

STATEMENT OF
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DEPARTMENT OF TRANSPORTATION
BEFORE THE
SENATE COMMITTEE
ON COMMERCE, SCIENCE, AND TRANSPORTATION

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Thank you Mr. Chairman, Members of the Committee. I am glad to be able to discuss domestic aviation issues with you, particularly at this time, because of their importance and the important changes that are taking place in the airline industry.

First, I want to briefly comment on the GAO report on airline deregulation, prepared at your request, that is being released today. We did have the opportunity to review a draft of that report. It provides a thorough analysis of cities that account for the vast majority of domestic airline travelers. The conclusions in that report are consistent with our ongoing evaluation of domestic competitiveness, and in our view the report provides very useful insights about the effects of airline deregulation in domestic markets. We congratulate the GAO for this helpful analysis.

Not only does the thrust of the GAO report confirm what our analysis is showing--that the results of deregulation continue to be positive--I am convinced by our research that airline competition in the United States is going to continue to intensify not just to the benefit of air travelers, but on a scale that will create jobs, and expand local economies.

I base this on a Department of Transportation study Secretary Peña released this past Tuesday. In contrast to the GAO report, our study is not a broad-based evaluation of deregulation, but a report which focuses on the effects of entry of low cost airlines in the market, effects that are quite remarkable.

As you all well know, concern has existed in some quarters that airline deregulation was not working as it should, that a few large network airlines had become so dominant that competition was threatened. While for the past two or three years those concerns have proven to be less than system wide, as the results of the GAO study show, now we can tell you that there is additional competition. The established network airlines are under great pressure to become more efficient, and are having to carefully evaluate their business strategies for the future, because of inroads being made by a growing number of carriers whose principal strategic weapon is low operating costs.

Let me be clear about what we think this means. We are not suggesting that network operators are in jeopardy, but it is clear that network carriers are having to carefully react to the new low cost service competition with which they are now confronted. We see no evidence that they cannot do this and are confident that both types of service-- network service and low-cost service--will co-exist. During the past year, when low cost carrier service grew so rapidly, the industry achieved its most profitable calendar year in commercial aviation history.

This has important consumer implications because each type of service has something to offer air travelers; network carriers, by flowing passengers through their hubs, provide convenient service in markets of all sizes, and low cost carriers, provide passengers with very low prices in a growing number of markets.

This is what competition is all about, and this process is sorting itself out in the marketplace as it should.

But why have we concluded that the successful entry of low cost service is having such an effect that we call it “Revolution” in the title to our study? Highlighting the major findings of the study is the best way to answer this.

In the very recent past, only Southwest came to mind when low cost airline service was mentioned. Now, after years of little new entry in our airline industry, new carriers are operating throughout the country. Of course the term low cost now also brings ValuJet to mind, but all of a sudden we see a long list of low cost carriers, such as Air South, American Trans Air, Frontier, Reno Air, Vanguard, and Western Pacific to name but a few.

Most of these airlines are small; even Southwest is small by some of the more traditional measures of market share such as revenue passenger miles. But measured in

terms of the effect these carriers have on consumers and other carriers where they do compete, their effect is anything but small. In the aggregate, the group of low cost carriers that I just identified account for about 20 percent of domestic passengers, more passengers than our largest network airline. Depending on a variety of factors such as how much service they offer relative to other carriers, their competitors may or may not substantially reduce their own prices, but often they do. So low cost carriers affect not just the passengers they carry, but passengers of other carriers in the same markets.

As a consequence, a large and growing number of domestic passengers now travel in markets where low cost carriers operate. For the year ended September 1995 this proportion approached 40 percent, up from just over 30 percent for calendar year 1994, and we know that this number is continuing to grow rapidly.

