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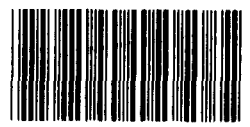
Testimony

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DOT Airline Industry Oversight

Statement of
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Before the
Subcommittee on Transportation
Senate Committee on Appropriations



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Mr. Chairman and Members of the Subcommittee:

We appreciate this opportunity to comment on the Department of Transportation's (DOT) oversight of the airline industry. Since 1985, when DOT inherited oversight responsibility from the Civil Aeronautics Board (CAB), a series of airline mergers has increased concentration in the industry. There is growing concern that this increased concentration could result in higher fares for many airline travelers and could adversely affect the quality of airline service.

In response to these concerns, you and the Chairman of the Subcommittee on Oversight and Investigations of the House Energy and Commerce Committee asked us to examine DOT's airline oversight activities.

We focused on three questions.

- How has DOT developed and implemented its policy for approving airline mergers?
- What has DOT done to protect airline passengers from unfair and deceptive trade practices?
- How has DOT maintained data bases needed to oversee the airline industry?

While our work is not complete, we have found the following:

- DOT developed its merger policy based on dated assumptions about competitive conditions in the airline industry. It has approved 20 mergers based on this policy. In the most recent merger case, however, the department considered newer assumptions that better reflect the realities of today's concentrated industry.
- While DOT has provided a clearinghouse for consumer complaints, it has not always focused its limited investigation and enforcement resources on the most important consumer concerns.

-- The unsuccessful transfer of airline data bases to the Transportation Systems Center reduced the accuracy and timeliness of important industry data.

In conducting this review, we interviewed DOT, former CAB, and airline officials, industry experts, state law enforcement officials, and consumer affairs advocates. We examined DOT's statutory authority and relevant merger and enforcement cases, and we reviewed economic and legal literature on the airline industry.

BACKGROUND

In 1984, the Congress passed the CAB Sunset Act to clarify where some of the remaining CAB regulatory functions would go when the Board was abolished in 1985. The act gave DOT, rather than the Department of Justice¹, authority to approve mergers because of DOT's specialized knowledge of the transportation industry. The Department also received CAB's authority to investigate and enforce rules against unfair and deceptive trade practices. In addition, the Congress reiterated the requirement that DOT collect data on airline operations CAB had previously collected.

DOT'S DEVELOPMENT OF ITS AIRLINE MERGER POLICY

To approve airlines' applications to merge, DOT used the same assumptions about the airline industry that CAB developed in 1979. From 1978 to 1985, however, fundamental changes in the industry caused many persons, including former CAB officials who first developed the assumptions, to question whether they continued to

¹. The Airline Deregulation Act of 1978 had originally specified that this authority would be given to the Department of Justice when CAB was sunset. DOT's merger authority expires in January 1989, and the Department of Justice will assume responsibility for airline industry mergers.

apply to the airline industry. DOT used these assumptions in approving 20 mergers between 1985 and 1987. In 1987, DOT began to examine alternative views of the industry.

CAB's Merger Policy

Airline mergers were subject to the Board's jurisdiction under 49 U.S.C. §1378. This statute prohibits mergers whose effect may be to substantially reduce competition. In developing a standard to use in evaluating mergers, CAB relied on what was then a relatively new economic theory known as contestability. Contestability theory focuses on the role of potential competitors, as opposed to existing competitors, as a force that restrains the ability of an incumbent firm to charge monopoly prices. This theory assumes that if a market is contestable, a merger among major competitors will not have a substantial negative effect because the threat of potential entrants will keep prices competitive.

When applied to deciding if a merger is anticompetitive, this theory suggests that the analysis of the merger should focus on (1) barriers that make it difficult for firms to enter or exit the industry and (2) how quickly incumbents can adjust their prices to meet competition. Consequently, if barriers to entry are high and/or incumbents can quickly change prices, the market is assumed not to be contestable.

