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FOR AVIATION AND INTERNATIONAL AFFAIRS
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COMMITTEE ON TRANSPORTATION AND INFRASTRUCTURE
CONCERNING THE FINANCIAL CONDITION OF THE AIRLINE INDUSTRY
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Mr. Chairman and Members of the Subcommittee, the Department of Transportation is pleased to have this opportunity to comment on the financial condition of the U.S. airline industry.

When I last appeared before this Subcommittee two years ago, the airline industry was in the very earliest stages of recovery from the most severe financial crisis in its history. In 1992, the U.S. aviation industry suffered its worst year ever, with total operating losses of $2.2 billion and net losses of $4.6 billion, and had accumulated over $10 billion in net losses from 1990 through 1992. All major passenger carriers except Southwest Airlines had suffered heavy losses. Several airlines, including Eastern and Pan American--two of America's oldest and largest airlines--had ceased operations and were liquidated during this period, and three more major airlines--America West, Continental, and TWA--had filed for bankruptcy protection under Chapter 11; several more airlines were considered by industry analysts to be on the brink of bankruptcy.

I am pleased to report that today's picture is different. Most airlines have experienced improvements in their financial condition. As the economy has recovered from recession, so has airline traffic. The airlines have also engaged in a major restructuring of their operations. As a result, they have increased efficiency, cut excess capacity, reduced unit operating costs, and enhanced their competitive strength. In addition, the three major airlines that had been under bankruptcy protection two years ago have since emerged from Chapter 11 proceedings.

Historic Financial Results

Since 1985 the airlines have ridden a financial roller coaster. From 1985 through 1989, the major airlines as a group had strong net income in every year but 1986. Over the five-year period, they had cumulative net income of over $3 billion, including $1.6 billion in 1988. By the end of 1989, the major airlines had aggregate net stockholders' equity of nearly $14 billion, and long-term debt of nearly $16 billion. The airlines' debt/equity ratio stood at a fairly healthy 53/47 level.

Beginning in 1990, the airlines suffered three consecutive years of massive losses. In 1990, the major airlines lost over $3.6 billion, due primarily to Iraq's invasion of Kuwait, the subsequent Gulf War, and the consequent increase in fuel prices and decline in international airline traffic. The airlines suffered another $1.8 billion loss in 1991 as the economy slid into recession, and $4.6 billion in 1992 (including over $2 billion in one-time charges to reflect changes in the airlines' accounting of pension liabilities). By the end of 1992, the majors' long-term debt had skyrocketed to over $21 billion, and stockholders' equity had plummeted to about $9.2 billion. The industry's debt/equity ratio had climbed to 70/30.

The industry began its recovery in 1993, when the major airlines earned operating profits of $1.4 billion and net income of $450 million. Six of the nine major passenger airlines were profitable in 1993. (These figures somewhat overstate the industry's improvement, as they include "fresh start" accounting for Continental and TWA with their emergence from bankruptcy in 1993.) Preliminary figures for 1994 show that, although they posted a small net loss of $63.6 million, the major airlines' operating profits increased to $2.4 billion. Five of the nine major passenger airlines posted operating profits and net profits, as did both major all-cargo airlines.

Although long-term debt continued to increase in 1993, to $27 billion, net stockholders' equity began to recover, climbing nearly one-third to $12.3 billion. According to preliminary figures, the industry's long-term debt declined in 1994 to $26.6 billion, and stockholders' equity grew another 30 percent to a record high of nearly $16 billion. The majors' debt/equity ratio has improved to 62/38.

The overall industry recovery during the last two years has been driven primarily by the general economic recovery from the 1991-1992 recession. In addition, carriers have been significantly aided by the rapid decline in aviation fuel costs since 1990. Because of instability in the oil markets caused by the Iraqi invasion of Kuwait, the industry's average cost of fuel jumped to nearly 78 cents per gallon in 1990. Fuel prices have declined sharply every year since then, falling to 60 cents in 1993 and to 56 cents during the first nine months of 1994. This steep, rapid decline in jet fuel costs has been a primary factor in the airlines' recovery over the last two years. Finally, most major carriers have restructured their operations to improve efficiency and cut costs, in order to become more competitive not only with each other but with low-cost carriers like Southwest and successful new entrants.

Since January 1992, no fewer than 30 new jet airlines have started up domestic U.S. operations, and we have authorized operations for 12 carriers who have not yet commenced service. At this moment, we have 10 more new entrant applications pending before the Department. These and other low-cost, mid-size airlines have filled a void left by the majors in point-to-point, short-haul and medium-haul city-pair markets with dramatically positive results. The larger carriers have been forced by this development to redouble their cost-cutting efforts. They have reduced service on unprofitable routes, expanded service on underserved routes, retired older, inefficient aircraft, and, in some cases, achieved new collective bargaining agreements that allow a more efficient use of labor. In order to improve the efficiency of their operations, airlines have entered into major domestic and international code-sharing and joint-marketing alliances with other carriers. Many have also restructured their debt and equipment leases to improve earnings and cash flow; others have reappraised their entire route structures and operating philosophies. In addition, management leaders at many airlines have increasingly formed partnerships with labor by encouraging employee ownership, primarily through Employee Stock Option Plans. Employees now hold an outright majority share of United, the nation's largest airline, and own large equity shares of many other airlines, including America West, Continental, Northwest, Southwest, and TWA.

