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DOMESTIC AVIATION

Barriers to Entry Continue to Limit Benefits of Airline Deregulation

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Mr. Chairman and Members of the Subcommittee:

We appreciate the opportunity to testify on competition in the domestic airline industry. In April 1996, we reported that the deregulation of the industry in 1978, as intended, has led to lower fares and better service for most air travelers.¹ Deregulation's benefits stem largely from increased competition spurred by the entry of new airlines into the industry and established airlines into new markets. Nevertheless, some airports, primarily in the East and upper Midwest, have not experienced such entry and thus have not experienced the lower fares and better service that deregulation has brought to other markets. In October 1996, we reported that certain industry practices, such as restrictive gate-leasing arrangements, impeded entry, particularly at a number of major airports in the East and upper Midwest.² Based on our findings, we made a number of recommendations to the Department of Transportation (DOT) aimed at addressing these barriers to entry and identified potential actions the Congress might wish to consider.

Our October 1996 report was the latest in a series of studies we have conducted over the past decade on domestic airline competition.³ As requested, our testimony discusses (1) our findings and recommendations concerning barriers to entry in the airline industry and (2) DOT's response to the recommendations in our October 1996 report.

In summary,

- In our October 1996 report, we stated that little progress has been achieved in lowering the barriers to entry since we first reported on these barriers in 1990. As a result, the full benefits of airline deregulation have yet to be realized. In particular, operating limits in the form of slot controls,⁴ restrictive gate leasing arrangements, and perimeter rules⁵

¹Airline Deregulation: Changes in Airfares, Service, and Safety at Small, Medium-sized, and Large Communities (GAO/RCED-96-79, Apr. 19, 1996).

²Airline Deregulation: Barriers to Entry Continue to Limit Competition in Several Key Domestic Markets (GAO/RCED-97-4, Oct. 18, 1996).

³These products are listed at the end of this statement.

⁴To minimize congestion and reduce flight delays, the Federal Aviation Administration (FAA) has since 1969 set limits on the number of operations (takeoffs and landings) that can occur during certain periods of the day at four congested airports—Chicago O'Hare, Washington National, and New York Kennedy and LaGuardia. The authority to conduct a single operation during those periods is commonly referred to as a "slot."

⁵Rules governing operations at New York's LaGuardia and Washington's National airports prohibit flights to and from those airports that exceed a certain distance.

continue to block entry at key airports in the East and upper Midwest. Likewise, several marketing strategies, including special incentives for travel agents and frequent flier programs, give advantages to the established carriers.⁶ These strategies, taken together, continue to deter new as well as established airlines from entering those markets where an established airline is dominant. The effect of these strategies tends to be greatest—and airfares the highest—in markets where the dominant carrier's position is protected by operating barriers. As a result, we recommended in October 1996 that DOT take actions that we had previously suggested in 1990 to lower the operating barriers. Moreover, we suggested that, absent action by DOT, the Congress may wish to consider revising the legislative criteria that governs DOT's granting slots to new entrants. We also suggested that the Congress consider granting DOT the authority to allow exemptions to the perimeter rule at National Airport to increase competition.

- In responding to our recent report, DOT concurred with our findings and expressed concern about “overly aggressive” attempts by established airlines to thwart new entry. To make it easier for new entrants to obtain slots, the agency indicated that it would revise its restrictive interpretation of the legislative criteria governing the granting of new slots. While this is a positive step, additional action will likely be needed because the number of new slots that DOT can grant is very limited. In our report, we also recommended that DOT create a pool of available slots by periodically withdrawing a small percentage from the major incumbents at each airport and distribute those slots in a fashion that increases competition. DOT indicated that it is still considering this action. The agency did not agree with our recommendation that FAA consider an airport's efforts to make gates available to nonincumbents when making federal airport grant decisions. Instead, DOT said that it would rather address this issue on a case by case basis as problems are brought to its attention. In light of the lack of progress over the past 7 years, however, we believe that our recommendations, combined with our suggestions for potential congressional action, offer prudent steps to promote competition in regions that have not experienced the benefits of airline deregulation.

⁶Established airlines include the nation's seven largest: American Airlines, Continental Airlines, Delta Air Lines, Northwest Airlines, TWA, United Airlines, and US Airways.