One reason this is so important, in addition to the new service alternatives these carriers provide consumers, is the very low fares these carriers charge. Typically their unrestricted fares are well below half what the network carriers have previously charged, and even though network carriers almost always offered some seats for sale at very low prices with restricted discount fares, overall average fares plummet when low cost carriers come on the scene. For the year ended September 1995, we estimate that passengers traveling in markets with low cost service paid \$54 less than they otherwise would have, which represents a 38 percent reduction.

While fare reductions of one half may for some seem amazing, it is very low fares that enable low cost carriers to compete with much larger network airlines, particularly at network hub cities where network carriers have tremendous flow traffic advantages.

And the overall magnitude of such fare savings for consumers is almost staggering.

We estimate that for the year ended September 1995 the availability of low cost service saved consumers \$6.3 billion dollars. To put this in perspective, this savings is one eighth of total domestic passenger revenues of just over \$50 billion, and exceeds the total passenger revenues of any individual carrier other than American, Delta, and United.

This number is so large because of the combination of the huge fare reductions and the very large portion of domestic passengers that now travel in markets where low cost carriers operate.

And low fares do more than provide existing travelers fare savings: they make the convenience of air travel affordable to more and more Americans. We have estimated that 47 million passengers are now flying because of the new availability of low cost service. This is one out of every seven travelers, and we believe that these passengers account for most of the traffic growth in the domestic market in recent years.

While some have said that the domestic market is “mature”, it is now clear that substantial room for growth exists as fares keep coming down, not just in real terms, but absolutely as low fare carriers expand and competitive responses to those carriers occur.

Some may be tempted to look at the current wave of new low cost entry as a temporary phenomenon like the wave of new entry in the early days of deregulation. We do not view the current wave of new entry as temporary. As our study points out, low cost service is spreading rapidly and is following the general model of Southwest Airlines which has demonstrated staying power.

Finally, on this subject, I must add that, while we believe the low cost service phenomenon is an extremely positive development, we are not without concern about its lack of success so far in disciplining prices at some network hub cities.

We know that low cost service can successfully compete at hub cities. A very large portion of Southwest’s service, for example, is in city-pair markets where one or even both cities is a network airline hub. And low cost service has eliminated or virtually eliminated overall fare premiums at some hubs and is making substantial progress at others. But at some network hubs low cost service is almost nonexistent. And our concern about this is amplified by complaints alleging that some reactions to new low cost service are not intended to compete, but to eliminate the competition.

It must be said that it is very difficult to determine when competition crosses the line from tough competition, which we encourage, to anticompetitive behavior. While we must take great care not to inhibit legitimate competition in any way, our study makes clear that the beneficial consumer impact of low cost new entry is too important to allow anticompetitive behavior to undermine it.

Our study identifies a six-step plan we will follow in promoting low cost service.

- o We will continue to monitor and report annually on the progress of low cost carriers.
- o We encourage communities to promote their own interests by undertaking efforts to encourage low cost new entry.
- o We will continue to consider and carefully review allegations of anticompetitive behavior that are brought to our attention.
- o Where appropriate we will pursue enforcement activity to prohibit any airline from engaging in behavior that may be anticompetitive.
- o We will build on this baseline study to examine further why low cost service is succeeding in most areas but not in others, particularly at concentrated hubs where the dominant carriers continue to charge high fares.
- o We will continue to encourage and facilitate applications to form new airlines.

While we have not yet taken enforcement action in such matters, we have been active on an informal basis on a number of occasions when informal complaints have come before us. I can assure you that we are very sensitive about how we proceed in this area, but we will take enforcement action when necessary. We have no intentions of dictating how competition works. Our concern is that it be allowed to work.

The next subject I will raise with you has to do with small communities. Last year, in response to concerns raised about service and fares specifically at small communities, Secretary Peña directed us to undertake a comprehensive study of air transportation at such cities to determine what has happened since deregulation and how the situation is changing.

We have almost completed that study and plan to issue it soon. I would like to describe for you today how the study was approached and present some overall findings.

