

State Of the U.S. Commercial Airline Industry and Possible Issues for Congressional Consideration

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I appreciate the opportunity to speak before the distinguished members and guests of the International Aviation Club of Washington. It is indeed an honor and a privilege to address you.

For those of you who don't know me, I'd like to note that I have a long association with the industry, both on a professional and a personal basis. The most significant or notable professional experience comes from my tenure as head of the PBGC during the 1980s. In that capacity, I had significant dealings with the airline industry, in general, and with distressed airlines, in particular.

On a personal note, my wife Mary—who's here today—has worked in the industry for 31 years. She is a flight attendant with Delta. This is her final week, as she is retiring on December 1. I have to add that she was flying out of Boston on the morning of September 11 on a 757 headed to the west. It was a very long hour for me before I learned that she was not on either of the two Boston 757s that struck the World Trade Centers. In the meantime, I had to focus on the more than 3,000 GAO and Army Corps of Engineers employees in our headquarters building.

Some of you may not be familiar with the agency that I lead. The U.S. General Accounting Office, better known just as GAO, is in the legislative branch of government. Our mission is to help the Congress maximize the performance and assure the accountability of the federal government for the benefit of the American people. Simply stated, we try to make government work better for all Americans.

At GAO, we are uniquely positioned to focus on longer range and cross-governmental issues, including ways to improve the economy, efficiency and effectiveness of the federal government. Our scope includes everything the federal government is doing or thinking about doing anywhere in the world, from taxes to transportation, national security to Social Security, and health care to human capital.

Our audits, investigations, evaluations, policy analyses and legal services can also include reviews of key sectors of the economy, including the commercial airline industry. In this regard, the Congress has had a long-standing interest in the functioning of the industry, while it was regulated by the Civil Aeronautics Board and since the industry was deregulated in 1978. The Congress has been particularly active in connection with airline industry issues in the aftermath of the tragic events of 9/11, and GAO has been there to help.

As some of you may know, GAO was actively involved in Congressional deliberations that led to the Act which established the Air Transportation Stabilization Board. We testified on September 20 on overall principles for federal assistance. On the basis of GAO's institutional experience with other assistance programs (e.g., Chrysler, NYC), these principles included:

The need to get a clear understanding/definition of diverse challenges confronting industry (e.g., separate effects of economic downturn from actions by the federal government on Sept. 11-13 to close the National Air Space)

The need to identify the best tools for addressing distinct problems (e.g., grants vs. loan guarantees vs. other federal intervening mechanisms)

The importance of designing appropriate mechanisms to protect federal government and taxpayers

- o suggested oversight board
- o discussed possible structure of assistance and eligibility and evaluation criteria

Of course, my reward for these efforts was to be tapped as a member of the Stabilization Board—a non-voting member. I don't believe that any the Board's members sought the honor of this appointment. GAO's position was that, if the Congress wanted to include me on the Board, it should be as a non-voting member. This was appropriate for both our institutional independence as well as my personal time management.

Having said that, I need to note that I am not speaking for the Board, and today's comments represent my personal perspectives on selected key challenges facing the airline industry.

It's appropriate that I make a few comments about the events of 9/11 first.

- September 11 served as a wake-up call for all Americans. We're now in a world that is very different from what it was on September 10. As citizens and as a country, we realize that we are going to have to do things differently.
- We will need to be more vigilant and in some cases, like at airports, more patient as we conduct our affairs. At the same time, we must get on with our lives and not live in fear.
- While many have been affected by the events of 9/11, the airline industry has been one of the most seriously impacted. Clearly, it is in the national interest to have an aviation industry that is vibrant, stable, efficient, and competitive. The real questions are: What is the best way to accomplish this, and what should be the proper role of government in the industry's future?

As you all know, industry profitability has been cyclical over time and negative since 9/11.

- Between 1990 and 1992, major U.S. carriers lost about \$10 billion. All but one major airline reported losses. Three major carriers—Braniff, Eastern, and Pan Am—went out of business and three others—TWA, Northwest, and Continental—entered bankruptcy proceedings.
- In 1992, Congress established the National Commission to Promote a Strong and Competitive Airline Industry. The commission made recommendations concerning FAA's structure, the airline industry's financial health, and foreign ownership limits.
- Between 1993 and 1999, nearly all major U.S. carriers reported annual operating profits.
- Most major airlines also reported net operating profits during each quarter of calendar 2000.

The events of 9/11 accelerated and aggravated negative financial trends already evident in the airline industry. That is, the industry was experiencing major net operating losses before 9/11. Over the long run, the airline industry must be profitable to sustain its financial health. Without profits, cash will not be generated internally and industry access to the capital markets will be

limited. As we all know, net income is important, but cash flow is key!

