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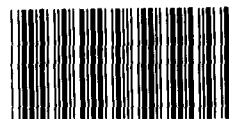
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Subcommittee on Transportation
and Related Agencies
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STATE OF THE AIRLINE
INDUSTRY

Strategies for Addressing
Financial and
Competition Problems

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Mr. Chairman and Members of the Subcommittee:

We appreciate the opportunity to testify on the state of the airline industry and the role that the efficient and effective use of budgetary resources by the Federal Aviation Administration (FAA) can play in helping this troubled industry. On February 18, 1993, we testified on the financial problems facing the airline industry before the Subcommittee on Aviation, House Committee on Public Works and Transportation. In that testimony we outlined some of the strategies that the Congress could pursue to help improve the financial health of the airlines and strengthen competition. Our testimony today builds on that statement and draws on an extensive body of work over the past several years on the state of competition in the airline industry and on the progress of FAA's airport and airways modernization programs. A bibliography of that work is attached to our testimony.

Our basic points are the following:

- Nearly all the major U.S. airlines have sustained serious losses over the last 3 years, but these losses have been especially severe for the financially weakest airlines. The five major airlines that have failed or are operating in bankruptcy have seen their market share fall from about 35 percent in 1987 to less than 18 percent in 1992. At the same time, the three largest airlines have increased their market share from 41 percent to almost 58 percent.¹
- No single factor can explain all of the airlines' financial problems. High debt-service costs resulting from leveraged buy-outs, ill-timed expansions, excess capacity, limited access to capital,² and fare wars have all contributed to the losses. The recession has exacerbated the industry's financial condition. The pricing practices of bankrupt airlines whose fares may not cover all of their costs of operations because of bankruptcy court protection practices are also alleged to be a factor undermining the financial condition of the industry. In addition, physical and marketing barriers to competition, such as restricted access to key airports and computerized reservation systems (CRS), have made it difficult for the smaller and

¹The five airlines are Eastern and Pan Am (which ceased operations in 1991) and America West, Continental, and TWA (which are reorganizing under bankruptcy court protection). The three largest airlines are American, United, and Delta. Market shares are based on systemwide revenue passenger miles.

²A major limitation on U.S. airlines' access to capital is the restriction on foreign investment and control.

financially weaker airlines to compete, especially in markets dominated by the largest airlines.

- Although the root causes of the airline industry's financial and competitive problems involve the more systemic issues noted above, FAA's efficient and effective use of budgetary resources can have a positive influence on airline operating costs. The areas where FAA can contribute the most include modernizing the air traffic control system, maintaining adequate workforces and deploying them to areas of greatest need, and making wise investments to improve airport access and operations. FAA performance shortfalls in any of these areas can increase the industry's operating costs. We have found that FAA needs to improve its performance significantly in each of these areas.

FAA's \$32 billion air traffic control modernization program, for example, has experienced serious schedule slippages and multi-billion dollar cost increases. As a result, the airlines and the flying public will not realize the billions of dollars in benefits FAA projects for many years. Furthermore, FAA's national plan for airport development lacks measurable objectives and offers little guidance for making funding choices among competing projects. We have made numerous recommendations to FAA on ways to improve these programs; full implementation of the recommendations would yield benefits to the industry and the consumer. Addressing the problems in these programs would help reduce airline operating inefficiencies, such as flight delays, and this, in turn, would affect airline and consumer costs. There are, however, other more basic reasons that underlie the airline industry's financial difficulties and competitive problems.

- Just as no single factor explains the current state of the industry, no single action will address its interrelated financial and competitive problems. Thus, the challenge will be for the Congress and the new administration to work with the industry toward a broad and well-designed strategy that combines efforts to reduce entry barriers with efforts to create a more efficient infrastructure. One possible vehicle for developing such a strategy would be the National Commission to Promote a Strong and Competitive Airline Industry.³ In our opinion, such a strategy would

³This commission was authorized by the Congress in October 1992 to examine current conditions in the airline industry and suggest possible strategies for addressing its problems.

be most effective if it contained four key elements: (1) improving U.S. airlines' access to capital markets through relaxing the restrictions on foreign investment and control, under certain conditions; (2) enhancing access to the growing international market for all U.S. airlines; (3) reducing barriers to competition; and (4) examining the claims and counterclaims about airline pricing practices, especially those of bankrupt airlines.

We would now like to discuss in more detail the competitive and financial problems of the airline industry, as well as the areas where FAA can use its budgetary resources more effectively to improve the operating efficiency of the industry.

THE INDUSTRY'S CURRENT FINANCIAL PROBLEMS MAY REDUCE FUTURE COMPETITION

The major U.S. airlines have lost over \$10 billion in the last 3 years. (See app. I, table I.1.) However, that aggregate figure is skewed by the huge losses suffered by a few airlines. For example, about two-thirds of the industry's 1990 and 1991 losses were recorded by Eastern, Pan Am, and Continental. Among the airlines reporting full-year financial results for 1992, about half of the losses reported are due to the new Financial Accounting Standard (FAS 106), which changes the way retiree medical and life insurance benefit costs are recorded. (See app. I, table 1.2) In addition, some of the losses reported by the three largest and strongest airlines (American, Delta, and United) stem from the costs associated with integrating the assets they have purchased from their bankrupt rivals in the last few years. For example, Delta's 1992 operating expenses rose more than 20 percent from calendar year 1991, largely because of the costs associated with the takeover of Pan Am's European operations.