In its review of the Texas International - National Airlines merger application, CAB assumed that most airline markets were contestable. The Board noted that it was relatively easy for a new

airline or an existing carrier to expand service into a new market. In CAB's view, the major barrier to entry, government regulation, had been removed. However, CAB's merger decisions identified concerns about applying the theory without adequate consideration of market structure. Further, a former CAB official told us that CAB intended to adjust the application of this theory as it gained more experience with a deregulated airline industry.

Fundamental Changes Have Occurred
in the Airline Industry

By 1985, when DOT assumed merger oversight responsibilities, the airline industry had undergone fundamental changes which may have affected the industry's contestability. For example, airlines had adopted the hub and spoke route system. This system allows an airline to efficiently combine passengers from "spoke" cities at the "hub" and offer more frequent and attractive service to more destinations. In 1986, DOT economists pointed out that a strong hub and spoke network can also make the incumbent airline virtually invulnerable to competition from another airline. Similarly, representatives of several major airlines told us that they believed an airline could only enter and compete at another airline's hub with service from its own hub.

Since deregulation, airlines have developed competitive tools such as frequent flyer programs and computerized reservations systems. Many industry analysts believe that frequent flyer programs make entry more difficult and that computerized reservations systems allow incumbents to rapidly respond to entry. For example, many industry analysts believe that frequent flyer

programs make it hard for a new entrant to attract passengers away from an incumbent. This may be particularly true if, in the case of an airline with a hub, the incumbent offers many, potentially attractive, destinations. Many analysts also believe that computerized reservation systems allow incumbents to make rapid price adjustments in response to potential entry.

These changes led former CAB officials, who first applied the theory of contestability to airline markets, DOT economists, and airline industry analysts to challenge the assumption that airline markets were contestable.

DOT's Merger Policy

Between 1985 and 1987, DOT reviewed and approved 20 merger applications. In implementing its merger policy, DOT attorneys, who developed and wrote the decisions, assumed, as had CAB, that airline markets were contestable. The Deputy Assistant Secretary for Policy and International Affairs told us that, despite concerns by DOT analysts about continuing to apply the contestability theory to the airline industry, an analysis of the applicability of the theory was not undertaken.

In 1987, DOT, in the USAir-Piedmont case, considered for the first time, the barriers to entry, such as frequent flyer programs and computerized reservations systems, that many analysts believed make the application of the theory of contestability to the airline industry questionable. After reviewing evidence submitted by merger opponents and DOT's Public Counsel, the Administrative Law Judge determined that barriers to entry made the relevant market

not contestable. Therefore, he found that the merger would be anticompetitive and recommended not approving it. The department reviewed his decision, concluded that it was not supported by the evidence, and approved the merger.

As a result of these mergers, concentration in the airline industry increased during the mid-1980's. In 1978, prior to deregulation, the five largest carriers controlled 69 percent of the market. By 1985, their market share had fallen to about 57 percent. As of November 1987, these carriers controlled 74 percent of the market. (See attachment I.) New entrants have seen their market share rise from nothing in 1978 to almost 6.5 percent in 1985, only to see it fall to less than 2 percent by November 1987. (See attachment II.) Several economic studies have shown that high concentration along city pair routes is associated with higher fares. At the request of the Ranking Minority Member of the Senate Committee on Commerce, Science and Transportation we are studying the effects of concentration on airline prices and services.

While we did not evaluate the correctness of individual merger decisions, we believe that merger analysis should include the full range of factors affecting entry in the airline industry, such as computerized reservations systems and frequent flyer programs. Although DOT did not consider these barriers in its initial cases, the USAir-Piedmont merger indicates that the department considered a fuller range of factors affecting entry. Under the CAB Sunset Act, the Department of Justice will assume responsibility for airline mergers in January of 1989. In view of

the increasing concentration in the industry, we would look for a fuller debate about these issues to continue.