It is a very thorough review of each of the 320 smallest communities that did not qualify as an FAA hub in the continental United States and that were served by a certificated carrier at the time of deregulation in 1978. We included all such cities in our review to insure that a complete spectrum of the changes that have occurred would be examined.

We reviewed three major areas -- the demand for air transportation, the supply of air service and the prices charged. The study documents in detail the changes that have occurred at each community and provides a good assessment of the level and quality of service that is being provided, how that has changed over the past 18 years, and how stable the situation is at this time. It does not attempt to determine the causes for changes that have occurred. Given the enormous restructuring of the air transportation

industry and the marketplace overall since deregulation, it is impossible to isolate with certainty the causes of these changes.

We considered a number of factors regarding both the quantity and quality of service. We focused not only on the number of flights and total number of seats operated to each community, but also the flight itineraries, number of stops, size of hubs to which service has been provided and the degree to which capacity is shared with other cities. We considered the number of carriers serving the communities -- a major determinant of the level of competition -- as well as the type of carriers -- majors, independent commuters or commuters affiliated with major carriers. We looked at the size of aircraft used and we compared the capacity offered to the levels of traffic.

Not surprisingly, the results have varied widely among communities. Some of the communities have experienced significant growth in traffic and service since deregulation while others have experienced declines. It is difficult to draw conclusions that apply universally to all of the small communities. But making a few general observations about the evolution of air service to small communities is helpful.

For the period from 1978 until the mid 1980's, air service at many small communities went through a transition. In 1978, a majority of these communities were served by major carriers with 50-seat or larger aircraft. By 1985, most of the major carriers had suspended service at these communities and were replaced by commuter carriers operating smaller equipment. Traffic levels declined during this period. After this

transition period, service and traffic at small communities has been much more stable. This stability is particularly evident during the most recent years.

As with the entire air transportation system, there have been structural changes in the type of service being operated. More small communities are receiving nonstop service to major hubs offering single connections to a larger number of markets than before. Thus, while the local service to a nearby hub may be provided with small equipment, there have been improvements in the overall air transportation available. More importantly, there is no evidence to suggest that the demand for transportation at these communities has not be met by the levels of service being provided.

With respect to fares, we attempted to analyze the fare levels at small communities relative to one another and to national averages. Because of the limited availability of fare data and small numbers of passengers, a conclusive statistical analysis applicable to all small communities is not possible. We did, however, undertake a review of a sample of communities for which relatively complete data is available, examining fares in various mileage spans and market densities. As with service, the fare levels at the individual small communities in the sample varied considerably from national averages. However, in general, there does not appear to be any systematic or pervasive evidence that small communities are experiencing different fare structures than other communities.

We will provide copies of our small community study to the committee when it is ready.

The last topic I will mention is what might be done at the policy level to improve service at rural communities. We recognize, as our study shows, that there are regional differences in the impact of deregulation on the smaller communities. These differences merit further study and we are proceeding with a staff analysis that will focus on regional needs. In the process, we will take into consideration the helpful information that is being produced for, and as a result of, this hearing. Among the areas that we are open to considering are aid and sustenance of regional airports, flexible funding approaches in partnership with states, inter-modal arrangements, and other concepts that any of you might suggest. I look forward to working with the members of this committee as we proceed with our analysis.

I would like to take this opportunity to raise an issue with regard to the Essential Air Service program. After the fiscal 1996 DOT Appropriations Act was signed last November, reducing EAS funding by one-third from the previous year, we reduced the service level at every community that was then being subsidized, in order to live within the available funding for the remainder of the fiscal year. Since that time, we have received notices of intent to discontinue unsubsidized service at other EAS-eligible communities and claims for higher subsidy rates at points already being subsidized. If we are to make it through this year without having to impose a further reduction in

service levels, we will need access to carryover funds from prior fiscal years, and language in the Continuing Resolution will accomplish that. I understand that this is included in the continuing resolution process and urge you to follow this closely.

Thank you.