In response to their losses, the major airlines have been implementing cost-cutting programs, laying off employees, cancelling or delaying aircraft deliveries, and refocusing service. For example, TWA reduced overall capacity by almost 20 percent between 1990 and 1992, and USAir closed its Dayton, Ohio, hub. While such actions should help the industry improve its financial performance, they can have negative impacts on an airline's long-term competitive position. For example, cancelling or delaying aircraft deliveries can reduce current capital spending but can also limit future service options because of airport noise reduction programs that restrict the use of older, noisier aircraft.

Financial Problems Weaken Competition
and Reduce Profitability

Both GAO and the Department of Transportation (DOT) have found that consumers pay higher fares when flying from airports where there is little competition. In our analysis of 1988 fares,⁴ we found that fares for flights from concentrated airports were about 20 percent higher than for trips of similar lengths from other airports.⁵ We are updating this study and the results should be available this spring. DOT reported that fares at a group of eight airports dominated by one airline were about 19 percent higher than average fares in 1988.⁶ A recently released DOT study of 1991 fares showed no change in this premium. While most routes continue to be served by several competitors, if the industry continues to consolidate, the decrease in competition could lead to higher fares.

Since January 1990 two major airlines have ceased operations and three more are reorganizing under bankruptcy court protection. The financially weaker airlines have also sold more than \$2 billion worth of assets, primarily international route rights and slots,⁷ to their stronger competitors. (See app. II.) The market shares of the five bankrupt major airlines have fallen from 35 percent in 1987 to less than 18 percent in 1992. During that same period, the market share of the three largest airlines has grown from about 41 percent to almost 58 percent.

Over the past decade, several large airlines have developed serious problems that weaken their financial positions. Chief among these problems are the high levels of debt some airlines have incurred to finance leveraged buy-outs and expansion plans and the

⁴Airline Competition: Higher Fares and Reduced Competition at Concentrated Airports (GAO/RCED-90-102, July 11, 1990). Our study compared fares on the basis of yield, i.e., fare per passenger mile.

⁵We classified an airport as concentrated if one airline handled at least 60 percent of the passengers enplaning at that airport, or two airlines handled at least 85 percent of the enplaning passengers. We excluded airports in metropolitan areas served by more than one commercial airport, such as New York City and Chicago, and airports outside the contiguous 48 states.

⁶In the DOT study, airports were classified as concentrated if one airline enplaned 75 percent or more of the passengers.

⁷A slot is a reservation for take-off or landing at one of four U.S. airports where access is restricted under the High Density Rule (14 C.F.R. Part 93, Subpart K).

operating and marketing practices that raise the costs of competing with the dominant airlines in a market. The five major airlines in financial trouble in 1990--America West, Continental, Eastern, Pan Am, and TWA--all experienced substantial increases in their debt ratios (i.e., long-term debt as a percentage of total capitalization) during the 1980s. All of those airlines had average debt ratios over 80 percent. In contrast, the other six major airlines all held their debt ratios under 65 percent, and most of them held their average debt ratios under 50 percent in 1985-89. (See app. IV.)

In the future, airlines will have to spend billions of dollars to repair and modify older aircraft to ensure safety and reduce noise. For example, we have estimated the industry's cost of retrofitting or replacing noisier Stage 2 aircraft to be between \$2 billion and \$5 billion dollars.⁸ In addition, airlines must finance the acquisition of new aircraft if they are to remain competitive.

Many factors affect the profitability of the airline industry and of individual airlines. Demand for air travel is sensitive to swings in the level of economic activity and to unexpected events, such as the increased concern about air travel safety during the Persian Gulf War.

For more than a decade, profit margins in the U.S. airline industry have been about half those of the average U.S. company in other industries, and airlines have had to borrow or sell stock to raise capital. Debt financing, whether through issuing debt instruments such as bonds or through the sale-leaseback of aircraft, carries fixed charges for interest, principal, and lease payments. In a cyclical industry like the airline industry, revenues available to cover fixed charges may fluctuate widely, making it difficult to cover fixed charges during cyclical downturns in demand or short-term increases in costs. Another way to raise additional capital is to sell stock. However, because of their low returns, the weaker U.S. airlines are not likely to attract much additional equity investment from U.S. sources. Therefore, the most likely investors are foreign airlines, because they can capitalize on operating synergies between the two airlines, something nonairline investors cannot do.

Some industry observers believe that the actions of certain bankrupt airlines may have also affected profitability. Because bankrupt firms can suspend repayment of long-term debt, they may set prices to generate sufficient cash flow to meet short-term needs, rather than setting prices that cover the full costs of

⁸Aviation Noise: Costs of Phasing Out Noisy Aircraft (GAO/RCED-91-128, July 2, 1991), p. 2. Our estimate reflects the present-value cost to the industry in 1990 dollars.

operation.⁹ To remain competitive, the other airlines would have to respond by matching these low fares and, as a result, suffer losses.