In order for the industry to return to profitability, several steps must be taken to (1) increase consumer demand for air travel, especially business travel, (2) control costs, and (3) address certain pricing issues. In addition, certain other public policy issues should be considered. More on this later.

The Congress has enacted and the President has signed into law several measures aimed at helping us to recover and respond to terrorist attacks. All are necessary, but all will cost money. The most recently visible, important piece of federal legislation is the landmark airline and airport security bill that the President signed on November 19. That bill is an important part in overall efforts to restore consumer confidence and for alleviating travelers' apprehension about flying.

Two other acts certainly merit attention:

Congress provided \$40 billion for the federal response to the terrorist attacks, including funds for increased transportation security.

Congress passed the Air Transportation Safety and System Stabilization Act, which provided a means to stabilize the industry at a time when it was financially reeling. This act provided a framework for federal financial assistance, including:

- o \$5 billion in direct compensation,
- o up to \$10 billion in loan guarantees,
- o insurance assistance, and
- o liability protection

There are critical differences between the types of assistance. The \$5 billion is to compensate the carriers for direct losses associated with the federal action taken on 9/11 and for incremental losses accrued during the remainder of the calendar year.

Of the \$5 billion, DOT has issued approximately \$2.4 billion to 112 air carriers. DOT plans to release another \$1.75 billion in the near future. (No time is certain yet.)

GAO reviewed whether the \$5 billion figure was reasonable and found that, in the aggregate, it was. We also reported that, given the formula under the act, questions would arise regarding how to deal with industry segments (e.g., cargo) and carriers who do not incur losses equal to or in excess of their applicable caps. My own observation is that there are no procedures for any reallocation of funds associated with carriers whose losses may not reach their caps; therefore, I suspect that the entire \$5 billion will not necessarily be disbursed.

GAO has also been asked to assess whether actual losses incurred by major individual carriers through December 31 equal or exceed individual grant amounts to those carriers, as well as reasonableness of amounts claimed by airlines for insurance premium increases. We expect to answer these questions with a report in the summer of 2002.

The purpose of the loan guarantees is to assist air carriers who suffered incremental losses due to the terrorist attacks of 9/11 and to whom credit is not otherwise reasonably available. The Stabilization Act established the Air Transportation Stabilization Board to oversee the loan guarantee program. Along with the Chairman of the Federal Reserve Board and the Secretaries of Transportation and Treasury, I am a member of that Board. However, as previously noted, I am the only non-voting member.

The other Board members so far have delegated their day-to-day responsibilities to other staff members. I have not done so because, as the only non-voting member of the Board, I will not be involved in the review of individual carriers' applications for loan guarantees. All decisions regarding the Board's criteria, processes, approvals, and terms and conditions will be made only by the Board's three voting members. This is appropriate because such decisions should be made by executive branch officials.

Several major events have occurred to date:

- OMB issued final regulations for the loan guarantee program effective October 12, 2001
- Applications are being made available by the Treasury Department
- America West has applied for a loan guarantee

The Board also has to protect the interests of the federal government and American taxpayer. It is authorized to determine first whether to approve a loan guarantee and, if so, what terms and conditions will attach to the federal credit instrument. The Stabilization Act requires the Board to ensure that the government is compensated for its risk in assuming guarantees and authorizes the Board to enter into contracts under which the government would participate in any equity gains.

There are major challenges concerning the Board's decision-making and actions. **Let me emphasize again that this is only my personal view and not that of the Board!**

One obvious and critical policy question that the Board will have to face concerns the issue of how to define when a carrier has access to credit on "reasonable terms." What does that mean?

Another key policy question involves the more philosophic question of how the Board might look at applications from different carriers. One possible framework that might be useful is to think of the industry as divided into three categories of carriers, on the basis of their current financial health and long-term viability:

- Category 1: carriers that were viable before 9/11 are still viable after 9/11 and can obtain commercial credit on reasonable terms
- Category 2: carriers that were viable before 9/11, but are considerably worse off financially since then. These carriers may not be able to obtain increases to credit on reasonable terms but may be able to provide reasonable assurance to the Board that any guaranteed loan would be repaid.
- Category 3: carriers that were facing significant financial challenges before 9/11 and that may be facing extreme financial challenges now. These carriers may not be able to obtain access to credit on reasonable terms, and may not be able to provide a reasonable assurance that the loan would be repaid.

It is unclear at this time what impact the loan guarantee program might have on the airline industry's competitive structure. The Board should carefully consider the possible impact on competition of its actions. It should not pick winners and losers. Rather, the burden should be on the carriers to demonstrate that they are in category 2.

GAO's role is not just oversight, but insight and foresight. In fact, I consider GAO's competitive advantage to be looking at longer range and cross-cutting issues. The GAO Strategic Plan identifies broad themes and trends such as increasing globalization, changing security threats, and a range of quality of life issues.