Airline Barriers to Entry Persist and Predominantly Affect Competition in the East and Upper Midwest

Operating barriers continue to limit competition and contribute to higher airfares in several key markets in the upper Midwest and East. In some cases, these barriers have grown worse. As a result, our October 1996 report recommended that DOT take actions that we originally suggested in 1990 and highlighted areas for potential congressional action. The report specifically addressed the effects of slots, perimeter rules, exclusive-use gate leases, and marketing strategies developed by the established airlines since airline deregulation.

Slots

To reduce congestion, FAA has since 1969 limited the number of takeoffs and landings that can occur at O'Hare, National, LaGuardia, and Kennedy. By allowing new airlines to form and established airlines to enter new markets, deregulation increased the demand for access to these airports. Such increased demand complicated FAA's efforts to allocate takeoff and landing slots equitably among the airlines. To minimize the government's role in the allocation of slots, DOT amended its rules in 1985 to allow airlines to buy and sell them to one another. Under this "Buy/Sell Rule," DOT grandfathered slots to the holders of record as of December 16, 1985. Emphasizing that it still owned the slots, however, DOT randomly assigned each slot a priority number and reserved the right to withdraw slots from the incumbents at any time.

In August 1990, we reported that a few established carriers had built upon the favorable positions they inherited as a result of grandfathering to such an extent that they could limit access to routes beginning or ending at any of the slot-controlled airports.⁷ In October 1996, we reported that this level of control over slots by a few established airlines had increased even further (see app. D). As a result, little new entry has occurred at these airports, which are crucial to establishing new service in the heavily traveled eastern and midwestern markets.

Recognizing the need for new entry at the slot-controlled airports, the Congress in 1994 created an exemption provision to allow for entry at O'Hare, LaGuardia, and Kennedy in cases where DOT "finds it to be in the public interest and the circumstances to be exceptional."⁸ However, the exemption authority, which in effect allows DOT to issue new slots, has resulted in little new entry because DOT has interpreted the "exceptional

⁷Airline Competition: Industry Operating and Marketing Practices Limit Market Entry (GAO/RCED-90-147, Aug. 29, 1990).

⁸FAA Authorization Act of 1994, P.L. 103-305, Section. 206. The number of flights at National Airport is further limited by federal law to address local concerns about noise. As a result of these additional limits, the Congress chose not to extend DOT's exemption authority to include National.

circumstances” criterion very narrowly. DOT has only approved applications to provide service in markets not receiving nonstop service, even if the new service would result in substantial competitive benefits. We found no congressional guidance, however, to support this interpretation. As a result, we suggested in our October 1996 report that the Congress may wish to revise the extraordinary circumstance provision so that consideration of competitive benefits is a key criterion.

Nevertheless, we indicated that action by the Congress would be needed only if DOT did not act. In our 1990 report, we had suggested several options to DOT aimed at promoting entry at the slot-controlled airports. These options included keeping the Buy/Sell Rule but periodically withdrawing a portion of slots that were grandfathered to the major incumbents and reallocating them by lottery. Because DOT had not acted on any of our suggestions and the situation had continued to worsen, we recommended in our October 1996 report that DOT hold periodic slot lotteries.

Perimeter Rules

At LaGuardia and National airports, perimeter rules prohibit incoming and outgoing flights that exceed 1,500 and 1,250 miles, respectively. The perimeter rules are designed to promote Kennedy and Dulles airports as the long-haul airports for the New York and Washington metropolitan areas. However, the rules limit the ability of airlines based in the West to compete because those airlines are not allowed to serve LaGuardia and National—airports that are generally preferred by more lucrative business travelers—from markets where they are strongest. For example, the rules keep the second largest airline started after deregulation—America West—from serving those airports from its hub in Phoenix. By contrast, because of their proximity to LaGuardia and National, each of the seven largest established carriers is able to serve those airports from their principal hubs.

While the limit at LaGuardia was established by the Port Authority of New York & New Jersey, National’s perimeter rule is federal law.⁹ Thus, we suggested that the Congress consider granting DOT the authority to allow exemptions to the perimeter rule at National when proposed service will substantially increase competition. We did not recommend that the rule be abolished because removing it could have unintended negative consequences, such as reducing the amount of service to smaller communities in the Northeast and Southeast. This could happen if major

⁹The Metropolitan Washington Airports Act of 1986 (P.L. 99-591, sec. 6012).

slot holders at National shift their service from smaller communities to take advantage of more profitable, longer-haul routes. As a result, we concluded that a more prudent course to increasing competition at National would be to examine proposed new services on a case by case basis.