However, it is true that the airline industry has often experienced excess capacity during economic downturns. Because the airline product--a seat-mile of service--cannot be stored, but is instead lost as soon as the plane takes off, the airlines are under pressure to fill their seats, as long as the fare covers the marginal cost of providing the seat. This behavior can also lead to fares below full cost, which can erode industry profit margins.

FAA ACTIVITIES AFFECT AIRLINE OPERATING EFFICIENCY AND INDUSTRY COSTS

While the root causes of the airline industry's financial and competitive problems involve more systemic issues, FAA's efficient and effective use of budgetary resources can have a positive influence on the industry's operating costs. FAA's Acting Administrator recently said that air traffic delays impose annual costs on the nation's airlines and air travelers of \$3 billion and \$7 billion, respectively. The areas where FAA could contribute most include modernizing the air traffic control system, maintaining adequate workforces and deploying them to the areas of greatest need, and making improvements to the airport grant program to relieve congestion and delays. FAA's performance in all of these areas needs improvement.

Air Traffic Control Modernization Should Help Airlines Operate More Efficiently, but Billions in Benefits Have Been Deferred

We have reported extensively on FAA's \$32 billion air traffic control modernization program. This program is intended to, among other things, allow the airlines to fly more efficiently, and thereby save fuel, crew, and other operating costs. FAA has projected over \$200 billion in benefits from air traffic control modernization, but few of these benefits have been realized. Key components of the program have experienced multi-billion dollar cost increases and serious schedule slippages of about 5 years. The estimated cost of the program's centerpiece--the Advanced Automation System--rose from \$2.5 billion in 1983 to a current estimate of \$5.1 billion. Completion of the project was originally scheduled for 1996; the current estimated completion date is 2002. FAA has been implementing numerous procurement reforms to address the underlying problems that have led to the schedule slippages. These reforms include efforts to better justify the need for systems in the first place, establish the expected benefits for the

⁹The full costs of operation would include, for example, the costs of financing aircraft.

airline industry, define the requirements of the project in the early stages of the acquisition and avoid premature commitments to production. These reforms are far from fully implemented, however, and their chief value will be for newer projects and, hopefully, to prevent further slippages for the older projects.

Also, we believe that FAA could do more to develop air traffic control systems that meet the needs of the airlines. First, as we reported to this Subcommittee in January 1993, FAA must do a better job of defining its own and the industry's needs.¹⁰ We identified numerous instances where project justifications contained no qualitative or quantitative information explaining what performance problem was to be fixed, or the extent to which a new investment could be expected to reduce delays or enhance capacity. For instance, FAA does not always use its information on airspace and airport delays when deciding on investments in system capacity. Also, in our November 1992 report on precision landing systems, we found that FAA had not done a runway-by-runway analysis to justify where upgraded landing system capabilities would be needed to reduce delays.¹¹ Second, FAA must carefully consider alternatives to meeting the air traffic control system's needs. In assessing alternatives, costs to the airlines are essential considerations. Our report on FAA's acquisition of precision landing systems noted that airlines are installing satellite compatible avionics to support aircraft operations during all phases of flight. If a satellite-based system can be used for precision landings, airlines may avoid spending between \$252 million and \$336 million on microwave landing system avionics.

FAA's Workforces Can Also Affect Airline Operating Efficiency

FAA also has opportunities to improve the efficiency of air traffic control operations and the maintenance of that system by making judicious staffing decisions. As we have been reporting for some time, FAA needs to assign controllers to where they are needed most. The controller workforce is largely rebuilt, but the distribution of controllers is less than optimal. Adequate controller staffing of air traffic facilities plays a key role in an efficiently-run air traffic system. According to data developed by FAA officials performing a facility-by-facility analysis of controller staffing, more than 200 terminal facilities were understaffed in May 1992, while more than 150 facilities were overstaffed. Similar problems exist in the en route centers. An improperly staffed facility can affect aircraft spacing and

¹⁰Air Traffic Control: Justifications for Capital Investments
Need Strengthening (GAO/RCED-93-55, Jan. 14, 1993)

¹¹Airspace System: Emerging Technologies May Offer Alternatives
to the Instrument Landing System (GAO/RCED-93-33, Nov. 13, 1992)

distances and cause extended holding patterns and holdover times at congested facilities. These problems have resulted in aircraft delays at a cost to the industry. FAA has been working to lessen the burden on the industry by implementing a central control facility that shifts the problem from the skies to the ground with the advantage of saving the industry considerable fuel.

The maintenance technician workforce--the people responsible for maintaining the system and preventing outages--poses a different problem. Due to slippages in the modernization effort, FAA must maintain old equipment much longer than expected and, in some cases must maintain a number of dual systems concurrently. In addition, the work force experience level has declined substantially as more journey-level technicians retire and are replaced by developmental personnel. According to FAA, today's technician has less than 10 years experience, while a technician 3 years ago may have had over 25 years. In order to meet the increased work load with a less experienced work force, FAA has relied more on contractors to maintain new equipment, increased overtime usage, and reduced maintenance coverage at some facilities. Although equipment redundancy has kept overall system availability very high, backup system failures are increasing and outages are more lengthy. Due to the importance of system reliability to industry operations and safety, we are currently examining FAA strategies to accommodate maintenance technician shortages.

