continued government reliance on bilateralism, restraints on capital movements and the limitations of airport and air traffic control infrastructure.

The restrictive bilateral system

The bilateral system of negotiating aviation rights is designed to limit, not to foster, competition, and inhibits or distorts globalization. The Chicago Convention -- established half a century ago toward the end of World War II -- dictates that nothing can happen unless government agreements explicitly permit it. Consequently, there are 1,200 bilateral agreements worldwide setting out exactly what airlines can do.

The U.S. didn't want this system 50 years ago, and we don't want it now. Indeed, this restrictive bilateral regime limits the competitive advantages and growth prospects of U.S. air carriers -- the most efficient in the world. That is because the bilateral system encourages many countries to focus on the fortunes of a single flag carrier -- thus viewing aviation negotiations as a zero-sum game. Secondly, the bilateral structure makes it extremely difficult and costly to build efficient airline systems. To do so requires a laborious process of assembling the necessary market access rights through a network of interlocking bilateral agreements. That is difficult in the best of times. It is virtually impossible when major nations adopt severely restrictive policies.

The French government, which renounced its treaty with us and now keeps a lid on U.S. carriers' growth, may be the most blatant example of resurgent airline protectionism at work. Air France, meanwhile, is undertaking a multi-billion dollar state-subsidized restructuring in an attempt to become competitive. Other governments are also restricting U.S. carriers. A key part of our international aviation policy strategy is to lift these mercantilist bilateral barriers and allow global aviation commerce to develop.

And the truth is, Mr. Chairman, protectionist barriers are little more than desperate, rearguard actions that cannot succeed in the long term. The longer national carriers are shielded from competition, the less effective they will become relative to their more nimble competitors in the race for shares of the growing international market. The waves of liberalization, while imperfect and far from universal, will continue to undermine fortresses built on the sand of protectionism.

Foreign investment

Intrinsic to the bilateral system is the requirement that airlines designated by each country be substantially owned and effectively controlled by nationals. Virtually all nations, including the U.S., have strict limitations on the degree of foreign investment allowed in their airlines. Clearly, these restrictions impede the free flow of airline capital. Thus a valuable corporate strategy used in other industries to increase growth -- market access through investment -- has been limited in the case of airlines.

Infrastructure constraints

Airlines have also been hindered in entering new markets or expanding services because of inadequate airport and airway capacity, thus distorting service patterns and the allocation of resources. The limitations at airports like Heathrow and Narita are well known, as are the constraints of fragmented European ATC systems.

European ATC capacity shortages and inefficiencies stem chiefly from the fragmentation of ATC services among more than 20 separate national systems. Political pressures have so far stymied the establishment of a single-integrated system even though European governments are embarked on a "harmonization and integration program" to improve coordination between national systems, agree on equipment standards and upgrade less advanced national systems.

The United States supports this effort to reduce delays. FAA experts have collaborated with their European and other world safety counterparts in the search for solutions and we will continue to work closely with them to mitigate this problem, which imposes billions of dollars of added costs each year on both U.S. and foreign carriers.

THE OUTLOOK: GLOBAL NETWORKS

All of these constraints -- the bilateral system, restraints on investment, and infrastructure limitations -- will continue, for some period, to limit airline flexibility in selecting markets and choosing corporate strategies, to deny new service to cities, and to deny passengers and shippers a full range of transportation options. In particular, there is a tension between the bilateral system, focused as it is on national boundaries and individual airlines, and the economic forces driving globalization. As some countries continue to work hard to protect their airlines, progress in some markets will be very difficult.

Ultimately, economic forces will prevail. The constraints, even taken all together, will only delay or distort -- not stop -- the process of globalization. Indeed, we expect this trend to continue well into the next century, leading to the development of a number of global aviation networks linking the three major regional air travel markets -- the Western Hemisphere, Europe (with Africa and the Middle East) and Asia.

These networks, based on major hubbing complexes in each region, will evolve in large part by the spread of various commercial arrangements to share passengers and freight between airlines. These arrangements will be the most efficient way to provide the "feed traffic" of people and goods needed to support complex, geographically diverse networks and sustain major hubbing operations.

We believe that U.S. airlines are strongly positioned to compete as lead players in these emerging global networks. First, because the U.S. domestic and international market accounts for 40 percent of all world air traffic today -- providing a rich base of passenger traffic; secondly, because deregulation has honed U.S. airlines to a high degree of efficiency.

Even though the first advantage is sure to diminish over time as air travel grows in other world regions, several U.S. airlines -- and it is difficult to predict which ones -- can emerge as the leading players in global networks.