These changes in the airlines' operations constitute the most comprehensive restructuring of the industry at least since the development of hub-and-spoke networks in the early and mid-1980s, and perhaps since passage of the Airline Deregulation Act in 1978.

As a result of this restructuring, most airlines have achieved dramatic improvements in their financial position. Northwest, in particular, has made enormous strides in the past two years. After suffering record losses of $386 million in 1992, it earned $81 million in 1993, and a record $430 million last year. American, America West, and United, which also suffered from heavy losses in 1992, were all solidly in the black by 1994. Southwest, which was the only profitable passenger carrier in 1992, has seen its net earnings increase by 73 percent to $290 million last year. And ValuJet, less than 2 years old, enjoyed an astounding 25 percent operating margin last year, with net income of over $20 million. Restructuring has also enabled the three major airlines formerly under Chapter 11 protection to reorganize and escape from bankruptcy. Continental emerged from bankruptcy in April 1993, TWA in November 1993, and America West in August 1994.

At the same time, the airlines' recovery has not been uniform. Despite their large aggregate operating profits, the major carriers posted net losses for 1994 of $64 million (based on preliminary data), and a few carriers remain in a weak financial position. Even the weaker carriers, however, have made significant progress in cutting unit costs, rationalizing their route systems, and increasing efficiency. As airline traffic increases with continued economic growth, the industry's fortunes should improve considerably.

Forecast Operating and Financial Results

The airline industry's financial prospects are critically dependent on continued airline traffic growth, which itself is a function of overall growth in economic output. Gross domestic product (GDP) grew by 3.8 percent in fiscal year 1994. At the same time, airline traffic increased by 5.5 percent, from 483 billion revenue passenger miles (RPMs) in FY 1993 to 510 billion in FY 1994.

OMB forecasts continued GDP growth of 3.1 percent in FY 1995, 2.4 percent in FY 1996, and 2.5 percent from FY 1997 to 2001, and 2.4 percent from FY 2002 to 2006. (The FAA's long-term traffic forecast is based on a consensus of long-term growth forecasts issued by OMB and several economic analysts in the private sector.) With these economic forecasts as a basis, the FAA forecasts that the currently robust airline traffic growth rates will continue for the next two years, and then continue at a healthy 4.2 percent through FY 2006. The FAA forecasts airline traffic of 537 billion RPMs in FY 1995, 567 billion in FY 1996, and 869 billion by FY 2006.

Most major airlines have announced plans to control or trim their capacity this year, and to continue pursuing reductions in unit costs. Continued strong growth in airline traffic, therefore, should result in higher load factors for the industry. This, in turn, should boost the airlines' operating profits, even as their real passenger yields (revenue per passenger-mile) continue to fall.

We are now optimistic that the airlines' net income should also continue to grow. Long-term debt should continue the slow decline begun in 1994, and net stockholders' equity should increase sharply.

As over the last two years, however, these benefits may not be spread evenly among the carriers. Airlines with high costs or poor route structures may continue to struggle unless they effect significant corrective steps. Highly leveraged carriers are especially vulnerable to upward pressures on interest rates. Nevertheless, we anticipate that even the weaker carriers should progress toward profitability over the next several years, albeit possibly at a slower rate than the healthier airlines.

Airline industry cost structure

The airline industry is labor-intensive. During fiscal 1994 (the most recent period for which we have detailed data), salaries and wages accounted for 24.8 percent of the major airlines' total operating expense, and fringe benefits comprised another 9.6 percent. Total labor costs amounted to 34.3 percent of their operating expense, by far the largest expense item.

Fuel and capital costs were the next largest expense groups. The majors' fuel and oil expense was 11.2 percent of operating expense. Total equipment costs (rentals plus depreciation) were 13.4 percent of operating expense. Passenger traffic commissions are also a major airline expense, amounting to 9.4 percent of operating expense. Altogether, labor, fuel, equipment, and commission costs made up 68.3 percent of total expense in FY 1994.

The distribution of airline expenses has not been static over time. Fuel and oil made up nearly 23 percent of airline expense in 1985, declining to a low of 13.7 percent in 1988 before climbing again to 16.7 percent in 1990 with the Iraqi invasion of Kuwait and the attendant instability in the oil markets. Since that time, the industry's fuel cost has declined as a share of operating expense to a 10-year low of 11.2 percent in fiscal 1994.