Moreover, we reported recently that the lack of common international certification standards for the design of aircraft creates a heavy burden on U.S. aircraft manufacturers and airlines without a corresponding increase in safety.¹² Despite FAA certification staff efforts to eliminate differences over the last decade, manufacturers continue to spend millions of dollars to obtain foreign approvals to export their aircraft after FAA has already certified the aircraft as safe. These costs are often passed directly to the airlines. In turn, airlines often spend millions of dollars to modify aircraft already in service to obtain foreign certifications. Manufacturers estimate that eliminating such differences would save the domestic industry up to \$1 billion over the next 10 years. Also, FAA estimates that airlines can save many times that amount if differences in operating and maintenance regulations between FAA and other nations are eliminated. Although FAA realizes that eliminating such differences would improve the financial condition of U.S. airlines, little progress has been made since 1983 when FAA and the European Community initiated an effort to eliminate these differences. Lack of a clear strategy, as well as questions of sovereignty, have prevented FAA from achieving progress. As a result, we recommended that FAA develop such

¹²Aircraft Certification: Limited Progress on Developing International Design Standards (GAO/RCED-92-179, Aug. 20, 1992)

mechanisms as joint certification teams with the European Community to help prevent late design changes and eliminate duplication during the certification process.

More Strategic Approach in Funding Airport Improvement Grants Could Improve Airline Industry Efficiency

FAA and the Congress have an opportunity to leverage the almost \$2 billion annual budget for the Airport Improvement Program (AIP) in ways that could be very important to the industry and the travelling public. As air traffic recovers, congestion problems could worsen at some major airports--increasing airline operating costs. AIP funding could be used more effectively to enhance capacity at airports or at nearby reliever airports and alleviate congestion.

As we have reported, however, FAA's 10-year national plan for airport development--which includes a total of \$40 billion in proposed projects--lacks a set of measurable goals by which to assess the effectiveness of its spending and is considered a "wish list" by many in the aviation community. Goals would set expectations for the plan as well as establish a basis for measuring its performance. Although a number of policy statements govern FAA's funding of airport improvement projects, none is stated in quantitative terms or applied to the planning process. Without ways to measure project performance, such procedures provide decision makers with little guidance for making funding choices among competing projects. On the basis of our work on several major airport development projects, FAA will need better data and analytic methods for judging how best to leverage airport improvement grant funds to best assist the industry and benefit the travelling public.

Despite the fact that AIP funds are limited, for example, an FAA-funded study of alternative sites for a new Chicago airport assumed that 20 percent of eligible construction costs would be paid out of AIP. One of the 5 sites reviewed (and the one favored by the selection committee) would have required more than \$3 billion from the AIP fund, an amount that would sharply reduce federal support for projects at other airports. The situation in Colorado offers another example. After committing \$500 million to the new Denver airport, FAA was considering investing in an all-cargo facility only a few miles away that would have taken traffic and needed revenues from the new airport. This may have increased costs for airlines operating out of the new Denver airport and for the travelling public as well.

The financial problems faced by the industry would be somewhat ameliorated by the more efficient use of budgetary resources by FAA. However, the more systemic problems undermining the competitive and financial health of the industry also must be addressed.

STRATEGIES FOR ADDRESSING AIRLINE FINANCIAL AND COMPETITIVE PROBLEMS

We believe that the most appropriate approach to resolving the competitive and financial problems of the airline industry is to focus on strategies that address the multiple factors that have led to the current problems. Airlines' access to capital needs to be improved, possibly by relaxing restrictions on foreign investment and control. However, improved access to capital is not a panacea for the airlines' financial and competitive problems. Access to international markets also needs to be enhanced, and the relaxation of U.S. restrictions on foreign investment could be linked to gaining better access for U.S. airlines to international markets. In addition, a number of barriers to competition resulting from airline marketing and operating practices continue and must be reduced if competition is to thrive. Finally, claims about unfair pricing practices need to be carefully examined before any action is taken to "protect" the airlines.

Improving Airlines' Access to Capital

U.S. airlines have not generated an attractive rate of return in recent years and, as a result, must either sell equity or borrow or to finance capital needs. However, borrowing raises fixed costs for debt repayment and many airlines already have heavy debt loads. Moreover, because of low rates of return, the most likely investors in the financially weaker U.S. airlines are other airlines that can capitalize on operating and marketing synergies. The continuing consolidation within the U.S. airline industry may mean that further mergers between U.S. airlines could have a difficult time clearing the Justice Department's antitrust scrutiny. The most likely investors, therefore, are foreign airlines that could link the domestic and international operations of the U.S. airline with their own route systems. For example, DOT recently approved Air Canada's investment in Continental, and USAir and British Airways have announced a modified version of their previous investment agreement, which was withdrawn last December.

