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AIRLINE DEREGULATION

Addressing the Air Service
Problems of Some
Communities

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Mr. Chairman and Members of the Subcommittee:

We appreciate the opportunity to testify on the air service problems that some communities have experienced since the deregulation of the airline industry in 1978 and on initiatives that may help address those problems. In April 1996, we reported that airline deregulation has led to lower airfares and better service for most air travelers, due largely to increased competition spurred by the entry of new airlines into the industry and established airlines into new markets.¹ However, some airports—particularly those serving small and medium-sized communities in the East and upper Midwest—have not experienced such entry and thus have experienced higher fares and worse service since deregulation. In October 1996, we reported that certain industry practices, such as restrictive gate-leasing arrangements at a number of key hub airports in these regions, have contributed to these problems.² As requested, our testimony draws from both reports to discuss (1) why some airports serving small and medium-sized communities in the East and upper Midwest have not experienced the same level of entry as those serving communities that have benefited from deregulation and (2) our recommendations and other initiatives that may help increase competition, reduce fares, and improve the quality of air service at those small- and medium-sized-community airports.

In summary,

- The combination of several factors has limited entry at airports serving small and medium-sized communities in the East and upper Midwest. These factors include slower economic growth, harsher weather, and the dominance of routes to and from those airports by one or two established airlines.³ In addition, operating barriers, such as slot controls,⁴ at nearby hub airports and incumbent airlines' marketing strategies, such as special incentives for travel agents and frequent flier plans, have fortified those

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).

³Established airlines include the nation's seven largest: American Airlines, Continental Airlines, Delta Air Lines, Northwest Airlines, TWA, United Airlines, and US Airways.

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

dominant positions and made it very difficult for nonincumbents to compete effectively. In contrast, the more wide-spread entry of new airlines at airports in the West and Southwest since deregulation—and the resulting geographic differences in fare and service trends—has stemmed largely from the greater economic growth in those regions as well as from the absence of dominant market positions of established airlines and barriers to entry.

- Increasing competition and improving air service at airports serving small and medium-sized communities that have not benefited from fare reductions and/or improved service since deregulation will likely entail a range of federal, regional, local, and private-sector initiatives. In our October 1996 report, we recommended that the Department of Transportation (DOT) (1) create a pool of available slots by periodically withdrawing a small percentage from the major incumbents at each of the four slot-controlled airports and distribute those slots in a fashion that increases competition and (2) direct the Federal Aviation Administration (FAA) to consider an airport's efforts to make gates available to nonincumbents when making federal airport grant decisions. We also suggested that the Congress consider revising the legislative criteria governing the granting of slots to make it easier for new entrants to obtain slots. Since our October 1996 report, two national conferences have also been held to examine various options. The conferences have spurred several initiatives, including (1) outreach efforts by communities to better inform airlines of local actions to generate economic growth and (2) commitments by corporations to support nonincumbents in markets where one or two established carriers dominate. In combination with such initiatives, commuter airlines' growing use of new regional jets instead of turboprops (propeller aircraft) has the potential to improve the quality of air service in many of the adversely affected small and medium-sized communities.

Slow Economic Growth and Airline Dominance Have Limited Entry at Small and Medium-Sized Airports in the East and Upper Midwest

Our April 1996 report found that since deregulation fares have fallen and service has improved for most large-community airports. Our report also found that substantial regional differences exist in fare and service trends, particularly among small- and medium-sized community airports. A primary reason for these differences has been the greater degree of economic growth that has occurred over the past two decades in larger communities and in the West and Southwest. In particular, we noted that most low-fare airlines that began interstate air service after deregulation, such as Southwest Airlines⁵ and America West, had decided to enter

⁵Before deregulation, Southwest provided intrastate air service within Texas.

airports serving communities of all sizes in the West and Southwest because of those communities' robust economic growth. By contrast, low-fare carriers had generally avoided serving small- and medium-sized-community airports in the East and upper Midwest, in part because of the slower growth, harsher weather, and greater airport congestion in those regions.

Our review of the trends in fares between 1979 and 1994 for a sample of 112 small-, medium-sized, and large-community airports⁶ identified 15 airports at which fares, adjusted for inflation, had declined by over 20 percent and 8 airports at which fares had increased by over 20 percent. Each of the 15 airports where fares declined was located in the West or Southwest, and low-fare airlines accounted for at least 10 percent of the passenger boardings at all but one of those airports in 1994.⁷ Representatives of these low-fare airlines told us that they were attracted by the relatively strong economic growth at the communities these airports serve. Our analysis of data from the Bureau of Economic Analysis confirmed that substantial growth had occurred in these communities. Between 1979 and 1993, for example, the average annual growth in employment at these 15 communities was 2.6 percent, compared with 1.5 percent for the other 97 communities in our sample. On the other hand, each of the eight airports where fares had increased by over 20 percent since deregulation was located in the Southeast and Appalachia. We found that little new entry had occurred at these airports and that economic growth in the communities they serve had been slow.⁸ Between 1979 and 1993, for example, the average annual growth in employment at these eight communities was 0.9 percent.