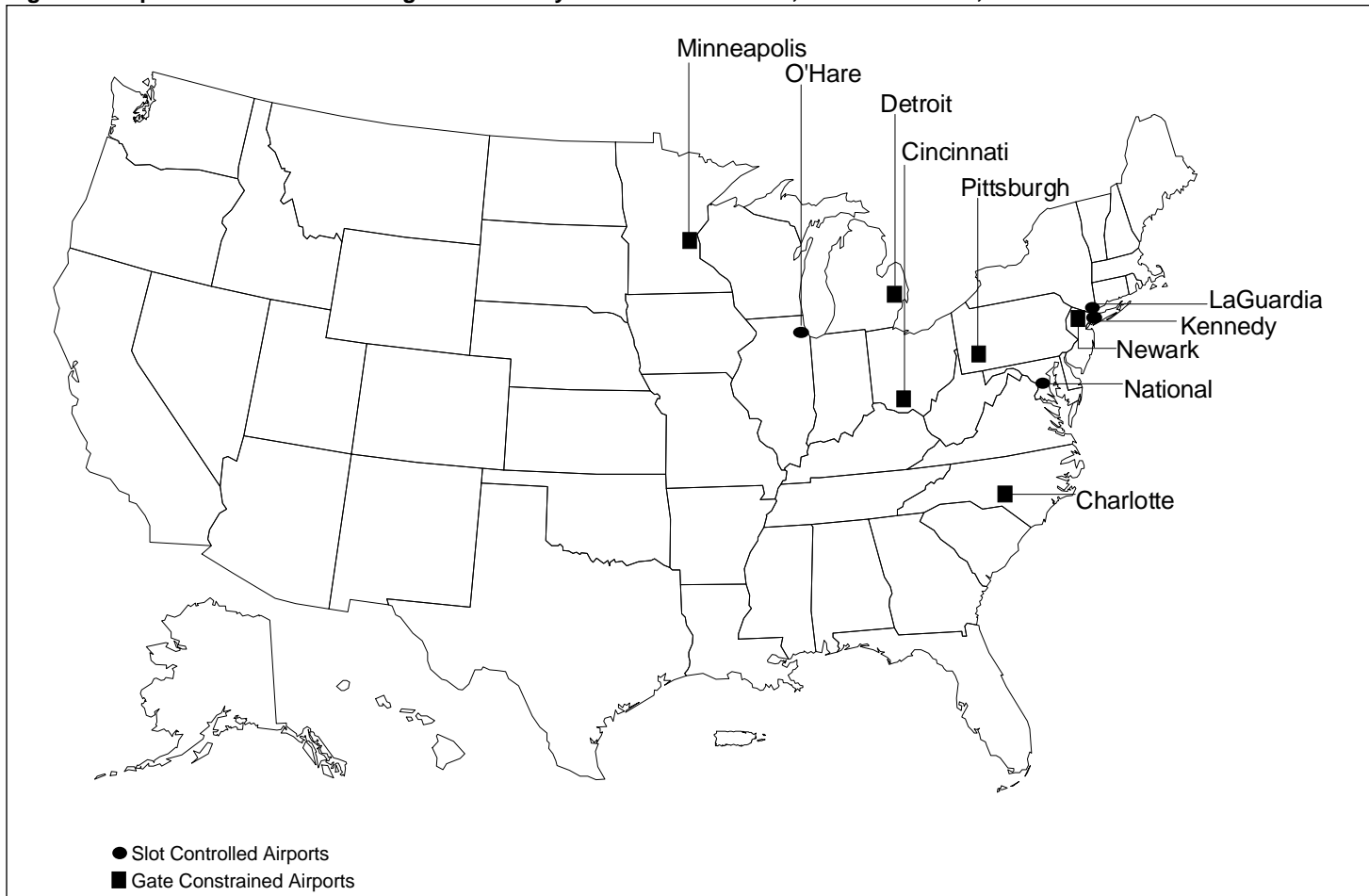
Long-Term, Exclusive-Use Gate Leases

Opportunities for establishing new or expanded service also continue to be limited at other airports by restrictive gate leases. These leases permit an airline exclusive rights to use most of an airport's gates over a long period of time, commonly 20 years. Such long-term, exclusive-use gate leases prevent nonincumbents from securing necessary airport facilities on equal terms with incumbent airlines. To gain access to an airport in which most gates are exclusively leased, a nonincumbent must sublet gates from the incumbent airlines—often at non-preferred times and at a higher cost than the incumbent. Since our 1990 report, some airports, such as Los Angeles International, have attempted to regain more control of their facilities by signing less restrictive, shorter-term leases once the exclusive-use leases expired. Nevertheless, our 1996 report identified several airports in which entry was limited because most of the gates were under long-term, exclusive use leases with one airline.

Although the development, maintenance, and expansion of airport facilities is essentially a local responsibility, most airports are operated under federal restrictions that are tied to the receipt of federal grant money from FAA. In our 1990 report, we suggested that one way to alleviate the barrier created by exclusive-use gate leases would be for FAA to add a grant restriction that ensures that some gates at an airport would be available to nonincumbents. Because many airports have taken steps since then to sign less restrictive gate leases, we concluded in our 1996 report that such a broad grant restriction was not necessary. However, to address the remaining problem areas, we recommended that when disbursing airport improvement grant monies, FAA give priority to those airports that do not lease the vast majority of their gates to one airline under long-term, exclusive-use terms.

Figure 1 shows the six gate-constrained airports that we identified and the four slot-controlled airports. All of them are located in the East or upper Midwest, and as a result, affect competition throughout those regions. In 1995, these 10 airports accounted for approximately 22 percent of the nation's 517 million scheduled passenger enplanements.

Figure 1: Airports Identified as Having Limited Entry Due to Slot Controls, Perimeter Rules, or Exclusive-Use Gate Leases



Marketing Strategies

Even where airport access is not a problem, airlines sometimes choose not to enter new markets because certain marketing strategies of incumbent airlines make it extremely difficult for them to attract traffic. Taken together, these strategies have created strong loyalties among passengers and travel agents and have made it much more difficult for competing airlines to enter new markets. In particular, they deter new as well as established airlines from entering those markets where an established airline is dominant.