We have examined the issue of foreign investment in some detail.¹³ Federal law currently limits foreign investment in U.S. airlines to 25 percent of the airline's voting stock. In addition, the president and two-thirds of the airline's board of directors, and key management officials must be U.S. citizens. DOT interprets the law to require that effective control must also remain in the hands of U.S. citizens. Some of the reasons that the restrictions were first put in place, such as protection of a heavily subsidized, fledgling industry, are no longer a concern. Allowing greater foreign investment could help some U.S. airlines remain

¹³Airline Competition: Impact of Changing Foreign Investment and Control Limits on U.S. Airlines (GAO/RCED-93-7, Dec. 9, 1992).

viable competitors, thus enhancing domestic competition. However, other concerns remain.

On the one hand, foreign airlines are not likely to invest substantially in U.S. airlines, particularly the weaker ones, unless they can (1) exercise control over their investment commensurate with the amount of voting stock held and (2) integrate the operations of the two airlines into one system. On the other hand, U.S. airlines that already have significant international operations are concerned that allowing a foreign airline to gain control over a U.S. airline could place them at a competitive disadvantage, especially if the investing foreign airline is from a country that has a particularly restrictive bilateral agreement.

There are other issues in the debate on foreign investment and control as well. The Department of Defense is concerned about the continued availability of commercial aircraft and crews to supplement its own airlift capacity in times of military emergency. Airline labor unions are concerned about potential job losses, especially high-paying crew jobs on international flights, if foreign airlines are allowed to gain effective control over U.S. airlines.

Our analysis of the likely impacts of changing foreign investment and control limits showed that these interests and concerns could be addressed. If the Congress chooses to relax the limits on foreign investment and control of U.S. airlines, DOT could be required to proactively consider potential impacts on international aviation competition in assessing the proposed investment, and eligibility to make such investments could be limited to airlines from nations that are willing to exchange improved access to their markets. The Congress could also expand DOT's review of these transactions to consider their potential impact on national security. We also suggested that our examination of potential job impacts concluded that there are practical limits to the number of jobs that might be lost and that U.S. airline employees are highly cost-competitive with their international counterparts. Finally, the potential for jobs to be lost if an airline ceases operations because it cannot get the capital needed to stay afloat is likely to be much greater than any losses associated with increased foreign investment and control.

Domestic Issues Should Be Considered in the Context of the Changing International Environment

The second element of the strategy is enhancing access to international markets. The international aviation industry, like the domestic industry, has been changing. The international market is expected to grow about twice as fast as the domestic market through the year 2000. Thus, the major U.S. airlines have begun to focus greater attention on expanding their international

operations. Between 1987 and 1991 the proportion of major U.S. airlines' systemwide revenue passenger miles represented by international operations grew about 22 percent, and international operations now account for about 26 percent operations. (See app. III.) For the three largest major airlines, the growth in international operations has been dramatic, with international revenue passenger miles more than doubling between 1987 and 1991.

Access to international markets is regulated by bilateral agreements between governments that set the conditions under which U.S. and foreign airlines operate and compete. These agreements, known as bilaterals, can restrict competition by limiting the services and fares that can be offered. The United States has 72 bilaterals with 95 countries around the world, each one separately negotiated. Although the European Community (EC) has integrated its internal market, the European Commission does not yet negotiate aviation issues for the 12 EC member nations as a whole. While the United States can mandate change in the domestic industry, it can influence, but cannot dictate, the pace of international change. Change in the international arena is likely to be slow because of the many bilaterals in place and the necessity of negotiating changes with each country individually under the current system. We believe that an examination of U.S. policy, to ensure that it encourages greater international competition, protects the interests of consumers, and allows all U.S. airlines to participate in international markets, would be useful.

Also, while some industry analysts believe that the system of bilaterals will be replaced by a more open, competition-oriented system, the results of recent negotiations with our aviation trading partners are mixed. For example, within the past year the United States had concluded an open-skies bilateral with the Netherlands, but several other countries--France, Germany, and Japan--have requested changes to their bilaterals, such as temporary capacity constraints, that would place additional limits on competition. In addition, many industry officials and analysts believe that the current consolidation in the U.S. airline industry is the precursor of a global trend, leading to the eventual domination of worldwide aviation by a handful of mega-carriers. Thus, many U.S. and foreign airlines have been developing networks of equity and marketing alliances to improve access to each others' international and domestic markets and thereby improve their chances of surviving the expected restructuring.

An airline's financial condition affects whether it can continue to participate in international markets and how it can participate. The financially distressed airlines have sold international routes, and some have reduced their participation in the international market, while the stronger U.S. airlines have expanded their international operations. In addition, some of the smaller or financially weaker U.S. airlines have had to rely on marketing agreements with foreign airlines to continue or expand

their participation in some international markets. Thus, U.S. airlines must be financially sound if they are to continue to play a significant role in international markets.

Barriers to Competition Limit
Market Entry and Raise Fares

The third element of the strategy is addressing the barriers to competition on which we have reported and testified extensively. Airline operating and marketing practices make it more difficult for some airlines to compete by limiting access to airports and by limiting the ability of new airlines on a route to market their services. These practices also affect airline profitability by raising the costs of competing airlines. When entry into markets is constrained, competition is reduced. In our 1991 report,¹⁴ we found that fares were 5 to 9 percent higher on routes when two or more of these barriers were present. We have previously presented a number of options for addressing these barriers, which we will summarize today.