Our review of the trends in service quantity and quality at the 112 airports revealed similar findings. Large communities in general, and communities of all sizes in the West and Southwest, had experienced a substantial increase in the number of departures and available seats as well as improvements in such service quality indicators as the number of available

⁶Our sample of 112 airports included 49 airports serving small communities, 38 serving medium-sized communities, and 25 serving large communities. In 1994, these airports accounted for about two-thirds of all domestic airline departures and passenger enplanements in the United States. We defined small communities as those with a metropolitan statistical area population of 300,000 or less, medium-sized communities as those with a metropolitan statistical area population of 300,001 to 600,000, and large communities as those with a metropolitan statistical area population of 1.5 million or more.

⁷Of the 15 airports, 5 serve small communities, 5 serve medium-sized communities, and 5 serve large communities.

⁸Of these eight airports, three serve small communities, four serve medium-sized communities, and one serves a large community.

nonstop destinations and the amount of jet service. Smaller and medium-sized communities in the East and upper Midwest, on the other hand, had generally experienced a decline in the quantity and quality of air service. In particular, these communities had experienced a sharp decrease in the number of available nonstop destinations and in the amount of jet service relative to turboprop service. This decrease occurred largely because established airlines reduced jet service from these airports since deregulation and deployed turboprops to link the communities to those airlines' major hubs. We found that the greatest declines in the quantity and quality of service occurred where growth had been the slowest and little new entry had occurred. In some cases, the communities served by these airports contracted. For example, in Charleston, West Virginia, the average annual change in population between 1979 and 1993 was -0.6 percent and in Moline, Illinois, -0.5 percent.

Our April 1996 report noted that, in addition to slower economic growth, the dominance of one or two established airlines over routes to and from these airports had further limited competition. At each of the eight airports in the Southeast and Appalachia where fares increased by more than 20 percent between 1979 and 1994, for example, one airline accounted for the vast majority of enplanements. We subsequently found in October 1996 that operating barriers at key hub airports in the East and upper Midwest, combined with certain marketing strategies of the established carriers, fortified established carriers' dominance of (1) those hub airports and (2) routes linking those hubs with nearby small- and medium-sized-community airports.

In the upper Midwest, there is limited competition in part because two airlines control nearly 90 percent of the takeoff and landing slots at O'Hare,⁹ and one airline controls the vast majority of gates at the airports in Minneapolis and Detroit under long-term, exclusive-use leases. Similarly, in the Southeast and Appalachia, one airline controls the vast majority of gates under exclusive-use leases at Cincinnati, Charlotte, and Pittsburgh. Finally, in the Northeast, a few established airlines control most of the slots at National, La Guardia, and Kennedy. As a result, the ability of nonincumbents to enter these key airports and serve nearby small and medium-sized communities is very limited.

⁹While retaining the right to withdraw slots at any time from their holders, DOT in 1985 allocated slots to the incumbent airlines at the four slot-controlled airports and began allowing airlines to buy and sell them. Our October 1996 report found that a few established airlines had been allowed to purchase most of the available slots and increase their slot holdings to such an extent that they could limit other airlines' access to routes to and from those airports.

Our October 1996 report also emphasized that certain marketing strategies of incumbent airlines had made it extremely difficult for nonincumbents to enter markets dominated by an established airline. These strategies, taken together, have created strong loyalties among passengers and travel agents and deterred new and established airlines from entering those markets. Two strategies in particular—booking incentives for travel agents and frequent flier plans—have encouraged business flyers, who represent the most profitable segment of the industry, 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. Similarly, frequent flier programs have become an increasingly effective tool to encourage customers’ loyalty to a particular airline. As such, entry by new and established airlines alike into a market dominated by one carrier is very difficult. This is particularly true given that to attract new customers 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 chose not to enter, or quickly exit, markets where they did not believe they could overcome the combined effect of booking incentives and frequent flier programs to attract a sufficient amount of business traffic.

Range of Initiatives Will Likely Be Needed to Address Air Service Problems of Communities Adversely Affected Since Deregulation

Because a variety of factors have contributed to the decreased competition, higher fares, and poorer service that some small and medium-sized communities in the East and upper Midwest have experienced since deregulation, it is likely that no single action will be able to solve those problems. Instead, a coordinated effort involving federal, regional, local, and private-sector initiatives will be needed. In addition to our October 1996 recommendations to DOT, several public and private initiatives that are currently underway as well as other potential options are discussed below. If successful, these initiatives would complement, and potentially encourage, the increasing use of small jets by the commuter affiliates of established airlines—a trend that has the potential of increasing competition and improving the quality of service for some communities.

