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Airline Competition: Impact of FAA Reauthorization Legislation on Passenger Facilities Charges and Trust Fund Spending

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Mr. Chairman and Members of the Commission:

We appreciate the opportunity to testify today on our work on airline competition and on the implications of proposed FAA reauthorization legislation for enhancing airline access to airports. The California legislature has recently considered a series of bills aimed at improving access to major airports in the state, and the Congress is also concerned about whether there is sufficient competition among the airlines at the nation's major airports. This problem of competitive access to many major airports has been an important focus of GAO work for several years. We recently completed a national airport survey that examined the availability of gates and the ability of airports to build new gates to accommodate airlines that want to start up service at the airport.

In addition to briefly reviewing our recent work on airline competition in our testimony today, we will address several provisions of the proposed reauthorization legislation (H.R. 5170). This bill addresses the problem of inadequate capacity to accommodate new entry and seeks to provide means to expand aviation system capacity. Our testimony today focuses on our findings on airport access and addresses approaches to expanding airport capacity as advanced in H.R. 5170. Our principal points are:

--H.R. 5170 authorizes the Secretary of Transportation to grant airports the authority to levy passenger facility charges (PFCs) on travelers using the airport. Although it is not a panacea for competition and capacity problems at the nation's airports, airports could use this independent source of funds to expand capacity to accommodate new entry.

--Legislation authorizing PFCs must be carefully structured so that new facilities built with PFC revenues are readily accessible to potential new entrants.

--H.R. 5170 also authorizes more spending on airports and airways by accelerating spending from the uncommitted balance in the aviation trust fund for air traffic control modernization, for airport development, and for FAA operations and systems maintenance.

OVERVIEW OF GAO WORK IN THE AIRLINE COMPETITION AREA

For several years, GAO has been actively studying airline industry competition, especially the relationship between fares and market dominance. Our principal reports and testimonies on airline competition are listed in Appendix I to this testimony. Our work indicates that while deregulation still benefits many American travelers, a growing trend toward reconcentration exists

in the industry, with the major airlines establishing dominant positions at key airports around the nation.

Indeed, through various strategies, such as frequent flyer programs, ownership of the computerized reservations systems (CRS) used by travel agents, travel agent commission overrides, codesharing arrangements, and other marketing practices, airlines dominating particular markets have made it very difficult for other airlines to enter these markets and to compete for the traffic. In addition, traditional airline/airport arrangements, such as long-term exclusive-use leases and majority-in-interest clauses in lease agreements also make it difficult for airlines to enter into markets dominated by others[1]. We have found that air fares are generally higher at airports where one or two carriers handle most of the traffic.

Currently, we are using an econometric model of airline fare determination to analyze the relative importance of the various barriers to market entry in determining air fares. Once this work is complete, we will issue a report to Congress with appropriate policy recommendations.

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[1]A majority-in-interest clause in airport leases give airlines with a majority of the operations at an airport a voice in airport decisions that would affect the airlines' financial commitment to the airport.

In the course of our work on airline competition, we have developed a number of policy options for improving the competitive climate. Some of these options address the problem of airport access and are included in the proposed reauthorization legislation. Other options address the barriers to competition raised by airline marketing strategies, such as codesharing agreements and computerized reservation systems. Legislation proposed in the Senate (S. 1741, the Airline Competition Enhancement Act of 1989) addressed some of these marketing barriers.

Airport/Airline Agreements Limit Airport Access

In order to learn more about market dominance and the accessibility of airport gates and other facilities to potential entrants, we recently surveyed more than 180 airports in the continental United States, including all 27 airports we classified (using FAA criteria) as large and all 39 we classified as medium-sized. Sixteen California airports were included in the survey.[2]

Nearly 99 percent of the airports responded to our survey. The respondents said they want to accommodate new entrants, but

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[2] Airline Competition: Industry Operating and Marketing Practices Limit Market Entry (GAO/RCED-90-147). The California airports in our survey were Burbank, Fresno, Los Angeles, Long Beach, Oakland, Ontario, Orange County, Palm Springs, Redding, Sacramento, San Diego, San Jose, San Francisco, Santa Barbara, Stockton, and Lake Tahoe.