CONSUMER PROTECTION ACTIVITIES

DOT has a number of regulations intended to protect airline consumers. These regulations address, among other things,

- unrealistic or deceptive scheduling,
- liability for lost or damaged baggage,
- payment and processing of requests for refunds,
- compensation for passengers who are denied a seat on an airplane, and
- charter operations.

The responsibility for implementing these regulations is split into three units.

- The Consumer Affairs Division, in the Office of Consumer Affairs, employs 13 people who receive and handle individual consumer complaints. It refers those complaints that appear to be patterns of violations of the regulations to the Investigations Division.
- The Investigations Division, also in the Office of Consumer Affairs, has a staff of four who look for trends in consumer complaints, and investigate allegations of unfair and deceptive trade practices. They also perform investigations at the request of both the Consumer Affairs Division and the Office of Aviation Enforcement and Proceedings.
- The Office of Aviation Enforcement and Proceedings, in the Office of the General Counsel, is staffed by eight attorneys who enforce the Department's consumer affairs rules as well as perform other duties.

Our preliminary work has found that while DOT does provide airline consumers with a process to have complaints heard and addressed, it has not always used its limited investigation and enforcement resources on the most important consumer issues.

Consumer Affairs Division

The Consumer Affairs Division resolves complaints received from the public by working with the carriers and the consumer. In 1987, the Consumer Affairs Division received almost 45,000 complaints--a record number. In contrast, its 1986 workload was almost 13,000 cases. (See attachment III.) Of the 45,000 complaints, over 18,000 were concerned with flight problems such as cancellations and delays. Other major complaint categories included baggage, customer service, refunds, ticketing, and overbooking. (See attachment IV.)

We found that the department does not systematically follow-up on the cases they handle to ensure that consumers were satisfied by DOT's actions. Rather, they rely on consumers to call back if a problem has not been resolved by the airline. Further, although DOT regularly publishes consumer complaint data we found that they have no random validation procedures to ensure that the information they receive contains no spurious complaints.

Investigations Division

The Investigations Division examines matters referred to it by the Office of Aviation Analysis, the Office of International Aviation, the Consumer Affairs Office, and the Office of Aviation Enforcement and Proceedings and performs self-generated work. Division records indicate it closed 212 cases in 1987. (See attachment V.) The largest number of cases, 57, were checks of persons holding or applying for authority to provide airline service and were not related to the consumer complaints being

received. Approximately 51 of their 212 cases in 1987 and 96 of their 118 cases through mid-February of 1988 involved Superbowl package tour advertisements. Although this work was initiated by the Investigations Division, there were no consumer complaints about such tour packages, and only a few violations were uncovered.

While it is responsible for spotting patterns in consumer complaints, the Investigations Division did not act on a pattern in the area of refunds. Specifically, in 1987, the division received 35 refund cases, about 15 percent of its total caseload. Of these, 28 involved one company. However, since this company would offer refunds when the department asked, the division did not pursue the matter any further. Independently, in late 1987, the Federal Trade Commission shut down this same company and froze its assets for fraudulent activity.

Office of Aviation Proceedings and Enforcement

The Office of Aviation Proceedings and Enforcement obtained 26 consent orders and collected fines totaling almost \$900,000 in 1987. (See attachments VI and VII.) This was the first time since DOT assumed responsibility for consumer protection in 1985, that the office dealt with complaints similar to those received by the Consumer Affairs Division, such as denied boarding compensation and refunds. In contrast, in 1986, the office collected \$137,000 in fines and handled only seven cases, five of which were not related to consumer protection, while the remaining two involved violations of DOT's charter rules.