Our October 1996 Recommendations and Other Federal Initiatives

Our October 1996 report recommended that DOT address the operating barriers to entry by (1) creating a pool of available slots by periodically withdrawing a small percentage from the major incumbents at each of the

four slot-controlled airports and distributing those slots in a fashion that increases competition and (2) directing FAA to consider an airport's efforts to make gates available to nonincumbents when making federal airport grant decisions. We also suggested that the Congress consider revising the legislative criteria governing the granting of slots to make it easier for new entrants to obtain slots. In its January 1997 response to our report, DOT stated that it shared our concerns about operating barriers and the dominant position of some established carriers in some markets. DOT indicated that it planned to be more accommodating to new entrant requests for slots and would give serious consideration to our recommendation that the agency periodically hold slot lotteries.

Citing DOT's response to our October 1996 report, several airlines recently applied to the agency for slots at O'Hare and La Guardia in order to serve medium-sized communities in the East and upper Midwest. In April 1997, Trans States Airlines requested slots at O'Hare for nonstop service from Asheville, North Carolina; Chattanooga, Tennessee; Roanoke, Virginia; and Tri-City Airport (Bristol, Johnson City, and Kingsport) in Tennessee. In May 1997, AirTran Airways requested slots at La Guardia for nonstop service from Akron, Ohio; Knoxville, Tennessee; Bloomington, Illinois; and Moline, Illinois. Also in May 1997, Valujet Airlines applied for slots at La Guardia for service from Atlanta, in part to provide one-stop service via Atlanta to New York for many of the cities in the Southeast, such as Mobile, Alabama, that Valujet serves. DOT is currently considering these applications.

DOT's response to our report also stated that action may be needed at some hub 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. DOT 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 constitutes an unfair or deceptive practice or an unfair method of competition. If so, the agency noted, it will take appropriate action.

DOT has also developed and implemented some useful initiatives. In response to a growing number of complaints by new airlines of

anticompetitive behavior by established carriers, DOT has opened formal investigations of allegations of predatory pricing—the practice of setting fares below the relevant cost in an effort to drive competitors out of markets. The agency has also begun publishing the average airfares for 1,000 domestic routes every 3 months in part to highlight for consumers those markets where dominance by one carrier has led to significantly higher fares.

Finally, in order to ensure adequate air service to the nation's smallest communities, the Congress in 1996 directed that funding for the Essential Air Service (EAS) program be increased. The EAS program was established in 1978 to ensure that smaller communities that had air service under regulation would continue to have service after deregulation. Currently, 100 communities receive EAS-subsidized air service. The Federal Aviation Reauthorization Act of 1996 authorized that funding for EAS be increased to \$50 million annually. In fiscal year 1997, EAS funding was \$25.9 million. For fiscal year 1998, the EAS program has been funded at \$50 million. The act also directed that the \$50 million be funded by new user fees charged to foreign airlines for FAA's air traffic control services in handling their flights over—but not departing from or arriving in—the United States and for other services provided to foreign governments.

Regional, State, and Local Initiatives

Recognizing that federal actions alone would not remedy their region's air service problems, several airport directors and community chamber of commerce officials in the Southeast and Appalachian region recently initiated a coordinated effort to improve air service in their region. As a result of this effort, several members of Congress from the Southeast and Appalachian region in turn organized a bipartisan caucus named "Special Places of Kindred Economic Situation" (SPOKES). Among other things, SPOKES is designed to ensure sustained consumer education and coordinate federal, state, local, and private efforts to address the air service problems of communities adversely affected since deregulation. Two SPOKES-led initiatives under way include establishing and developing a Website on the Internet and convening periodic "national air service roundtables" to bring together federal, state, and local officials, and airline, airport, and business representatives to explore potential solutions. On February 7, 1997, the first roundtable was held in Chattanooga, and a second roundtable is planned for later this year in Jackson, Mississippi.

A key conclusion of the February 1997 roundtable was that greater regional, state, and local efforts were needed to promote economic growth

and attract established and new airlines alike to serve small and medium-sized markets in the East and upper Midwest. Suggested initiatives included (1) creating regional trade associations composed of state and local officials, airport directors, and business executives; (2) offering local financial incentives to nonincumbents, such as guaranteeing a specified amount of revenue or providing promotional support; and (3) aggressively marketing to airlines community efforts to spur economic growth. In at least two recent cases, communities have succeeded in outreach efforts. After intense outreach efforts that highlighted recent growth in their communities, officials from two of the eight communities identified in our April 1996 report as having had fares increase by over 20 percent since deregulation—Chattanooga and Jackson—were successful in attracting a low-fare airline to serve their airports and in improving the quality of their communities' air service.