Two strategies in particular—booking incentives for travel agents and frequent flier plans—are targeted at business flyers, who represent the most profitable segment of the industry, and encourage them to use the

dominant carrier in each market. Because about 90 percent of business travel is booked through travel agencies, airlines strive to influence the agencies' booking patterns by offering special bonus commissions as a reward for booking a targeted proportion of passengers on their airline. Our discussions with representatives of the nation's largest travel agencies confirmed the importance of these booking incentives. For example, a senior travel agency executive told us that when one established airline attempted to enter a number of markets dominated by another established airline, the nonincumbent complained that the travel agency was not booking passengers on its flights in those markets. The travel agency, according to the executive, told the nonincumbent that it could not support it in those markets because the agency had an incentive agreement with the incumbent airline involving those markets. As a result, the nonincumbent later pulled out of those markets.

Similarly, frequent flier programs solidify the dominant carrier's position in a market. Since their inception in the early 1980s, these programs have become an increasingly effective tool to encourage customers' loyalty to a particular airline. The travel agencies with whom we spoke noted that business travelers often request to fly only on the airline with which they have a frequent flier account. As such, entry by new and established airlines alike into a market dominated by one carrier is very difficult, particularly since a potential entrant must announce its schedule and fares well in advance of beginning service, thus giving the incumbent an opportunity to adjust its marketing strategies. In many cases, we found that airlines have chosen not to enter, or quickly exit, markets where they do not believe they can overcome the combined effect of booking incentives and frequent flier programs and attract a sufficient amount of business traffic.

In our 1996 report, we found that the effect of these marketing strategies tends to be the greatest—and fares the highest—in markets where the dominant carrier's position is protected by operating barriers. Overall, fares were 31 percent higher in 1995 at the 10 airports affected by the operating barriers than at the other 33 airports that comprise FAA's large hub classification. Moreover, the highest fares were at Charlotte, Cincinnati, Pittsburgh, and Minneapolis—markets where a single airline accounts for over 75 percent of passengers and operating barriers persist. However, we also noted that the marketing strategies produced consumer benefits, such as free frequent flier trips, and concluded that short of an outright ban, few policy options existed that would mitigate the marketing strategies' negative impact on new entry.