Thus, there is a place for GAO in raising broad issues for possible congressional consideration. I would offer the following:

Commercial aviation seems to be at a critical juncture in its history. The structure and relative competitiveness of U.S. commercial aviation is unlikely to resemble what existed prior to 9/11. Why?

- Major pressures on the industry for consolidation and cost control
- Possible long-term shift in demand – particularly by critical business travelers

Any such major structural upheaval will raise a number of business issues for carriers and public policy issues for consideration by the Congress.

The maintenance and application of economic merger analysis for domestic and international mergers, consolidations, and alliances. Public policy needs to be guided by sound principles. It is important to examine the substantive effect that mergers and alliances may have on competition in general and on consumers in particular. International alliances may have a somewhat different form than domestic mergers, but may have the same substantive effect on competition and thus appear to merit similar review and oversight. In general, I am a believer in a substance versus form doctrine.

Government needs to continue its reviews of various consolidations, using sound, traditional economic-based merger analysis. It should do so at all times, including times when the industry is experiencing financial difficulties.

The Transportation Research Board's 1999 report on Entry and Competition in the Airline Industry recommended that all collaboration plans among major U.S. airlines be subject to traditional, economic-based merger analyses by the Dept. of Justice. Clearly, both DOT and Justice need to be involved in this analysis. However, who should be in charge?

TRB also recommended that Justice have distinct approval authority with international aviation agreements, in addition to the approval authority vested with DOT.

GAO is completing work on the potential impact on competition of the proposed international airline alliance between American and British Airways. The key issues concern the extent of the potential benefits to consumers and how those can be weighed against the potential competitive harm. We expect to issue our report on this issue in the near future.

Controls on the exercise of market power at major hubs. Congress may want to examine new approaches to large market shares at major airline hubs. As you know, the Senate took up this question last spring with S. 415. In general, we agreed with the overall thrust of that legislation—to increase competition in the market, especially at dominated hubs—but raised a number of concerns that it may not achieve its intended results.

A related issue is how a restructured industry will serve smaller communities. In many communities, airlines have reduced the amount of service they provide via their regional affiliate carriers. How should these communities be connected to the national network? How much air service is truly needed vs. wanted in connection with these communities?

GAO has work underway on the issue of small community service. Since the terrorist attacks, we have re-designed that work and expect to issue the first of a series of reports on air service to smaller communities at the beginning of 2002.

Pricing and allocation policies for slots at congested airports. The events of 9/11 provided a respite from the congestion that plagued the industry over the past several years. Even with sharply reduced forecasted growth, most believe that traffic will eventually return to pre-9/11 levels. The only question is when. That means that congestion will return.

There are real limits to the extent to which FAA can alleviate congestion—especially at key selected facilities—through current air traffic control technology and adding additional runways at existing airports. However, in addition to its management of air traffic and airport development, FAA policies and actions also affect competition and congestion.

Moreover, current FAA restrictions on airport pricing and policies for allocating slots at congested airports have adverse effects on competition. For competition to be healthy, new airlines have to have the ability to enter and compete in key markets. Current slot controls at major U.S. airports have long represented major barriers to entry for new carriers. The government may need to take a serious look at how access to those key facilities is provided.

Restrictions on foreign ownership and operation of U.S. based airlines. We live in a global economy, with global enterprises. We need to look at issues differently now—with a global framework. We are sensitive to the legitimate security concerns raised by the idea of foreign ownership of U.S. airlines and airlift capacity. Particularly in these times!

However, to a certain degree, our airlines are already international carriers, operating with foreign partners in international service. Now, it may be time to raise the question of whether to ease—not eliminate—the limits on foreign capital. To induce new competition into domestic markets or, in the event of a financial failure of a large airline, to provide the capital needed for a competitive large network of airlines, the U.S. might need to reexamine current limits on foreign ownership.

Access to new sources of capital could allow weaker U.S. carriers to reduce debt costs, invest in new aircraft, and compete more effectively.

Federal law and policy limits foreign investment in U.S. airlines to 25 percent of the voting stock and limits foreign investors' ability to elect members of boards of directors and other key officers.

GAO has a long history of involvement with, and analysis of, key issues in the deregulated commercial airline industry. This includes issues relating to safety, security, airports, air traffic control, and domestic and international airline competition.

In the past year, GAO reported on the proposed merger between United and US Airways and on American's acquisition of TWA. We reported on how changing ticketing rules regarding back-to-back and hidden-city ticketing may affect consumers, especially in smaller communities. We testified on consolidation in the industry, and the possible exercise of market at major airline hubs.

We will continue do to our part to help Congress make timely and informed judgments on key issues.

I thank you for your time and attention and would be happy to answer your questions.



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