DOT ACTIONS TO PROMOTE THE GROWTH AND DEVELOPMENT OF INTERNATIONAL AIR SERVICES

Against this background of continuing globalization, enhanced competition remains the core of U.S. aviation policy. We are convinced that airlines responding to the demands of a competitive marketplace produce the best results for their shareholders, for their employees, and for the passengers, shippers and communities they serve. That has been our experience at home and we believe that competition will multiply the benefits of increased air travel throughout the global economy.

There are, of course, obstacles to the implementation of an effective pro-competitive aviation policy. As I mentioned, Mr. Chairman, some foreign governments have restricted U.S. airlines operations in the interest of protecting their airlines from competition. We appreciate the concerns of our trading partners and we are prepared to adopt innovative programs to deal with them -- provided that our joint efforts lead to the elimination of restrictions on airline services and otherwise liberalize international aviation markets.

We face continuing challenges in assessing the shifting, often difficult-to-quantify opportunities and benefits for diverse U.S. carriers and the U.S. economy and in crafting effective strategies to guide us in negotiating and maneuvering from today's airline world into the globalized future. We need to give our airlines the opportunities they need to choose the corporate strategies they believe are in their best interests. While we cannot change the basic economic forces airlines face, we must do our utmost to insure that their choices are not constrained by artificial barriers.

Our goal throughout should be to maximize overall U.S. interests -- defined in the broadest sense to encompass airlines and their employees, the traveling and shipping public, U.S. cities and our national economy as a whole.

DOT, in partnership with the Department of State, has been pro-active in seeking to increase opportunities around the world for our airline industry and its customers. We played a key role in the formation and deliberations of the National Airline Study Commission, and in crafting the Administration's Civil Aviation Initiative. Since taking office, we have shared the frustrations of U.S. carriers faced with restrictions placed on their operations by foreign governments, and we have acted to remove these restrictions wherever possible.

In general, Mr. Chairman, our international aviation policy has been consistently guided by the strategies to support globalization and open markets that I enunciated in a speech before the International Air Transport Association last November:

1) First, we actively seek unrestricted, multilateral and sectoral agreements with those groups of nations that are willing -- and able -- to bring comparable benefits for U.S. carriers and the U.S. economy to the table.

2) Secondly, while we pursue multilateral accords, we also seek to

liberalize existing bilateral agreements -- ensuring that any such agreements actually stimulate more air travel, increase competition, and add to -- not reduce -- any other aviation rights that existing bilaterals already contain. We plan to move forward -- not backwards.

3) Thirdly, while we seek to move beyond the obsolete regime of bilateral accords, we will vigorously defend any and all existing U.S. bilateral rights. We will act, through all available means, against any foreign competitors whose governments discriminate against or fail to honor the rights of U.S. airlines. No one should underestimate our resolve in this regard.

4) Fourthly, we will explore the formation of a global coalition of like-minded, free market-oriented nations that could significantly advance liberalization.

In applying these strategies, we seek solutions that reflect a genuine exchange of reciprocal economic opportunities. In our recent agreement with Germany, for example, we preserved and enhanced the competitive position of U.S. carriers, obtaining new opportunities to balance the temporary moderation in capacity growth, and embarked firmly on the path to an Open Skies regime. We have also begun to seek multilateral arrangements to replace the outmoded bilateral regime, notably with the European Union in exploring air cargo liberalization.

As for encouraging the free flow of capital, we support raising the current 25 percent limit on foreign voting equity in U.S. carriers in markets governed by liberal arrangements.

To continue these initiatives in a comprehensive way, we are refining our strategies for liberalizing the prevailing international aviation regime. I have asked my international aviation policy staff, in coordination with the Department of State, to prepare practical strategies for achieving a liberalized international regime.

We will seek the advice of members of Congress in this effort and I expect to complete it by early summer.

Our current negotiating strategies -- like the comprehensive strategy to be embodied in the policy statement -- will be guided by one bright, unwavering lodestar: enhanced competition.

Nations that adopt more competitive policies and more liberal aviation agreements deliver measurable benefits to their citizens and businesses. As a study of aviation agreements from 1975 to 1989 concludes: "Having a liberal agreement in place results in 46 percent more passengers traveling between the United States and a foreign country and an annual passenger growth rate of 11 percent higher than it would be if there had been a non-liberal agreement in place -- after controlling for other country-specific factors....."

That's why we are confident that protectionist incidents will decline over time. First, because airlines worldwide all need to grow and globalize. Secondly, because airline consumers, businesses and tourist officials worldwide are realizing that they are not being "protected" -- but are instead badly hurt -- when their own governments adopt restrictive aviation practices.

