United States General Accounting Office 143892

GAO

Testimony

143892

For Release on Delivery Expected at 9:30 a.m. EDT Wednesday May 15, 1991

AIRLINE COMPETITION

Pending Legislation Helps to Address Serious Competitive Problems

Statement by
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Before the
Subcommittee on Aviation
Committee on Public Works and Transportation
House of Representatives

GAO/T-RCED-91-54

051388 / 143892

GAO Form 160 (12/87)

Mr. Chairman and Members of the Subcommittee:

We appreciate the opportunity to testify on pending legislation relating to airline competition. A little over three months ago, we testified before this Subcommittee on the financial crisis of the airline industry. We are now here to discuss four bills under consideration by the Subcommittee that embody possible long-run solutions to the competitive problems that have contributed to that crisis--H.R. 2074, H.R. 2037, H.R. 782, and H.R. 66. We agree with the Members of this Subcommittee who have introduced these bills that it is now time to move forward to find solutions to the problems that beset the industry.

We have completed an extensive body of work over the past several years on issues related to airline competition, including the recently released results of our econometric analysis of airline fares.[1] In our testimony today, we will summarize our findings on the competitive problems of the airline industry; discuss how the provisions of the various bills address those problems; and then offer some observations on some of the bills' specific provisions.

Our basic points are the following:

-- Effective competition in the airline industry requires that airlines have access to airport facilities on terms comparable to their competitors and that they be able to market their services on a level playing field. As we have pointed out in a series of reports going back over five years, these conditions are often not met. Our analysis of concentrated airports found that carriers that dominated an

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[1]<u>Airline Competition: Effects of Airline Market Concentration and Barriers to Entry on Airfares</u> (GAO/RCED-91-101, Apr. 26, 1991). A list of our reports and testimonies on airline competition can be found in the attachment.

airport were able to charge substantially higher fares on routes from that airport. Our work on barriers to entry found that slot restrictions and limited availability of gates limit carriers' access to airports. We also found that restrictive marketing practices relating to computerized reservation systems (CRSs) and frequent flyer plans make it difficult for carriers to compete effectively in each other's markets. Finally, some of these factors have a significant upward impact on airfares, according to our recently released econometric analysis of the effects of market concentration and entry barriers on airfares.

-- The bills you have asked us to review address several of these problems. Their provisions would ease access to gates, slots, and foreign route rights; reduce the anticompetitive effects of CRSs; direct the Secretary of Transportation to initiate a rulemaking addressing the competitive problems of frequent flyer plans; allow greater access to foreign sources of capital for financially marginal firms that may not be able to survive without that access; and address a wide range of consumer protection issues in the airline industry.

-- We believe that several of the provisions of these bills, particularly those relating to gates and CRSs, would for the most part be effective in dealing with some of the competitive problems we have identified. The legislation would provide for Secretarial review of the competitive impacts of major slot transfers and would require a review of the competitive impacts of frequent flyer plans. The proposed legislation is not a panacea for the competitive problems of the airline industry, but it should help to prevent further erosion in the industry's competitiveness. In some areas, such as foreign ownership and consumer protection issues, we are in the midst of additional work and will have more to say on these issues when that work is complete.

-- We do not view these legislative initiatives as representing a draconian "re-regulation" of the airline industry. We would consider as "re-regulation" any attempt to abandon competition as the primary regulator of fares and service. We view these measures, instead, as representing an effort to strengthen competition by providing a level playing field that allows more airlines to compete. The recent financial crisis of the airline industry has unfortunately made these initiatives even more necessary. If we wish to preserve the benefits of deregulation, and prevent the airline industry from collapsing into a tight oligopoly, additional action along the lines proposed in these bills is needed. We would caution, however, that unless some carriers cut their debt burdens to more reasonable levels, changes in government policy might not succeed in preserving a competitive environment.

I would now like to discuss in more detail the competitive problems of the airline industry and how the provisions of these bills respond to those problems.