Traffic commissions grew rapidly and nearly continuously during the last ten years, from 7.8 percent of expense in 1985 to 10.3 percent in Calendar Year 1993, an increase of one-third, before declining to 9.4 percent in fiscal 1994. Aircraft rentals have also grown from 3.5 percent in 1985 to 8.5 percent in FY 1994.

Labor expenses as a share of total expense have fluctuated a great deal over the last 10 years, falling from a high of 38.6 percent in 1986 to a low of 31.9 percent in 1990. They have since increased to 34.3 percent in FY 1994. Depreciation has shown a similar trend, declining from 5.5 percent in 1985 to 4.3 percent in 1990, and since then climbing to 4.9 percent in FY 1994.

Unit costs have also shifted over time. Total operating expense per available seat-mile (ASM) grew from a low of 7.2 cents in 1986 to a peak of nearly 9.3 cents in 1991. Since that time, total unit cost has declined somewhat to about 9.2 cents per ASM. Labor costs, which were 2.7 cents per ASM in 1986, have climbed steadily, reaching nearly 3.4 cents in FY 1994. Passenger commissions have also grown continuously and rapidly, from 0.6 cents per ASM in 1986 to nearly 1.1 cents in 1993, an increase of over 72 percent in seven years, before declining in FY 1994 to 1.0 cents per ASM. Equipment costs (depreciation, amortization, and rentals) have also increased, from 0.8 cents per ASM in 1986 to nearly 1.4 cents in FY 1994. Fuel costs, on the other hand, peaked at 1.6 cents per ASM in 1990, and have since declined nearly one-third to less than 1.1 cents per ASM.

By functional grouping, the airlines' largest costs were aircraft operating expense, which accounted for 40.1 percent of total operating expense in fiscal 1994. (Aircraft operating expense consists of flying operations expense, flight equipment maintenance, and depreciation and amortization on flight equipment.) Other major functional groupings are reservations and sales expense (including commissions), which accounted for 16.6 percent of total expense, traffic servicing at 10.3 percent, passenger servicing at 9.4 percent, and aircraft servicing at 6.2 percent of operating expense. Together these five groups accounted for 82.6 percent of the airlines' operating expenses in FY 1994.

Effect of the 4.3 cent jet fuel tax

Two years ago, Congress temporarily exempted the airlines from paying the 4.3 cents-per-gallon excise tax on jet aviation fuel. That statutory exemption expires September 30, 1995. At the time Congress granted the exemption, airlines were undergoing their worst financial crisis in history.

The industry is now in a position to accommodate this tax increase. Therefore, we do not support a further extension of the exemption. As I noted earlier, fuel costs have continued to fall, and now represent only about 11 percent of the industry's total operating expense. In absolute terms, fuel is now about 56 cents per gallon, down from 78 cents in 1990 and 64 cents in 1992. In that perspective, the impact of a 4.3 cent-per-gallon fuel tax is far less onerous. Based on the latest reported data, if the tax were imposed on the 12.1 billion gallons of jet fuel purchased by the major airlines, the airlines' fuel expense would be higher by $543 million annually--an increase over actual fuel expense of 7.9 percent, but an increase in total operating expense of only 0.7 percent.

The Department of the Treasury estimates that, for every dollar it gains from the aviation fuel tax, it loses about 25 cents in corporate income tax from the airlines. Thus, a very rough estimate of the net effect of the fuel tax on the airlines would appear to be about $407 million, or only about one-half of one percent of operating expense. Moreover, we anticipate that the airlines will pass through some portion of the tax onto passengers and shippers in the form of higher fares and rates. We also expect that the airlines will adjust capacity and make equipment and service adjustments to increase fuel efficiency, thus further reducing the tax's cost burden. Thus, the net impact on the industry would be substantially less than $407 million.

In this context, the case for extending an exemption is very difficult as a matter of fairness to other transport modes, which have paid increased excise taxes on fuel during the past two years. The Administration's position, therefore, is that there is no longer a justification for exempting the airlines from paying their fair share of energy taxes beyond the current fiscal year.

Recommendations to enhance airline profitability

Because the airline industry is hyper-sensitive to overall economic conditions, the surest road to the industry's recovery is continued economic growth. As Laura D'Andrea Tyson, then Chair of the President's Council of Economic Advisors and now Chair of the National Economic Council, wrote last year in introducing the Administration's Initiative to Promote a Strong Competitive Aviation Industry, "A strong economy will be the best medicine for what ails the aerospace complex."

Nevertheless, as Dr. Tyson added, "a strong economy cannot alone cure these industries' ills." There is still a role for government policies to promote the financial health of the aviation industry. Two years ago, at the Administration's behest, Congress established the National Commission to Ensure a Competitive Aviation Industry to investigate the causes of the aviation industry's financial woes, and to recommend measures to speed their recovery. The Commission adopted a list of 61 recommended steps to improve the aviation and aerospace industries' viability.