many reported that they face major constraints in making existing facilities available or in expanding airport capacity. Most existing gate space is leased for the long-term, exclusive use of the incumbent airlines, with most of these gates leased to the eight major airlines. This is particularly true at the larger airports. Nearly 88 percent of the 3,129 gates at the 66 large and medium-sized airports are leased to the airlines and 85 percent of the leases are for the exclusive use of the lessee. Ninety percent of all leased gates are leased by the eight major airlines. Gate leases also tend to be long term. Eighty-seven percent of leased gates at large and medium-sized airports have long-term leases. Two-thirds of gate leases at large airports have more than 10 years remaining before the lease expires.

California airports in our survey reported that they leased 75 percent of their gates. Larger airports leased a greater proportion of their gates. Los Angeles leased nearly 80 percent of its gates and San Francisco leased all its gates. Five airports--Long Beach, Oakland, Ontario, Redding, and Stockton--reported no leased gates. Over 80 percent of all gates leased in California are leased for exclusive use.

Our nationwide survey showed that about 16 percent of the large and medium-sized airports have use-or-lose provisions in their gate lease agreements, allowing the airport to recapture the control of the gate if the leasing airline does not use it.

While we did not ask the airports how often they invoke these provisions, officials at four airports told us that an airline had to cease all operations for at least one to three months before the airport could exercise the use-or-lose option. Orange County, Palm Springs, and Santa Barbara airports reported that all leased gates were covered by use-or-lose provisions.

Some airports have tried to regain control over airport facilities by moving toward more preferential-use leases, more short-term leases, and more widespread use of recapture provisions. The airlines, however, are resisting these changes. As a result, airlines seeking to start new services at airports will often find that they must sublease space from the incumbent carriers. Airline officials told us subleasing is much more expensive than leasing facilities directly from an airport operator.

One solution to the problem of facility control through airline exclusive-use leases is for the airport to build more facilities, but airports face several major constraints to capacity expansion. Community opposition to expansion (especially to increased noise), and majority-in-interest (MII) clauses in airport lease agreements are leading factors limiting or delaying airport expansion.

Noise was the most frequently cited factor affecting airport expansion, and it was particularly important to California airport respondents. Nationally, 21 percent of the 178 airports that answered our inquiry on noise said community opposition to increased noise would "greatly limit or delay" airport expansion. Officials at half of the California airports, including San Francisco and Los Angeles, said community opposition to increased noise would "greatly limit or delay" airport expansion. Only Stockton and Redding airport officials did not report noise as a problem limiting expansion.

In addition, majority-in-interest clauses in lease agreements give airlines some control over airport expansion. Airlines, in return for making a long-term lease commitment to a particular airport, sometimes receive the right to approve some or all airport expansion projects. Airports securing these long-term agreements are generally able to get lower interest rates on their debt issues. In return, the airlines seek some guarantee that the airport could not unilaterally issue additional debt, which the airlines would have to help repay through higher lease payments, landing fees, or other charges. Over half of the large and medium-sized airports we surveyed reported they had MII agreements. Of the California airports in our survey, only three indicated they had MII agreements. Officials at one California airport indicated that their MII agreement could greatly limit or delay expansion plans.

These long-term agreements could negatively affect competition if they are used to prevent or delay the expansion of facilities that would allow space for new entrants. According to airport officials, the signatory airlines generally approve expansion projects that directly benefit the incumbent airlines but are reluctant to approve projects that would benefit other users or projects such as parking garages that would benefit passengers, but not the airlines directly. In addition, airlines are often reluctant to fund expansion projects before their operations are actually overcrowded. As a result, we believe that MIIs contribute to chronic overcrowding and this, in turn, discourages entry by competing airlines.