Other Consumer Protection Issues

In addition, our work to date has also identified problems with (1) potentially ineffective action in a key enforcement decision, and (2) coordination with the states in addressing important consumer issues. As noted previously, flight problems, such as delays, have been a major consumer concern. However, as part of a special investigation into airline scheduling delays by the Office of the Secretary, the department negotiated a performance standard below that already being achieved before the settlements. As a result, the airlines in these settlements can have late flights up to 50 percent of the time over a 3 month period at the affected airports without incurring any penalties. At the time of the settlement the affected airlines' late flight average was below 50 percent. Further, the settlement only covered 6 airlines at 4 airports, or about 10 percent of all domestic flights.

State Attorneys' General are receiving an increasing number of complaints about the airline travel industry. In response, the National Association of Attorneys General promulgated guidelines which were intended to address complaints in the areas of deceptive advertising, frequent flyer rules, and denied boarding compensation. Although DOT has opposed a number of the guidelines on the basis of federal preemption of state law, the complaints received at the state level could be used by the department for enforcement and industry compliance efforts, especially given the small number of DOT staff assigned to investigate unfair and

deceptive trade practices in the airline industry. The Federal Trade Commission, for example, relies on information received from the states for its enforcement activity.

AVIATION DATA BASE TRANSFER

DOT's aviation data bases contain information on traffic volumes, fares, airline operations and finances, and airport use. This information is used to allocate money from the Airport and Airway Trust Fund, manage the Essential Air Services program, decide merger and international route cases, and forecast traffic.

In 1986, the Research and Special Programs Administration (RSPA) began to move the aviation data bases from the Office of Aviation Information Management (OAIM) in Washington, D.C. to the Transportation Systems Center (TSC) in Cambridge, Massachusetts. RSPA said that this move would enable DOT to recoup money for data base access from users of the data bases and would make the data bases self-sustaining. In a March 27, 1987 report on the then pending move², we noted that RSPA had not completed plans for the move but had given its commitment to meeting the concerns of users that the move not reduce the quality or timeliness of the data bases.

The move to TSC was unsuccessful. Our work to date has revealed several reasons.

- Planning to guide the transfer was inadequate.
- Staff experienced in managing the data bases did not want to move and left DOT.

2. Aviation Information: Movement of Personnel and Data Bases, GAO/RCED-87-116FS, March 27, 1987.

- Replacement staff did not receive adequate training.
- DOT's computer operating system was changed before the data base programs could be rewritten to run on the new system.

As a result, the reliability of the data bases suffered. For example, data used to allocate \$500 million to airports from the aviation trust fund was sent to the FAA without information for several carriers for entire quarters, thus understating the number of passengers who had flown from certain airports. An FAA employee discovered the error in time to correct the problem before funds were misallocated.

Data timeliness also suffered. The data used in industry analysis fell three quarters behind schedule and data for the fourth quarter of 1986 had to be completely reentered.

In order to correct these problems and improve service to data base users, DOT has transferred the data functions back to OAIM. Progress is being made on bringing the data bases up to date and improving their accuracy.

CONCLUSION

In conclusion, we believe our work suggests several ways in which DOT could improve its industry oversight functions. With respect to merger approval, we believe that it would have been more consistent with DOT's role as an expert agency if it had critically examined, at an earlier juncture, the assumptions it was using about the contestability of the airline industry, and factors that affect entry such as computerized reservations systems, frequent flyer programs, and hub and spoke systems. Responsibility for