Our attitude toward competition, our approach to international negotiations and indeed, our definition of what the United States' national interest is in shaping aviation policy are all profoundly different from most other nations, Mr. Chairman.

Most of our trading partners have only one or two national carriers. My counterparts in those countries need not look beyond the interests of those carriers when they develop their aviation policies. They believe -- and act -- as if what is right for their national airlines is the supreme good for their nation.

The U.S. is very different in this regard. Almost every international aviation issue that my Department deals with involves the interests of several of our airlines. We rarely enter bilateral negotiations with broad consensus, let alone unanimity of strategy by U.S. carriers. What one carrier may view as a positive outcome others often vigorously oppose. Therefore, I must always seek to discern what is in the best interest of the United States as a whole.

Moreover, U.S. airlines are not the only parties whose legitimate interests the federal Department of Transportation must consider.

To our cities, international air service represents a vital element in their strategies for economic development.

For our economy as a whole, increased air access to foreign markets creates more trade, tourism and jobs. Growth in aviation markets -- brought about by rising traffic and competition -- means that U.S. aircraft manufacturers will be able to sell more planes and hire more workers. Finally, the interests of the U.S. consumer -- in inexpensive, convenient and safe air travel -- must be a paramount consideration for all of our policy.

That means that as Secretary, I must look beyond the specific interests of individual airlines to develop an aviation policy that takes all of these important "customers" into account before arriving at what I believe best serves the national interest. I know the members of this Committee appreciate that this is no easy task. There is no simple solution that will allow everyone to achieve all of their objectives.

I strongly believe that the strategies governing our aviation policy, which I have described to you today, have been developed and applied in a way that best serves America's national interest. I can also tell you that this same concern will remain the guiding principle as we further develop and implement the aviation policies of this Administration.

CODE SHARING

Mr. Chairman, I want to touch on the practice of code sharing, one of the key strategies that airlines are pursuing in building global networks.

Code sharing can provide real economic benefits by offering improved market access at reasonable costs. It also offers important marketing advantages. Airlines can establish a new market presence or supplement their own flight frequency with code-shared flights, thus freeing up their own aircraft for use in other markets. Code-share alliances can also produce a level of cooperation and coordination that approximates the advantages of single-carrier service in scheduling, connections, baggage handling and pricing.

We think, however, that it is critical that passengers know exactly what they are buying when they purchase code share tickets. Today, the Department is announcing a proposal to ensure that the identity of each of the airlines in any code-share relationship is disclosed fully and clearly to all passengers.

We know from our recent experience with code-sharing that this practice can be a powerful tool for capturing additional traffic at relatively little cost. It also represents a highly effective strategy for foreign carriers to tap into the traffic from U.S. interior points. Absent reciprocal opportunities for access by these U.S. carriers to foreign markets, code-sharing has the potential to create an unacceptable imbalance in our existing aviation relationships.

At DOT we are deeply engaged in analyzing the international implications of code-sharing. We have also engaged the services of an airline economic consulting firm to assist us to further develop conceptual models in the area. We are also considering ways to obtain additional information from U.S. and foreign carriers about their code sharing operations. Our policy in the area of international code sharing requests is comparable economic opportunities.

That means that before a foreign carrier is allowed to undertake code-share arrangements in the U.S., we will require that its homeland guarantee U.S. airlines comparable market access. Those countries that continue to pursue restrictive aviation policies should understand that the benefits of code-share alliances will not be extended to their airlines until those policies have changed. It is noteworthy that while there are 80 code sharing arrangements with U.S. airlines, the largest and most comprehensive code-share arrangement between a U.S. and foreign carrier, Northwest and KLM, was approved in the context of our most liberal aviation relationship, the U.S.-Netherlands Open Skies Agreement.

We have dealt with code sharing arrangements in keeping with our fundamental goal of moving to a truly open international aviation regime, and have approved them only where consistent with that vision, or where approval was required by pre-existing bilateral commitments.

CONCLUSION

In summary, as the trend towards globalization of the airline industry continues, U.S. carriers are performing well compared to the majority of the world's carriers. However, because our carriers are doing so well, foreign governments are trying to protect their national flag carriers in various ways ranging from limiting our carriers' services to outright massive subsidies of their airlines. These efforts have produced tensions in many of our aviation relationships, and have created inefficiencies for our airlines and their customers, the traveling and shipping public.

Due to the tensions described above, during the next few years the transition from a restrictive regulatory regime to a more liberal and competitive environment will be extremely difficult. Our goal is to be firm in our commitment to providing the flying public with greater choices at reasonable prices and increased international market opportunities for our airlines.

Thank you for convening these hearings, Mr. Chairman.

I will be happy to answer any questions that you or members of the Committee may have.