THE PROPOSED LEGISLATION WOULD ADDRESS MANY OF THE COMPETITIVE PROBLEMS OF THE AIRLINE INDUSTRY

The premise of deregulation was that competition could be relied on to maintain adequate service and reasonable fares. If competition is weak, deregulation will not succeed. Our studies over the past several years found that in most markets competition is strong and deregulation is a success; but in a substantial number of markets, one or two carriers have achieved dominance and fares are substantially higher than what effective competition would produce. Our analysis of concentrated major airports, for example (where most of the traffic is carried by one or two airlines), found that 15 concentrated airports had average fares 27 percent higher than at 38 unconcentrated airports.[2]

We have identified a number of restrictive practices in the airline industry--including exclusive gate leases, slot restrictions, CRSs, and frequent flyer plans--that help to preserve dominant positions. In our most recent report on airline competition, we estimated the impact of some of these practices on airline fares, while taking into account other important factors such as route distance, traffic volume, and consumer preferences for different airlines. No single practice could be identified as having a predominant impact on fares. Most have a modest but statistically significant impact, typically pushing up fares by 1 to 4 percent. But when these factors and others relating to competitive conditions on routes and at airports are combined, they account for a substantial increase in fares.

While these practices have allowed carriers to dominate many markets, most routes are still effectively competitive. However, the exit of additional carriers from the industry could make these dominant positions the norm rather than the exception. The fragile financial health of several carriers makes such additional exits likely. The four jet carriers currently in bankruptcy or in default on their loans carry 24 percent of the nation's air passenger traffic. With 76 percent of the nation's passengers flying on routes served by three or fewer carriers, the loss of even a single carrier could reduce competition on a substantial number of routes.

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[2]The 15 concentrated major airports originated 15 percent of airline passengers in 1988, while the 38 unconcentrated major airports originated 32 percent. The remaining passengers originated at smaller airports or at airports in multi-airport cities that were considered neither concentrated nor unconcentrated.

Restrictions on Access to Airport Gates Limit Competition

Restrictive gate leases and airport use agreements limit access to airport facilities. Airlines that were protected by Civil Aeronautics Board (CAB) route regulation until 1978 are still protected by long-term exclusive-use gate leases that in many cases were signed before deregulation.[3] In our August 1990 report on industry operating and marketing practices, we found that 85 percent of leased gates are leased for the exclusive use of a single airline, and that 60 percent have more than 10 years left to run on the lease. At concentrated airports these figures were even higher (89 percent exclusive-use and 77 percent for more than 10 years). Exclusive leasing limits access to gates because in some cases gates are used only part of the day, but cannot be used by any airline other than the lessee because of the exclusive lease. Entrants can usually lease gates, but not always on terms comparable to those of incumbents. The more gates a carrier controls at an airport, the higher its fares tend to be.[4]

Some of the provisions proposed in the pending legislation should make it easier for new entrants to secure access to gates. One provision would allow a carrier that has difficulty gaining gate space at a concentrated airport to petition the Secretary of Transportation to direct the airport to make space available when the space is not being used. If vigorously enforced by the Secretary, this provision could ease many gate access problems. Another provision would require the Secretary to review transfers of gates to ensure that the transfer enhanced competition. It

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[3]According to our survey of airports, about 37 percent of currently leased gates are on leases signed in 1978 or earlier. Some leases go back to 1958.

[4]For example, holding other factors constant, doubling a carrier's share of an airport's gates (e.g., from 10 percent to 20 percent), whether exclusively leased or not, was associated with 1-percent higher fares.

would also allow airports to charge lower prices for gate space to airlines with a smaller share of gates at the airport than to airlines with larger shares. Another proposal would allow the Attorney General to disapprove gate transfers if they were found to be anticompetitive.

While the proposals embodied in this legislation would not solve all problems of gate access, we believe they would ease access to gates. The passenger facility charge (PFC) legislation enacted last fall should increase the supply of airport facilities in the long run by giving airports a more secure source of financing. However, action is also needed to make more efficient use of the facilities we have available now. Long-term, exclusive-use gate leasing allows unused or underused gates to lie idle even when other carriers could make use of them. Action to require sharing of existing gates would provide more access to airports even before the increased capacity financed by PFCs becomes available. In the longer run, short-term gate leases would allow easier access to gates without having to involve the Secretary in re-allocating gates.