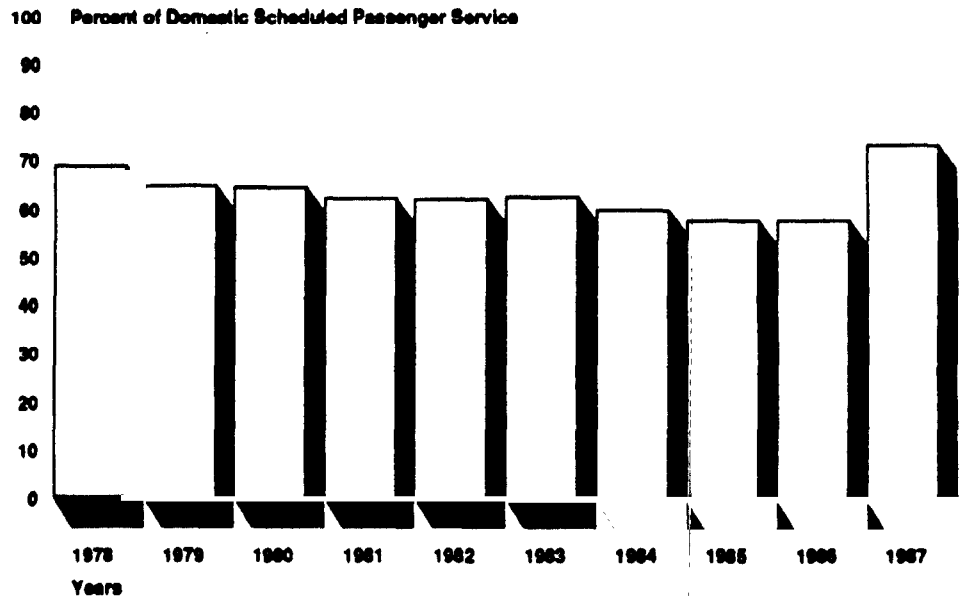
merger approval will pass to the Justice Department in January 1989. Because of fundamental changes in the airline industry, future merger decisions, which could further concentrate the industry, will need to consider these factors.

In the consumer affairs area, we found that the department does provide a clearinghouse for airline consumer complaints, and that recent enforcement actions appear to be more closely linked to the complaints received in the Consumer Affairs Division. Our work suggests, however, that the department could ensure its effectiveness and improve the use of its limited resources by (1) following up on consumer complaints to make sure they are resolved, (2) focusing its investigation resources on major consumer concerns, and (3) using all available resources, including those available from the state attorney generals' offices, to obtain information on consumer concerns.

While the department's unsuccessful attempt to transfer its aviation data bases to TSC reduced data accuracy and timeliness, our experience suggests that the department has taken the right step by returning control of the data bases to DOT headquarters in Washington.

This concludes my prepared statement. I will be pleased to respond to any questions you may have.

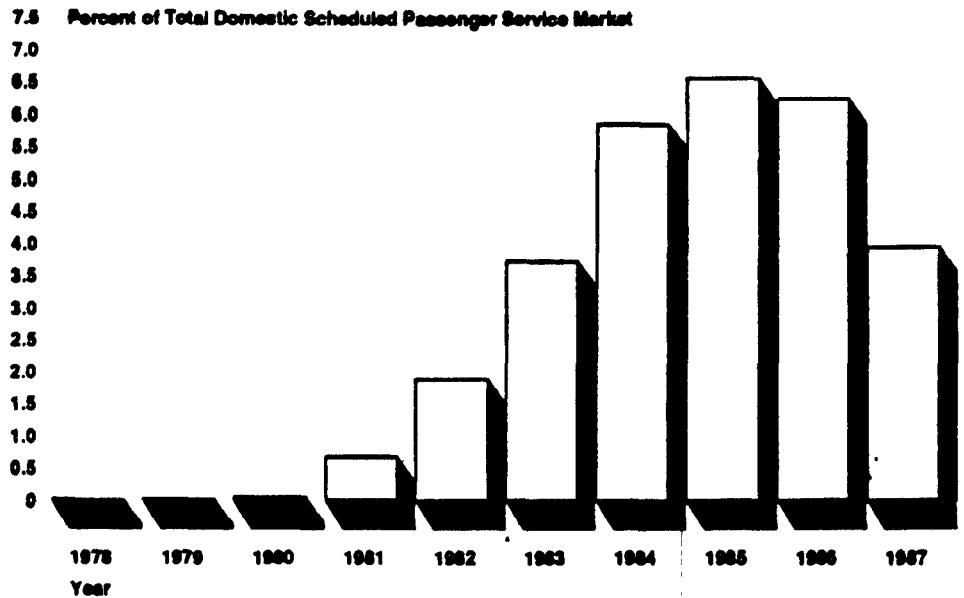
Market Shares of the Largest Five Airlines 1978-1987



1987 figures include Continental and Eastern as one entity. If they are counted separately the largest five airlines account for 65.5 percent of the domestic scheduled passenger market for 1987.