Private-Sector Initiatives

To grow and prosper in small and medium-sized communities, businesses need convenient, affordable air service. As a result, businesses located in the affected communities have increasingly attempted to address their communities' air service problems. Perhaps the most visible of these efforts has been the formation of the Business Travel Contractors Corporation (BTCC) by 45 corporations, including Chrysler Motors, Procter & Gamble, and Black & Decker. These corporations formed BTCC because they were concerned about the high fares they were paying in markets dominated by one established airline. On April 23, 1997, BTCC held a national conference in Washington, D.C. to examine this problem and explore potential market-based initiatives. One initiative identified at the conference involved the corporations giving support to nonincumbent airlines so that they can overcome operating and marketing barriers and compete successfully against the dominant airline in a market.

Since the April 1997 conference, BTCC has continued to develop this concept. Under BTCC's approach, for a route that is dominated by one carrier, member corporations located in communities on both ends of the route would commit to purchasing a specified number of tickets from a new entrant over a set period of time to ensure that the incumbent airline cannot drive the new entrant out of that market. BTCC is currently working with several low-fare airlines on this concept and has identified a number of potential routes to test the initiative. While many of these routes are between large communities, such as Minneapolis and Detroit, a number also involve small and medium-sized communities in the East and upper Midwest, including the following routes: Washington, D.C.—Charleston,

South Carolina; Washington, D.C.—Fayetteville, North Carolina; South Bend, Indiana—Tulsa, Oklahoma; Evansville, Indiana—Port Smith, Maine; and Fort Wayne, Indiana—Binghamton, New York. To highlight the progress of this initiative and to explore other potential options that may be available to the private sector, BTCC has scheduled another conference for October 3, 1997, in Washington, D.C.

Regional Jets

In addition to public and private sector initiatives, the increasing use of 50- to 70-seat regional jets is improving the quality of air service for a growing number of communities. Responding to the preference of consumers to fly jets rather than turboprops for greater comfort, convenience, and a perceived higher level of safety, commuter affiliates of established airlines are increasingly using regional jets to (1) replace turboprops on routes between established airlines' hubs and small and medium-sized communities and (2) initiate nonstop service on routes that are either uneconomical or too great a distance for commuter carriers to serve with slower, higher-cost, and shorter-range turboprops. The following are examples of this growing trend:

- Comair, which is a Cincinnati-based commuter partner of Delta, put the first regional jet used in the United States into service in June 1993 and currently operates more regional jets than any other commuter carrier. It serves approximately 60 small and medium-sized communities in the East and upper Midwest with regional jets.
- Continental Express initiated new nonstop flights with regional jets in May 1997 between Cleveland, Ohio, and White Plains, New York, and in June 1997 between Newark, New Jersey, and Savannah, Georgia. Previously, there were no nonstop flights between Cleveland and White Plains, and Savannah did not have nonstop service to the New York area.
- Atlantic Southeast Airlines—another Delta affiliate—recently ordered 30 regional jets and announced that it would replace some turboprop service between Delta's hub in Atlanta and several communities in the Southeast. It also indicated that it would use regional jets to initiate several new routes.
- Last week, American Eagle ordered 67 regional jets and indicated that, starting next year, it would use the first jets that are delivered to replace turboprop service between American's hub at O'Hare and several communities in the upper Midwest.

Because regional jets can generally fly several hundred miles farther than turboprops, commuter carriers will be able to link more cities to

established airlines' hubs. To the extent that this occurs, it could increase competition in many small and medium-sized communities by providing consumers with more service options. For example, consumers traveling from Savannah to Boston now have the added choice of a Continental Express regional jet flight to Newark connecting to a Continental flight to Boston. Previously, consumers had the choice of one-stop service by US Airways via Charlotte or by Delta via Atlanta.

The benefits of regional jets are only beginning to emerge and will likely increase substantially in the near future. As of January 1997, regional jets accounted for only 90 of the 2,127 commuter aircraft in service in the United States (4 percent). However, commuter carriers currently have on order over 200 regional jets for delivery over the next several years and have placed options to buy over 400 more. Moreover, local communities could accelerate this trend by providing incentives for commuter carriers to serve their airports with regional jets. If this trend continues, regional jets offer the promise of mitigating the problems of some communities adversely affected since deregulation and buttressing public and private initiatives already under way to address these problems.

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.

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