<u>Restrictions on Access to</u>
<u>Airport Slots Limits Competition</u>

Airport access to the four slot-controlled airports is limited by the Federal Aviation Administration's (FAA) High Density Rule.[5] Here again, access has been given to the airlines that, for the most part, originally gained access through CAB route awards before deregulation. The Department of Transportation's (DOT) 1985 amendment to the High Density Rule, allowing buying and selling of slots, has effectively given these airlines grandfather privileges. Our analysis found that airlines owning slots can charge 4-percent

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[5]14 C.F.R. Part 93 Subpart K. The four airports are Washington's National Airport, New York's LaGuardia and JFK Airports, and Chicago's O'Hare Airport.

higher fares, on average, on routes to and from these airports. DOT's buy/sell rule has allowed airlines to buy and sell the privilege of using publicly controlled airspace.

One of the provisions in the pending legislation would subject slot transfers amounting to more than 5 percent of an airport's slots to the same Secretarial review as proposed for gate transfers. The purpose of the Secretarial review is to ensure that other carriers have an opportunity to bid on the slots and that the bid that most enhances competition is approved. We are concerned that this may not be sufficient to make slots available to entrant airlines. There are over 500 slots at National Airport, over 700 at LaGuardia, over 1,500 at O'Hare, and over 200 at JFK.[6] Slot transfers would therefore be subject to Secretarial review only if they amounted to at least 25, 35, 75, or 10 slots, respectively. A carrier seeking to establish service between its hub and, say, National Airport might wish to have six slots so as to have three flights per day each way. In order to qualify for Secretarial review, the transfer would have to be part of a sale or lease of 25 slots over the course of a year--far more than it may need or be able to afford to buy from a carrier currently holding them. A lower threshold for Secretarial review of slot transfers would provide for reviews of the sorts of transfers that a new entrant would most likely be interested in.

Moreover, we found that relatively few slots are transferred in any case. In 1988, the most recent year that we have analyzed, slot sales per quarter amounted to less than one percent of all slots. About 5 percent of all slots are leased, but leasing (typically for a 30- to 90-day period) does not provide a reliable basis on which to establish service. Secretarial review only of slot <u>transfers</u> may therefore have little impact on slot

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[6]The actual number of slots allocated to domestic carriers fluctuates somewhat depending on how many are made available to foreign carriers.

availability. Securing availability of slots may require a more fundamental revision to the current system for allocating slots. Slot leasing by FAA, for example, would allow all carriers to bid on slots as slot leases came up for renewal, without requiring the Secretary to allocate slots administratively.

We would also raise one concern about the proposed section 420(d) concerning "Limitation on Statutory Construction." The text refers to the "right" of an air carrier to use a gate, have a slot, or hold a section 401 certificate. Current law and regulation make clear that holding a slot is a privilege, rather than a right. The Subcommittee may wish to keep that distinction clear in the proposed legislation.

Airline-owned Computerized Reservation Systems Reduce the Ability of New Entrants to Compete Effectively

Even if an airline can gain access to an airport on reasonable terms, it still needs to be able to compete on a level playing field. Restrictive marketing practices such as CRSs limit the ability of a new carrier in a market to compete. CRSs force carriers to market their tickets through systems controlled by their competitors, on terms set by their competitors. For example, the booking fees that other airlines must pay to book their tickets on the CRS have in some cases been set at levels far in excess of the cost of providing the service.

Also, the system software used by the CRS is often designed so that flight bookings on the host carrier are easier and more reliable than on the other participating carriers, thus generating additional ("incremental") airline revenues for the airline that owns the CRS at the expense of participating airlines. For example, information on the number of seats available is generally more reliable for the host carrier, and bookings on the host carrier generally require fewer keystrokes.

Finally, restrictive provisions in contracts between CRS vendors and travel agents make it difficult for an agent to switch from one vendor to another. As a result, after the carriers that had CAB route authority established CRSs and signed up most of the travel agents in the late 1970s and early 1980s, it became virtually impossible for other carriers to establish a competitive CRS, though some other carriers have bought minority shares in existing CRSs.

Two systems dominate the CRS market, with a combined market share of 71 percent. We calculated, based on 1986 data, that each of these two CRSs annually transfers over $300 million from other participating airlines to the airlines that own these two systems. While the exact figure has probably changed somewhat since then, we believe these transfers remain substantial.[7] In an industry with profit margins as low as those of the airline industry, these transfers can spell the difference between profit and loss.