Source: DOT Air Carrier Traffic Statistics 1978-1987

Market Shares of New Entrants 1978-1987

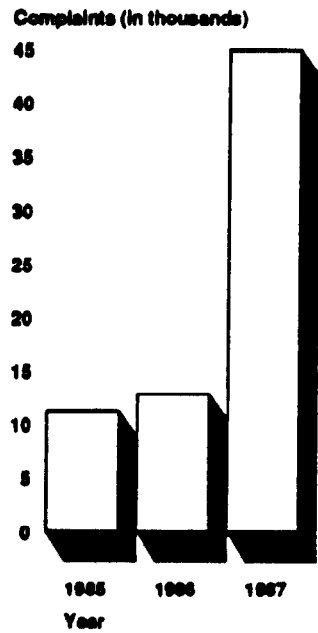


Source: Market share percentages for the years 1978 to 1986 based on December year-end data in DOT's Air Carrier Traffic Statistics.

Market share percent for 1987 based on November 31, 1986 to November 31, 1987 data in DOT's Air Carrier Traffic Statistics.

Note: Based on November 1987 data in DOT's Air Carrier Traffic Statistics new entrants now account for 1.91 percent of the domestic scheduled passenger service market.

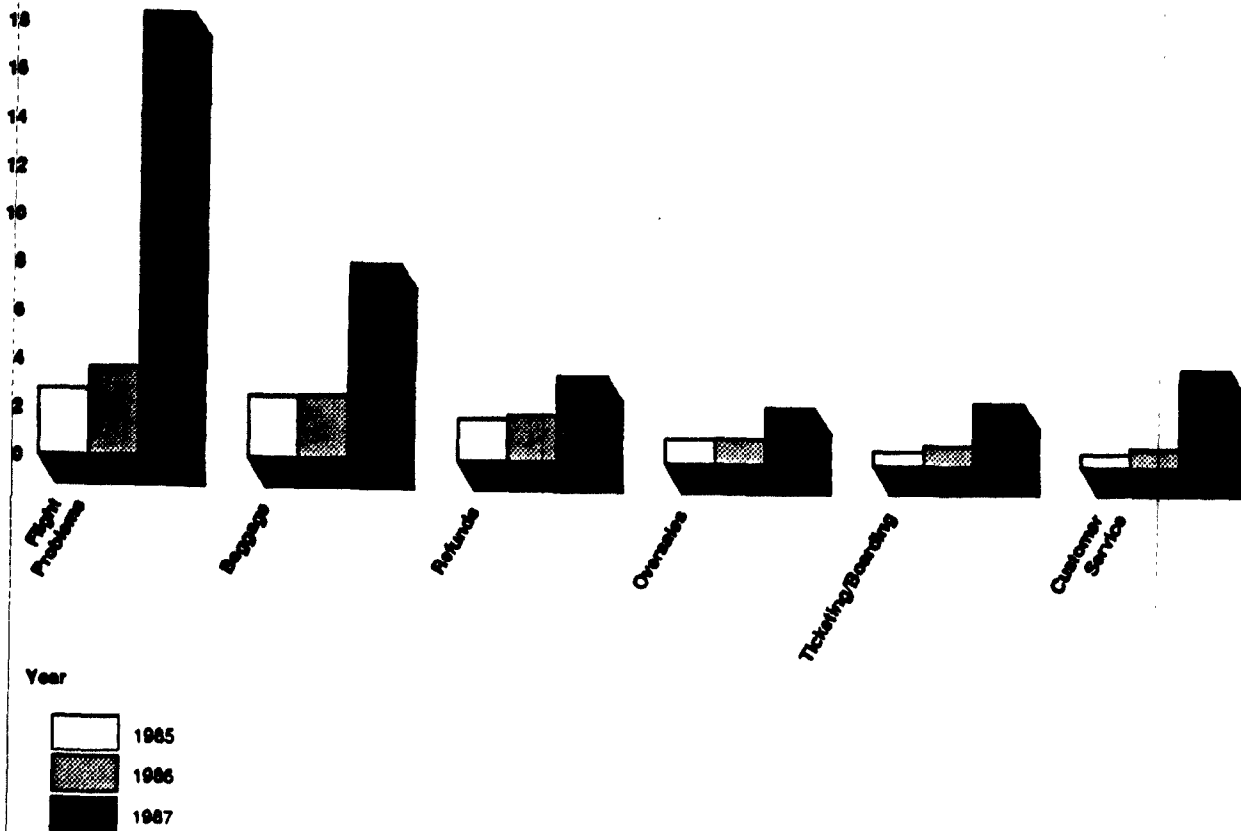
**Airline Consumer
Complaints 1985-1987**