While DOT's Recent Actions Represent Positive First Steps, Additional Actions Will Likely Be Needed

In its January 1997 response to our report, DOT stated that it shared our concerns that barriers to entry limit competition in the airline industry. The agency indicated that it would include competitive benefits as a factor when determining whether to grant slots to new entrants under the exceptional circumstances criterion. While this is a positive step, additional action will likely be needed because the number of new slots that DOT can grant is very limited. Recognizing this, DOT committed to giving careful consideration to our recommendation that it hold periodic slot lotteries.

DOT also agreed with our position that action may be needed at some airports to ensure that nonincumbents are able to obtain competitive access to gates. However, DOT did not concur with our recommendation that FAA make an airport's efforts to have gates available to nonincumbents a factor in its decisions on awarding federal grants to airports. According to DOT, the number of airports that we identified as presenting gate access problems is sufficiently small that the agency would prefer to address those problems on a case by case basis. The agency emphasized that in cases where incumbent airlines are alleged to have used their contractual arrangements with local airport authorities to block new entry, the agency will investigate to determine whether the behavior constituted an unfair or deceptive practice or an unfair method of competition. If so, the agency noted, it will take appropriate action.

Finally, DOT expressed concern about potentially overly aggressive attempts by some established carriers to thwart new entry. According to DOT officials, since our report, several smaller carriers have complained to DOT that larger carriers are employing anticompetitive practices, such as predatory pricing—the practice of setting fares below marginal cost in an effort to drive competitors out of markets. According to DOT officials, the agency has expressed its concern to the established carriers involved and has notified them that it is investigating the allegations.

Mr. Chairman, this concludes our prepared statement. We would be glad to respond to any questions that you or any member of the Subcommittee may have.

Percentage of Domestic Air Carrier Slots Held by Selected Groups

Airport	Holding Entity	1986	1991	1996
O'Hare	American and United	66	83	87
	Other established airlines	28	13	9
	Financial institutions	0	3	2
	Post-deregulation airlines	6	1	1
Kennedy	Shawmut Bank, American, and Delta	43	60	75
	Other established airlines	49	18	13
	Other financial institutions	0	19	6
	Post-deregulation airlines	9	3	7
LaGuardia	American, Delta, and US Airways	27	43	64
	Other established airlines	58	39	14
	Financial institutions	0	7	20
	Post-deregulation airlines	15	12	2
National	American, Delta, and US Airways	25	43	59
	Other established airlines	58	42	20
	Financial institutions	0	7	19
	Post-deregulation airlines	17	8	3

Notes: Numbers may not add to 100 percent due to rounding. Some airlines that held slots have gone bankrupt, and as a result, financial institutions have acquired slots.

Source: GAO's analysis of data from FAA.

Related GAO Products

Airline Deregulation: Barriers to Entry Continue to Limit Competition in Several Key Domestic Markets (GAO/RCED-97-4, Oct. 18, 1996).

Changes in Airfares, Service, and Safety Since Airline Deregulation (GAO/T-RCED-96-126, Apr. 25, 1996).

Airline Deregulation: Changes in Airfares, Service, and Safety at Small, Medium-Sized, and Large Communities (GAO/RCED-96-79, Apr. 19, 1996).
Airline Competition: Essential Air Service Slots at O'Hare International Airport (GAO/RCED-94-118FS, Mar. 4, 1994).

Airline Competition: Higher Fares and Less Competition Continue at Concentrated Airports (GAO/RCED-93-171, July 15, 1993).

Airline Competition: Options for Addressing Financial and Competition Problems, Testimony Before the National Commission to Ensure a Strong Competitive Airline Industry (GAO/T-RCED-93-52, June 1, 1993).

Computer Reservation Systems: Action Needed to Better Monitor the CRS Industry and Eliminate CRS Biases (GAO/RCED-92-130, Mar. 20, 1992).

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

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

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Department of Transportation's Slot Allocation Rule (GAO/RCED-86-92,
Jan. 31, 1986).

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