The legislation pending before the Subcommittee has several detailed provisions dealing with CRSs. One provision would subject booking fees to arbitration to ensure that they are set at fair and reasonable levels. Another set of provisions would prohibit two major forms of bias: a CRS would be prohibited from giving preference to the carrier that owned the CRS, either in how the flights of different airlines are ranked on its display screen (screen bias), or in how easily an airline's flights can be booked (architectural bias). A third set of provisions would prohibit restrictive provisions in contracts between CRS vendors and travel agents, such as multi-year contract terms, broad liquidated damages

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[7]These calculations are based on proprietary data gathered for a 1988 DOT study. More recent data are not available.

provisions, automatic rollovers of contracts, and minimum-use clauses.[8]

We believe the proposed CRS provisions would be effective in dealing with the competitive problems in the CRS industry that we have identified in our previous reports and testimony. The arbitration provisions for booking fees appear to be a reasonable way of dealing with the problem of excessive booking fees without involving the Department of Transportation in protracted price regulation. The anti-bias provisions should help to reduce incremental revenues, and the prohibitions on restrictive travel agent contract terms should make it easier for agents to switch from one CRS to another, thus reducing the dominance of the CRSs that have traditionally dominated the market.

Frequent Flyer Plans Protect Markets of Dominant Airlines

Frequent flyer plans also tilt the playing field on which carriers compete. In our survey of travel agents, 81 percent of the agents said that business passengers chose their flights on the basis of frequent flyer plans more than half the time. The structure of frequent flyer plans--in particular, the inability to transfer mileage earned to another participant--encourages participants to book as many flights as possible on the dominant airline, so as to build up enough miles to earn an award. Any carrier can set up a frequent flyer program, and most have, but a

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[8]Most CRS contracts are for 5-year terms, thus discouraging the agent from switching to other systems. This effect is reinforced by broad "liquidated damages" provisions, which subject the agent to heavy financial penalties if the agent cancels the contract before the term has expired. Many CRS vendors also encourage travel agents to renew their contracts long before they have expired, and in the past some have had provisions requiring such "rollovers" when new equipment is leased. Many CRS contracts also have clauses that require the travel agent to use the system for a minimum number or proportion of the agent's bookings, thus discouraging use of other systems.

frequent flyer plan is unlikely to help a carrier gain a significant number of passengers from cities that are already dominated by another carrier.

The legislation pending before the Subcommittee includes one provision affecting frequent flyer plans, requiring the Secretary of Transportation to open a rulemaking focusing on whether frequent flyer miles should be transferable between participants or between programs. A more specific legislative requirement, requiring frequent flyer plans to allow their participants to transfer earned mileage to other participants within the same plan, would provide greater assurance of eliminating most of the competitive problems of frequent flyer plans while still allowing airlines to make use of the plans as legitimate promotional vehicles.

Under a transferable mileage requirement, passengers would no longer have an incentive to concentrate all their flying on the dominant airline in each market--they could spread their flying across several airlines, and sell off the miles they could not use. A transferable mileage requirement would probably not induce airlines to drop their frequent flyer plans, because airlines would still be able to provide their passengers with a promotional benefit--free travel--whose value to passengers is normally greater than its cost to the airline.

An alternative solution--requiring airlines to honor miles earned on other airlines--might disadvantage airlines that fly to particularly desirable locations, such as vacation destinations and overseas.

Limitations on Foreign Ownership
May Weaken Airline Finances

Federal law currently limits foreign ownership of U.S. carriers to 25 percent of the carrier's voting stock. Some industry observers have suggested that this restriction limits the access of U.S. carriers to capital and thus reduces their ability to compete. DOT announced in January that it would allow up to 49 percent of the nonvoting stock of U.S. carriers to be acquired by foreign interests. Two of the bills would allow foreign ownership of up to 49 percent of the voting stock of a U.S. carrier under certain conditions. The conditions would require that the country of the purchaser have a procompetitive air service agreement with the United States; that the president and two-thirds of the board and other managing officers be U.S. citizens; that the country of the purchaser allow foreigners to purchase similar shares of its air carriers; and that the stock acquisition be found consistent with the national security interests and public interest of the United States. One of the bills imposes additional conditions, including that the purchasing entity not be more than 50 percent government-owned, that the purchase be necessary to keep the U.S. carrier operating, and that control of the carrier remain, in any case, in the hands of U.S. citizens.