PASSENGER FACILITY CHARGES PROVIDE AN INDEPENDENT SOURCE OF FUNDING FOR AIRPORT EXPANSION

An alternative way for airports to finance capacity expansion would be through charging passengers for using the airport. Such charges are prohibited under the Airport Development Acceleration Act of 1973, but H.R. 5170 would authorize the Secretary of Transportation to allow airports to collect a fee of $1, $2, or $3 from passengers enplaning at the airport. The fee, or passenger facility charge, would be included in the ticket price, collected by the airlines the same way the federal ticket tax is collected, and remitted directly to the airports, less a uniform handling charge, approved by the Secretary, for the airlines. In our

recent testimony before the Subcommittee on Aviation, House Committee on Public Works and Transportation, we addressed the need for PFCs and ways to ensure that PFCs, if permitted, are used for the purposes Congress intended.[3]

We believe PFCs could shift some control over airport expansion decisions from the airlines back to the airports by reducing airports' need for airline approval of capital projects. A PFC could be especially useful at airports where one or two airlines control most of the traffic or most of the gates and other essential facilities through restrictive leases. PFC funds could also help fill the gap between airport capital needs and federal funding. However, a PFC is not a panacea, as a lack of adequate funding is not the only problem faced by airports trying to expand capacity or promote greater competition among airlines. At some airports noise concerns could effectively block capacity expansion. At others, the marketing practices of the incumbent airlines may make it very difficult for potential competitors to capture a meaningful share of the air travel market, even if gates and other facilities are available..

Potential Problems With PFC Funds

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[3] Airline Competition: Passenger Facility Charges Can Provide An Independent Source of Funding for Airport Expansion and Improvement Projects (GAO/T-RCED-90-99, June 19, 1990).

We have identified a number of potential problems with PFC funds such as the possible diversion of the revenues collected to nonairport uses. This problem could be avoided, as we stated in our testimony, if the authorizing legislation contains adequate safeguards to ensure that PFC funds would be used only for airport projects to expand capacity and improve competitive access and to ensure that potential entrant airlines have access to PFC-funded facilities. H.R. 5170 requires that PFC funds be spent only to support projects eligible for assistance under the federal Airport Improvement Program or noise abatement program. In addition, the proposed legislation authorizes using PFCs for gates and related areas for handling passengers. The proposed bill also provides that any facilities built with PFC funds may not be subject to contracts granting airlines exclusive right to use the facilities. Without such safeguards, a risk exists that PFC funds collected from the traveling public could be used to reinforce the dominant position of incumbent airlines at some airports.

For example, exclusive-use lease provisions on facilities built with PFC funds could ultimately serve to benefit only incumbent airlines without improving access for potential competitors. We believe that any facilities built with PFC funds should be leased only on a preferential-use basis. Preferential-use leases protect the tenant airline by giving it the first right to use the facilities under lease, but also allow the airport operator to assign secondary use of the facilities to other

airlines when the tenant airline does not have operations scheduled.

Leases on PFC-funded facilities could also contain a clause providing that the tenant airline accommodate a secondary user at some of the facilities it leases, if the airline's use of all leased facilities (including those on pre-existing exclusive-use leases) permits. Without such a clause, an airline could lease PFC-funded facilities on a preferential-use basis, use the new facilities intensely, and leave exclusively leased facilities unused for extended periods, thereby negating the capacity and competition-enhancing effect of the new facilities.

MII clauses can also detract from the effectiveness of a PFC. Some MII agreements require airline approval for any projects that could affect incumbent airlines' operating costs, even if the projects are not financed with airline-backed bonds. Thus, at some airports, PFC funds could not be used to support a bond issue or combined with funds from other sources, including federal grants, without the consent of the incumbent airline. According to the Airport Operators Council International, 25 of the nation's 30 largest airports have restrictions in their agreements with airlines that limit the airport's ability to make effective use of a PFC. Some agreements contain specific clauses prohibiting the airport from charging fees to airline passengers. In addition, residual funding agreements would include PFC

receipts as airport revenues and such agreements would require the airport to lower its landing fees or lease charges to the extent it received PFC revenues. We told the Subcommittee that authorizing legislation must take these agreements into account if PFCs are to be effective. H.R. 5170 prohibits PFCs from being counted as airport revenues for contract purposes.