Source: DOT Office of Consumer Affairs

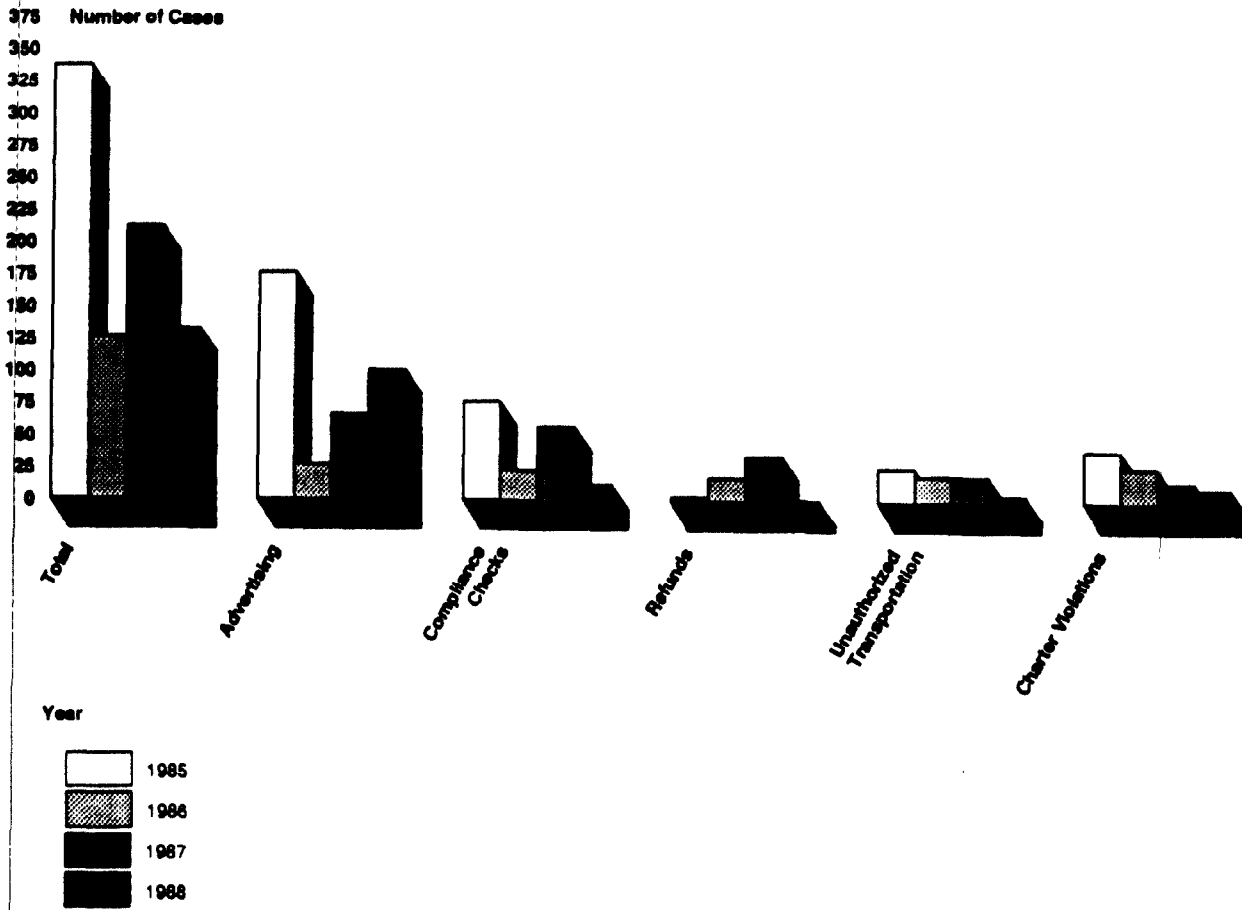
Breakdown of Consumer Complaints 1985-1987