Certain Practices Limit Access to Airports

Airport access is limited by the practice of leasing airport gates and other facilities to airlines on long-term, exclusive-use leases. These leases give control of key airport facilities to airlines and make it possible for them to exclude other airlines from using the facilities. Federal government action to encourage the use of preferential-use leases on airport facilities could help improve access to the terminal facilities an airline needs to offer service.¹⁵ Since new facilities built with Passenger Facility Charges (PFC) cannot be leased on long-term, exclusive-use leases, the 1990 PFC legislation clearly moved in that direction.¹⁶ As of November 1992, this legislation has made more than \$75 million available for terminal expansion projects that could increase competition.

Another factor limiting airport access is the FAA's High Density Rule, which restricts access to take-off and landing slots

¹⁴Airline Competition: Effects of Airline Market Concentration and Barriers to Entry on Airfares (GAO/RCED-91-101, Apr. 26, 1991).

¹⁵A preferential-use lease protects the primary lessee's right to use the facilities whenever the airline has operations scheduled, but allows the airport to make the facilities available to other airlines when the facilities would otherwise be idle.

¹⁶PFCs were authorized in sec. 9110 of the Aviation Safety and Capacity Expansion Act of 1990, which was signed by the President on November 5, 1990.

at four key airports--Washington's National, Chicago's O'Hare, and New York's Kennedy and La Guardia Airports. Competition at the slot-controlled airports could be enhanced if slots were made available to airlines with little or no service at those airports. The limits on operations at the slot-controlled airports were designed to tailor demand for air traffic services to the capacity of the airports. However, technical improvements in air traffic control may make it feasible for FAA to increase the number of slots available at those airports. In addition, the buy/sell rule, which was designed to create a market in slots, could be altered to encourage airlines to sell slots they do not use.

Marketing Practices Limit the Ability of Airlines Entering New Markets to Compete

Certain airline marketing practices also limit competition. These practices include computerized reservation systems (CRS), travel agent incentives, frequent flyer plans, and code-sharing.

CRSs and Travel Agent Incentives--Because each airline must, as a practical matter, have its flights listed on each CRS in order to market its flights successfully, each airline must pay the booking fees charged by the other airlines that own the CRSs. As we reported in 1991,¹⁷ the lack of effective competition in the CRS industry allows the dominant CRSs, which are controlled by American and United, to each receive substantial revenues, in excess of the costs of the service provided (including a reasonable profit),¹⁸ from other airlines in the industry, most of which are financially weaker. Travel agent commission overrides may also restrict competition.¹⁹ Commission overrides and other travel agent incentives encourage agents to divert traffic to the airline offering the best incentives, usually the largest in the market, when the passenger's needs can be met by the services of more than one airline.

DOT issued new CRS rules in September 1992 that addressed the concerns we have raised in the past about the contractual relationships between travel agents and CRS vendors. These

¹⁷Airline Competition: Weak Financial Structure Threatens Competition (GAO/RCED-91-110, Apr. 15, 1991).

¹⁸Based on data collected by DOT for its 1988 study of the CRS industry, we calculated that the two dominant CRSs annually transferred over \$300 million to their airline owners. Although we recommended that DOT update its information on the CRS industry, DOT has not gathered more recent data.

¹⁹Commission overrides are bonus commissions paid by individual airlines to travel agents to encourage booking on a particular airline.

concerns included minimum-use clauses, automatic rollovers, and 5-year minimum contract terms. The new regulations should make it easier for travel agents to change systems. However, DOT did not address the problem of booking fees. Eliminating or reducing booking fees would halt or reduce the revenue transfers from participating airlines to CRS vendor airlines. Although such a strategy could raise the cost of the systems for travel agents, travel agents are in a better position to negotiate terms with the vendors than are the airlines that, as a practical matter, must participate in every system. Alternatively, requiring arbitration of increases in booking fees could give participating airlines some leverage and help minimize revenue transfers. In addition, eliminating commission overrides and other travel agent incentives could reduce agents' tendency to book on the dominant airline in a market. However, policies to eliminate the adverse effects of CRSs on competition should be designed to preserve their positive features. Consumers benefit from CRSs because the systems allow travel agents to quickly search among the fare, route, and schedule offerings of competing airlines to find the flight that best meets the passenger's needs.

Frequent Flyer Plans--Frequent flyer plans may also have a significant effect in reinforcing the market power of dominant airlines. Our survey of travel agents indicated that business flyers often choose an airline on the basis of frequent flyer plans, which generally favor the larger airlines in each market. The aspects of frequent flyer plans that reinforce the market power of dominant airlines could be reduced without eliminating the plans. For example, making mileage transferable between passengers belonging to the same plans would reduce passengers' incentives to fly only with the dominant airline in a market, but airlines and travelers would still benefit from the plans. Benefits would occur because passengers must still take flights on an airline to earn awards from that airline, but the passengers do not have to concentrate their travel on a single airline if they can trade mileage earned with other travelers who belong to the same frequent flyer programs.