In January 1994, in response to the Commission's recommendations, the Administration unveiled its Initiative to Promote a Strong Competitive Aviation Industry. The Administration adopted 49 of the Commission's recommendations. As of January 1995, the Department has taken a large number of specific administrative actions to implement these recommendations.

Among the Department's most prominent actions are the introduction of new technology and navigation rules to streamline the FAA's air traffic control, which has already significantly reduced fuel consumption and airport delays for many carriers; accelerated implementation of the Global Positioning System; and a comprehensive examination of the High Density Rule affecting the four slot-controlled airports (Kennedy, LaGuardia, O'Hare, and Washington National), in order to determine the rule's impact on airline competition, fares, and service patterns. In addition, the Department has continued to monitor closely the airlines' operating and financial results, has encouraged the entry of new airlines by removing hindrances to market entry and assuring that new carriers are not harmed by unfair competitive practices.

We are also continuing to reassess the economic impact of existing regulations in order to minimize regulatory burden on the industry.

Another important way to improving airline profitability is liberalization of routes, fares, and rates. Although the domestic industry has been deregulated for over 16 years, international routes are still subject to severe restrictions in many bilateral aviation markets. Liberalization of our bilateral aviation agreements with our trading partners, therefore, is another important goal of the Administration.

To achieve this, the Administration has adopted "Open Skies" initiatives with a number of our trading partners. The most dramatic fruit of this effort was the recent signing in Ottawa of the new U.S.-Canada aviation agreement. That agreement provides for complete "Open Skies" to be phased in over three years between the U.S. and the Canadian cities of Montreal, Toronto, and Vancouver, and for immediate "Open Skies" in all other U.S.-Canada markets. The Department has just issued temporary exemption authority to six U.S. carriers to provide new service to Montreal, two airlines to Toronto, and six to Vancouver. We expect the new U.S.-Canada agreement to result in several billion dollars in new trade between the two countries.

The Administration has also aggressively pursued "Open Skies" agreements with countries overseas. In the last few weeks, the United States has initialed "Open Skies" agreements with Austria, Belgium, Iceland, Luxembourg, and Switzerland. "Open Skies" negotiations with Finland are scheduled for this week, and should begin soon with Denmark, Sweden, and Norway. In addition, the Administration is seeking to improve bilateral agreements with a number of our other trading partners, including China, Japan, Peru, Poland, and the United Kingdom.

Successful implementation of "Open Skies" or liberalized bilateral agreements will provide U.S. airlines with more opportunities to compete on an even footing for increasingly valuable international traffic. Since U.S. carriers are the most cost-efficient in the world, we are confident such opportunities will result in increased profitability recovery.

In addition to the foregoing administrative actions, and as Secretary Peña discussed with this Subcommittee on February 14, the Administration has proposed draft legislation to restructure FAA's Air Traffic Control functions in a new government-owned corporation funded by user fees. This would allow for more flexible personnel and procurement policies, ensure that the ATC system is able to respond quickly and efficiently to the growth of the industry and to technological advances, and provide for the highest degree of safety. We expect to transmit the draft legislation to Congress shortly.

Last year, in response to recommendations of the Airline Commission, the Administration supported provisions in proposed legislation to reform the bankruptcy laws, including changes with respect to airlines. Last October Congress enacted the Bankruptcy Reform Act of 1994 we included several of the provisions we supported.

In addition, on February 15, 1995, Representative Clinger introduced legislation in H.R. 951 to liberalize the restrictions on foreign ownership of U.S. carriers. Liberalization of foreign ownership rules was included in the Commission's recommendations, and has been adopted by the Administration in its Aviation Initiative and by the Department of Transportation in its recent international aviation policy statement. The Department is reviewing H.R. 951 in light of these factors.

Conclusion

With competitive pressures exerted by low-cost carriers, every major airline has launched a program to cut costs to the bone. These programs have included withdrawal from unprofitable routes and stations, retiring inefficient aircraft, reducing food service, changing distribution channels, shifting to ticketless reservations and booking, cutting commissions, and trading labor concessions for equity stakes in the airlines. These developments reflect the major changes going on in the airline industry as it restructures itself into a more efficient, highly competitive, and low-cost service industry. When these efficiencies are combined with today's health economy, and with our ongoing efforts to promote the health of this important economic sector, we see a profitable era for airlines.

Mr. Chairman, let me once again extend my thanks for the opportunity to present the Department of Transportation's views on the current and future health of the aviation industry. I am confident that, as our economy continues to grow, as U.S. air carriers become more efficient, and as the policies the Department has proposed or has underway are implemented, the aviation industry will grow, flourish, and prosper.