Number of Complaints (in thousands)



Source: DOT Office of Consumer Affairs

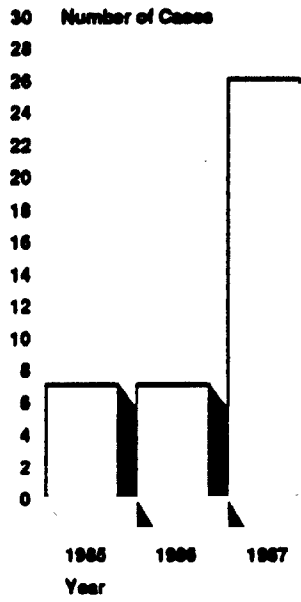
Caseload - Investigations Division, DOT Office of Consumer Affairs



Note: 1988 figures through 2-12-88.

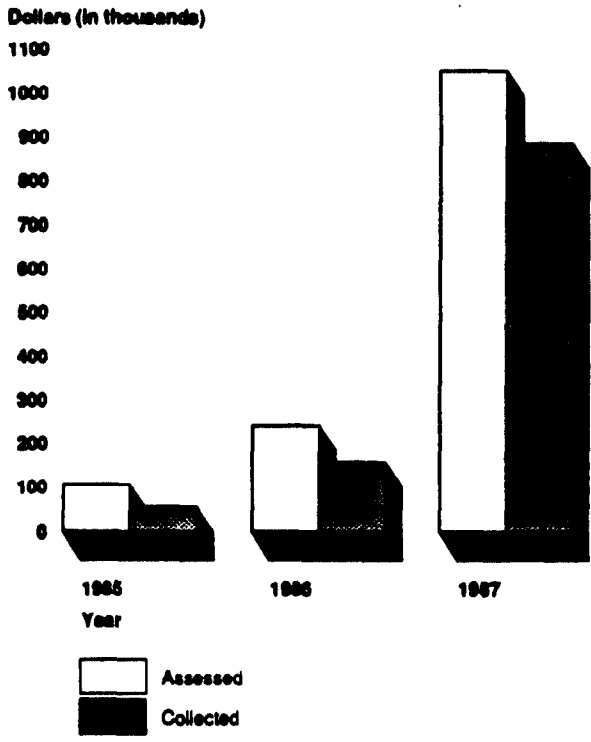
Source: Investigations Division, DOT Office of Consumer Affairs

Caseload - DOT Office of Aviation Enforcement and Proceedings



Source: DOT Office of Aviation Enforcement and Proceedings

**Fines Assessed and Collected: DOT
Office of Aviation Enforcement and
Proceedings**



Source: DOT Office of Aviation Enforcement and Proceedings