Potential Benefits From PFC Funds

PFCs could help close the gap between federal funding and airport capital needs in two ways. First, a PFC would give airports additional funds to use on projects eligible for federal funds but for which federal funds are unavailable. Second, PFC funds could be used for projects, needed to expand airport capacity or to promote competition, that are not currently eligible for federal funds. The FAA provides grants to airports out of the Airport and Airways Trust Fund through the Airport Improvement Program (AIP) for capacity and safety projects. However, expansion of revenue-producing facilities, such as gates, are not covered by this program. Nearly one-third of the airports in our survey reported that the unavailability of funding, including funds from the AIP, could greatly impede their plans for expansion.

Available federal funding falls far short of meeting airport capital development needs in the next five years. FAA estimates

airport AIP-eligible capital needs over the next five years are $31 billion, an average of more than $6 billion annually. The President's Budget for fiscal year 1991 allocated only $1.5 billion for AIP projects. In addition, the Airport Operators Council International estimates there is a current backlog of $7 billion in unfunded AIP projects. PFCs could help alleviate the shortfall in federal funding. For example, in 1990 the nation's 31 busiest airports will receive approximately $250 million in AIP entitlements. A $3 PFC at all of these airports would generate almost $1 billion.

Although airports with fewer boardings might not be able to generate sufficient funds through PFCs to finance needed projects, they could still gain from PFCs. Large airports levying PFCs could forego some AIP funds which, in turn, could be made available to smaller airports. Large airports would benefit from having access to funding that was independent from airline approval as long as the reduction in AIP funds was not on a dollar for dollar basis. However, as the reduction in AIP funds to large airports increases, the incentive to levy a PFC would decrease.

Protection of Passenger Interests

Finally, air traveler interests need to be safeguarded if PFCs are approved. We testified that some limit should be placed on the number of PFCs that can be assessed on a single trip and

that travelers should be informed of the effect of PFCs on the cost of their trips.

The development of hub-and-spoke route systems means that many travelers must change planes one or more times to complete their trips. If they are assessed a PFC at each airport where they board or change planes, the air fare paid could increase significantly. We suggested that the Congress might wish to limit the number of times a PFC can be levied on a single trip. H.R. 5170 limits the number of PFCs to 2 on each one way trip.

Passengers must also be informed about the presence and amounts of PFC charges for their trips. One alternative would be to require that PFC charges be included in advertised air fares. Another alternative would be to allow airlines to exclude PFCs from their advertised fares but require their disclosure when travelers book their flights. The Secretary of Transportation could resolve this issue through the PFC regulations authorized by H.R. 5170.

TRUST FUND PROVISIONS IN H.R. 5170 REDUCE THE SURPLUS AND GIVE FAA GREATER FUNDING FLEXIBILITY

H.R. 5170 would expand the capacity of nation's aviation system by accelerating spending out of the Airport and Airways Trust Fund. This trust fund was established by the Congress in 1970 and is financed by excise taxes levied on passengers, air

cargo, and aviation fuel. Most of the fund is devoted to airport grants and capital improvements, such as new radar and traffic control towers. The fund can also be used to support FAA's operations, but the amount available for FAA operations has historically been limited by the Congress with the remainder paid out of the general fund. Generally, receipts have exceeded trust fund spending. The current $14.6 billion balance exceeds outstanding commitments by more than $7.6 billion.

Trust fund spending for operations is currently capped at an amount equal to 50 percent of the total amounts available for airport grants, acquisition of facilities and equipment, and research and development. This cap is much less than the burden created by the aviation system's users. A 1988 Congressional Budget Office study concluded that commercial and general operations are responsible for about 85 percent of FAA's programs, while public aviation (primarily military) account for 15 percent. The maximum allowable amount that can be spent on FAA operations is further reduced if spending targets for capital programs are not met. As a result, only about one-half of FAA's budget (and about one-fourth of its operating expenses) have been financed by the trust fund. If it were not for these limitations on financing operations, there would be no surplus.