We are currently studying the issue of liberalized foreign ownership of U.S. carriers. We are addressing concerns about the effects of greater foreign ownership on national security interests, on bilateral and multilateral negotiations over international route rights, and on its effects on the competitive position of U.S. carriers and U.S. airline industry employees. We have not yet reached any conclusions on the advisability of increased foreign ownership of U.S. airlines. We will be prepared to have more to say on this issue when our audit work is complete in the fall.

THE PROPOSED LEGISLATION ADDRESSES A WIDE RANGE OF CONSUMER PROTECTION ISSUES

Finally, the legislation before the Subcommittee has a number of consumer protection provisions, dealing with problems like missed connections, delayed and cancelled flights, lost and damaged baggage, carrier bankruptcies, deceptive advertising, insufficient capacity for frequent flyer flights, and nonrefundable tickets. The legislation would impose additional airline reporting requirements concerning missed connections, late arrivals, lost baggage, and cancellations, so that passengers could be better informed about the quality of airline service. We generally support the thrust of reporting requirements as a useful way of determining the extent of these problems.

The legislation would also provide additional rights to airline passengers concerning delayed and cancelled flights, compensation for lost baggage, bankruptcy protection, and nonrefundable tickets. We have not yet done sufficient work on the passenger rights issues raised by these provisions to offer any conclusions on their necessity or efficacy; the proposed reporting requirements may help to determine the need for additional passenger rights. We are currently completing work on airline passenger rights at the request of Chairman Eckart of the Subcommittee on Antitrust, Impact of Deregulation, and Privatization of the House Committee on Small Business, and we will have more to say on these issues when that work is complete.

We do have one concern, however, with the provision to require the Secretary of Transportation to publish service quality rankings of the various airlines. Such a ranking would inevitably require a weighting of several different dimensions of service quality, such as the extent of missed connections, late arrivals, lost baggage, and denied boarding. We believe that any single ranking would be of limited value, because different passengers place different weights on these different dimensions of service quality. A passenger who usually flies on direct flights would place little importance on missed connections, for example, while a passenger who usually did not check baggage would place little weight on lost baggage problems. Since no one ranking would be useful for all passengers, we believe it is better for DOT to publish rankings on individual dimensions, and let passengers choose their carriers on the basis of the dimensions that are most important to them.

CONCLUSIONS

We do not view these proposals as a draconian "re-regulation" of the airline industry. We view them, instead, as being for the most part a reasonable response to demonstrated competitive problems in the airline industry. The proposed legislation in many cases requires review of a potential problem by the Secretary, with the Secretary having discretion whether to act or not. This approach should generally mean that the burden on the industry will be modest except in cases where action is clearly necessary. We view their cumulative effect as being to strengthen competition in the airline industry and to preserve the gains in reduced fares and improved service resulting from deregulation. In our view, those gains are imperiled by the weakened financial condition of several of today's carriers. While competition is vigorous on most routes today, competition may become less vigorous as additional carriers cease operations. To forestall that eventuality, action along the lines proposed in these bills is needed. In the long run, more fundamental restructuring of some aspects of the airline market might be necessary to ensure a level playing field without having to involve the Secretary in frequent reviews of particular problem areas.

Government action by itself, of course, will not preserve a competitive airline industry. If airlines are not soundly financed, they will remain vulnerable to the cyclical swings of demand for airline services and costs of aviation fuel. But government action can provide the preconditions for effective competition--equal access to the nation's publicly financed airports, and a level playing field for marketing their services.

That concludes my testimony. I would be happy to respond to any questions you may have.

RELATED GAO PRODUCTS

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

Airline Competition: Weak Financial Structure Threatens Competition (GAO/RCED-91-110, Apr. 15, 1991; GAO/T-RCED-91-6, Feb. 6, 1991)

Airline Competition: Fares and Concentration at Small City Airports (GAO/RCED-91-51, Jan. 18, 1991)

Airline Competition: Passenger Facility Charges Represent a New Funding Source for Airports (GAO/RCED-91-39, Dec. 13, 1990)

Airline Deregulation: Trends in Airfares at Airports in Small and Medium-Sized Communities (GAO/RCED-91-13, Nov. 8, 1990)

Airline Competition: Industry Operating and Marketing Practices Limit Market Entry (GAO/RCED-90-147, Aug. 29, 1990)

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

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

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

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

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

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

Airline Takeoff and Landing Slots: 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, Nov. 6, 1985)