Code-sharing Agreements--Code-sharing agreements²⁰ appear to strengthen the position of major airlines with such agreements, especially at the airlines' hubs. One option for reducing the anticompetitive impact of code-sharing would be to remove the preference code-shared flights currently have over interline

²⁰Code-sharing agreements are cooperative marketing agreements, generally between large airlines and smaller, commuter airlines, in which the commuter airline transports connecting passengers to and from the larger airline's flights. The passenger's ticket shows the two-letter airline code of the larger airline for all segments of the trip even though part of the trip is actually flown on the smaller airline.

flights in CRS displays,²¹ since flights that are displayed sooner are more likely to be booked. However, our survey of travel agents showed that passengers tend to prefer code-shared flights over interline flights because of customer convenience factors, such as the proximity of gates for changing planes and increased reliability in baggage handling. Thus, passengers should at least have information on whether code-shared flights are available so that they may choose the service that best meets their needs.

Conflicting Claims About Airline Pricing Practices Should Be Carefully Examined

The fourth element of the strategy is a careful examination of the claims and counterclaims about the role of airline pricing practices in the industry's financial difficulties. We urge caution before acting on the claims and counterclaims about the pricing practices of airlines. The extent of the problem and its systemwide effects need to be established and weighed against the longer-term competitive implications of any proposed action. Some industry observers believe that bankrupt airlines may be pricing below the full costs of operations. However, because the bankruptcy code is not structured on an industry-specific basis, any action to change the bankruptcy laws would likely affect firms in other industries as well as airlines. In addition, actions that would force airlines to limit time spent in reorganization could force additional airlines to simply cease operations and adversely affect the interests of airline creditors. If measures were implemented to protect the non bankrupt airlines from alleged below-cost pricing by bankrupt airlines, these measures could make it more difficult for bankrupt airlines to successfully reorganize, regain financial health, and offer effective competition. Moreover, not all discounting is initiated by bankrupt airlines. Finally, actions to limit airline pricing activity could harm consumers by reintroducing fare regulation and raising fares.

Thus, there are risks to competition from intervening in the market, even if there is a need to protect airlines from unfair pricing practices, whether the practices emanate from bankrupt airlines or from other airlines. In our opinion it is crucial to first determine whether the pricing practices of the airline industry are unique and would thus warrant different treatment before giving consideration to changing airline pricing behavior or to changing the bankruptcy laws.

²¹Interlining arrangements are the traditional method by which airlines facilitate travel for passengers who must use more than one airline to reach their destinations. Interlining agreements between airlines allow the passenger to book passage on one airline for the first part of a trip, on a second airline for the second part of a trip, and on other airlines for subsequent parts of the trip.

CONCLUSIONS

Overall, deregulation of the domestic airline industry has benefited U.S. consumers and has made U.S. airlines more efficient competitors. Fares are lower and service is more frequent on many routes. U.S. airlines have become more efficient, and U.S. airline employees are among the world's most productive. Nevertheless, some firms in the industry face serious financial problems, and the long-term competitive health of the industry could be at risk. For its part, FAA, through more efficient allocation and use of its budgetary resources, can reduce airline operating costs and help the airlines improve their operating efficiency. In selecting solutions to the more systemic problems facing the industry, such as barriers to entry and access to capital, a well-designed, broad strategy that covers the elements we have outlined today is the best approach for improving the long-term financial status of distressed airlines and making them more effective competitors. Postponing action will dramatically narrow the range of options open to the Congress. Ensuring a competitive market will be much more difficult with fewer airlines in the marketplace.

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That concludes our testimony. We would be happy to respond to any questions you may have.

Table I.1: YEARLY AND CUMULATIVE NET INCOME/LOSSES OF MAJOR U.S. AIRLINES, 1987-92

Airline	1987	1988	1989	1990	1991	1992	1987-92 total
America West	\$(45.7)	\$9.4	\$20.0	\$(74.7)	\$(213.8)	(131.8)	(436.6)
American	207.6	449.5	423.1	(76.8)	(239.9)	(935.0)	(171.6)
Continental	(258.0)	(315.5)	3.1	(1,236.4)	(305.7)	(125.3)	(2,237.8)
Delta	217.5	344.5	473.2	(154.0)	(239.5)	(564.8)	76.9
Eastern	(181.7)	(335.4)	(852.3)	(1,115.9)	b	b	(2,485.3)
Northwest	140.7	162.8	355.2	(10.4)	(3.1)	(383.0)	261.4
Pan Am	(274.6)	(118.3)	(414.7)	(638.1)	(283.1)	c	(1,728.8)
Southwest	3.8	57.4	71.4	47.1	26.9	103.6	310.2
TWA	106.2	249.7	(298.5)	(237.6)	48.2 ^d	(239.8)	(371.8)
United	33.3	589.2	358.1	95.8	(331.9)	(956.8)	(212.3)
USAir	238.6	217.2	2.1	(410.7)	(305.3)	(1,230.0)	(1,488.2)
Total	\$187.9	\$1,310.5	\$140.6	\$(3,811.8)	\$(1,847.2)	\$(4,462.9)	\$(8,482.9)

Note: Losses are in parenthesis.

^aTotals may not add due to rounding.

^bNo data available. Eastern ceased operations in January 1991.

^cPan Am ceased operations in December 1991. Full-year 1991 and 1992 data are not available. 1991 data reflect January-through-September results.

^dTWA had an operating loss of \$353.5 million during 1991. Its net profit, therefore, can be attributed to the sale of three of its transatlantic routes to American Airlines for \$445 million.