This year the administration proposed that the trust fund be used to cover 85 percent of FAA's total budget, thereby

eliminating the subsidy from the general fund to aviation system users. The administration proposed that passenger ticket taxes, which form the bulk of trust fund revenues, be increased from 8 percent to 10 percent. However, in our May 8, 1990, testimony before the Subcommittee on Investigations and Oversight, House Committee on Public Works and Transportation, we suggested that current user fee revenues could be combined with the uncommitted balances in the trust fund to cover 75 percent of FAA's budget. This approach would reduce the subsidy and draw down the surplus over time without raising the excise tax. H.R. 5170 authorizes trust fund spending of $13.2 billion in the next 2 years and provides that the trust fund may be used to underwrite 75 percent of FAA`s authorized budget. Capital spending for air traffic control is scheduled to increase by 59 percent, while spending on airport development would increase by 29 percent.

In our May 11, 1989 testimony before the Subcommittee on Transportation, Senate Committee on Appropriations, we suggested that the Congress consider eliminating the restrictions on spending from the trust fund to cover FAA operating expenses. H.R. 5170 eliminates the penalty clause, while reaffirming congressional commitment to capital spending as the primary purpose of the trust fund.

CONCLUSIONS

We believe that the proposals in H.R. 5170 to permit airports to levy passenger facility charges and to increase and liberalize spending from the Airport and Airways Trust Fund are steps in the right direction but are not panaceas for the problem facing competition in the nation's airline industry. Solutions to capacity limits must also address the problems of aircraft noise and the need to build new airports. Solutions to the problems arising from anticompetitive practices must also address airline marketing practices that make it very difficult for new entrants to successfully enter new markets even when airport facilities are available.

Mr. Chairman, this concludes my statement. I will be glad to respond to any questions you may have.

SELECTED GAO REPORTS AND TESTIMONIES ON AIRLINE COMPETITION

ISSUED REPORTS:

Airline Competition: Higher Fares and Reduced Competition at Concentrated Airports (GAO/RCED-90-102, July 11, 1990).

Airline Competition: DOT's Implementation of Airline Regulatory Authority (GAO/RCED-89-93, June 28, 1989).

Airline Service: Changes at Major Montana Airports Since Deregulation (GAO/RCED-89-141FS, May 24, 1989).

Airline Competition: Fare and Service Changes at St. Louis Since the TWA-Ozark Merger (GAO/RCED-88-217BR, Sept. 21, 1988).

Airline Competition: Impact of Computerized Reservation Systems (GAO/RCED-86-74, May 9, 1986).

Airline Take-off and Landing Slots: The Department of Transportation's Slot Allocation Rule (GAO/RCED-86-92, Jan. 31, 1986).

Deregulation: Increased Competition is Making Airlines More Efficient and Responsive to Consumers (GAO/RCED-86-26, November 6, 1985).

TESTIMONIES:

Airline Competition: Passenger Facility Charges Can Provide An Independent Source of Funding for Airport Expansion and Improvement Projects (GAO/T-RCED-90-99, June 19, 1990).

Effects of Airline Entry Barriers on Fares (GAO/T-RCED-90-62, April 5, 1990).

Operations of and Outlook for the Transportation Trust Funds (GAO/T-RCED-90-78, May 8, 1990).

Barriers to Competition in the Airline Industry (GAO/T-RCED-89-65, Sept. 20, 1989).

Air Fares and Service at Concentrated Airports (GAO/T-RCED-89-37, June 7, 1989).

Transportation Trust Funds (GAO/T-RCED-89-36, May 11, 1989.

Competition in the Airline Computerized Reservation System Industry (GAO/T-RCED-88-62, Sept. 14, 1988).

DOT Airline Industry Oversight (GAO/T-RCED-88-36, April 21, 1988).

REPORTS IN PROCESSING

Airline Competition: Industry Operating and Marketing Practices Limit Market Entry (GAO/RCED-90-147).