Source: Compiled by GAO from data supplied by the Air Transport Association.

Table I.2: One-Time Charges for Compliance with Financial Accounting Standard 106

Airline	1992 net income(loss)	FAS 106
American ^a	\$(935.0)	\$595.0
Northwest	(383.0)	227.0
United ^a	(956.8)	540.0
USAir ^a	(1,230.0)	848.4
Total	\$(3,504.8)	\$2,210.4

^aData shown are for the holding company.

Source: Compiled by GAO from Air Transport Association data.

SELECTED INTERNATIONAL ROUTE SALES BETWEEN
MAJOR U.S. AIRLINES, 1986-92

Dollars in millions

Buyer	Seller	Route	Price ^a
American ^b	Eastern	Latin American system	\$471
	Trans World	3 U.S.-London routes	445
Delta	Pan Am	European routes	526
	Pan Am	New York-Mexico City	25
Northwest ^c	America West	Honolulu-Nagoya, Japan	15
	Hawaiian	Pacific routes	9
USAir ^b	TWA	2 U.S.-London routes	50
United ^b	Pan Am	Pacific routes	716
	Pan Am	U.S.-London routes	400
	Pan Am	Latin American system, Los Angeles-Mexico City	148

^aPrices were verified with the airlines that bought the routes. In some cases, the prices include related facilities and assets as well as international route authority.

^bPrice given includes related facilities and assets.

^cPrice given does not include related facilities and assets.

PERCENTAGE OF MAJOR U.S. AIRLINES'
SYSTEMWIDE REVENUE PASSENGER MILES (RPMS)
REPRESENTED BY INTERNATIONAL OPERATIONS, 1987 AND 1991

Airline	International operations as percent of total operations		Percentage change in international operations (in RPMS) ^a
	1987	1991	
America West	0.0	1.9	^b
American	12.8	21.6	139.5
Continental	16.3	27.3	73.9
Delta	9.4	15.3	145.3
Eastern	9.2	1.3	(99.3)
Northwest	35.1	42.3	60.7
Pan Am	79.8	71.5	(27.9)
Southwest	0.0	0.0	^b
TWA	36.7	35.7	(17.9)
USAir ^c	1.7	3.5	498.2
United	15.5	30.7	142.6
Subtotal: American, United, and Delta	27.1	45.5	142.0
Subtotal: Top three airlines in 1987	58.6	41.0	(1.0)
Subtotal: Top three airlines in 1991	39.3	56.1	105.6

^aAn RPM is a revenue passenger mile, i.e., one paying passenger carried one mile.

^bNot applicable.

^cUSAir's data reflects the airline's acquisition of Piedmont on November 5, 1987.

Source: Compiled by GAO from Department of Transportation data.

LONG-TERM DEBT AS A PERCENTAGE OF TOTAL CAPITALIZATION, 1986-90

Airline	1986	1987	1988	1989	1990	Average
Pan Am Corp.	99.0	132.3	151.1	272.9	^a	131.1
Eastern ^b	90.7	97.3	473.3	(52.9)	(21.8)	117.3
Continental ^c	97.3	85.4	96.3	96.3	197.2	114.5
TWA ^d	94.2	89.8	101.3	114.8	140.6	108.1
America West	81.5	89.0	86.9	84.5	96.7	87.7
UAL Corp.	45.8	32.7	62.7	46.1	42.8	46.0
USAir ^e	24.8	44.5	35.6	44.8	61.8	42.2
AMR Corp.	45.1	45.0	41.0	33.5	42.8	41.5
Southwest	35.3	29.5	35.6	33.4	31.4	33.0
Delta ^f	33.4	28.7	21.0	18.3	29.8	26.2
NWA, Inc. ^g	50.8	34.4	32.1			
Industry average ^h	56.8	54.6	53.6	56.2	73.6	

Note: For years for which no data appear, data were not publicly available.

^aPan Am's ratio of long-term debt to total capitalization was infinity in 1990.

^bDue to Eastern's bankruptcy, 1989 and 1990 data for Eastern are not comparable with earlier data for Eastern or with data for other airlines.

^cBefore December 31, 1986, Continental had \$653.9 million in liabilities subject to Chapter 11 reorganization proceedings.

^dTWA's data for 1986 and subsequent years reflect the airline's acquisition of Ozark on September 15, 1986.

^eUSAir's data for 1987 and subsequent years reflect the airline's acquisition of Piedmont on November 5, 1987.

^fDelta's data for 1987 and subsequent years reflect the airline's acquisition of Western on December 18, 1986.

^gNWA, Inc., was acquired by Wings Acquisition, Inc., on August 4, 1989. Consequently, company reports for NWA, Inc., are not available for 1989 and subsequent years. NWA's data for 1986 and subsequent years reflect the airline's acquisition of Republic on August 12, 1986.

^bIndustry average data include data for Ozark, People Express, Piedmont, Republic, and Western until their respective mergers.

Source: Julius Maldutis, The Financial Condition of the U.S. Airline Industry at Year-End 1990, Salomon Brothers (New York: June 1991), p.8, fig. 10. Data are drawn from company reports.

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