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Before the

U.S. SENATE
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

April 10, 2008

Chairman Inouye and Members of the Committee:

Introduction

Thank you for the opportunity to appear before you to discuss "Challenges Facing Hawaii's Air Service Market." While there certainly are unique needs and characteristics in the Hawaii market, many of the challenges faced by the airline industry in Hawaii are similar to those facing our airlines in all markets, domestic and foreign.

State of the Airline Industry

Let me begin with the state of the airline industry. The U.S. airline industry has been emerging from a major restructuring precipitated by a fundamental change in passenger demand that began in the first half of this decade. Some large carriers have successfully restructured and adapted their business models, while other carriers have been slower to do so. Record fuel prices have offset the benefits that some carriers gained through cost reductions and other efficiencies achieved in restructuring, in and out of bankruptcy.

Despite fuel price increases, the industry as a whole was profitable for 2007, with net income of $3.8 billion in 2007 versus $1.7 billion in 2006. Going forward however, the outlook for airlines is hazy. The industry faces major challenges in 2008: high fuel prices, a potentially weaker economy, and labor cost pressures. These factors can severely affect demand for travel, particularly in discretionary markets, such as Hawaii.

Clearly the major challenge remains record high fuel prices, with crude oil hovering around $100 per barrel. Fuel cost is now the largest single cost center for the airlines. A one cent per gallon increase in the price of jet fuel costs the U.S. airline industry an additional $16 million per month more for fuel on a system basis. This may not seem like much, but when you consider the drastic change in the price of crude oil and its distillate, jet kerosene, over the last three years, the cost to the airlines becomes much more palpable. Between 2004 and 2007, jet fuel rose from an average of 86 cents per gallon to an average of $2.12 per gallon in 2007, non-inflation adjusted. This is a 248 percent increase in the cost per gallon of jet fuel. According to JP Morgan's analysis, every $10 increase in a barrel of oil requires $18 in additional air fare on average just to maintain a steady state. While the industry posted an operating loss of approximately $87 million in the fourth quarter 2007, it would have posted an operating profit of $1.35 billion in that quarter of

2007 had fuel prices remained at fourth quarter 2006 levels. Soaring fuel prices have masked the tremendous progress legacy carriers have made in reducing their costs to levels more competitive with low-cost/low-fare carriers and eclipsed gains that could have been used to fund essential long-term capital expenditures. Future fuel price uncertainty will continue to motivate industry-wide cost and capacity discipline.

There are other challenges facing the industry, including labor cost pressures and pressures from institutional investors to "unlock" shareholder value. As these other challenges are beyond the scope of this hearing, I will not elaborate on them today.

Nature of the Hawaiian Aviation Market

Next, I would like to summarize briefly the nature of the Hawaiian air service market.

Hawaii, of course, has six major islands that depend heavily on air service, and inter-island markets have been extremely competitive. While Aloha and Hawaiian Airlines have traditionally provided the bulk of inter-island air service, over the years there have been many smaller players that have entered and exited the market. In May 2006, Mesa's Go service commenced, and from that time until very recently, the inter-island market has been served by three high-frequency jet operators. Other smaller carriers like Island Air and Pacific Wings also provide service and make up approximately eight percent of the inter-island capacity. There are also a number of air taxis that compete for traffic in these markets.

Historically, average fares for local travel in the inter-island markets have been quite low, averaging less than $50 in the three year period 2000 through 2002 for each inter-island city-pair market. Beginning in 2001, average fares began a gradual increase in all inter-island markets, and more so in the smaller ones, until the Department granted Aloha and Hawaiian anti-trust immunity for a capacity cooperation agreement that was permitted under a special provision in the 2001 Aviation and Transportation Security Act. Shortly after the carriers implemented their capacity coordination agreement in 2002/2003, they discontinued the coupon distribution system for inter-island travel and implemented different pricing structures. Fares for both carriers rose significantly during the period in which capacity cooperation agreement was in effect. In 2005, Hawaiian's inter-island fares were about 7 percent higher across the board than Aloha's. In 2007, however, average fares for both carriers were about equal.

In general, average fares in the inter-island markets have been lower than average fares in markets of comparable distance and density (the number of people traveling in the market) in the continental United States, including markets served by low-fare carriers such as Southwest, JetBlue, and AirTran. For example, the Honolulu-Kona market at a distance of 163 miles had an average fare at the end of third quarter 2007 of $50. By comparison, Southwest's fare in comparable markets ranged between $80 and $111. In the Kona-Lihue market, the average fare was $81, whereas average fares for Southwest in markets of comparable distance ranged from $91 to $116.

Prior to Go's entry in the market in 2006, the number of flights and capacity offered in the inter-island markets had been slightly declining. A large decrease in service occurred right after September 11, 2001 and did not start to rebound until the third quarter of 2004.

After Go's entry into Hawaii and before Aloha's cessation of service, inter-island fares fell 27 percent to levels not seen since 2000, a time when fuel was one-quarter the price and inter-island passenger traffic was nearly 14 percent greater (capacity was 29 percent higher). Load factors on inter-island services have averaged between 65 percent and 70 percent prior to Aloha's shutdown.

The entry of Go into the inter-island markets came at a time when other structural economic developments exerted downward pressure on the demand for inter-island travel. First, as the other islands became more economically developed, the need for local residents to travel to Honolulu (Oahu) from the other islands for goods and services decreased. In addition, since 2000, carriers have tripled their service from the mainland directly to the Big Island, Maui, and Kauai, which means fewer travelers require inter-island connections. For example, the nearly two million visitors to Hawaii from California now have direct links from their state to Kahului, Kona, Hilo, and Lihue.

Second, Hawaii's critical international and domestic tourism market segments have been stagnant or declining over the past few years. In 2007, 7.4 million visitors arrived by air – a one percent decrease from 2006. The biggest decline was a five percent decrease by non-U.S. visitors to Hawaii. Approximately 70 percent of non-U.S. visitors come from Japan, a country whose economy continues to stagnate. Also, emerging tourist markets in Asia have exacerbated the situation as many Japanese are vacationing closer to home. In the future, tourists from China could replace those from Japan as rising incomes and a booming economy enable more Chinese citizens to travel. The Department has been aggressively seeking to liberalize the restrictive Chinese bilateral air services agreement to increase the numbers of flights permitted between the U.S. and China. One bright spot is Canada. While Canada accounts for just 4 percent of all visitors to Hawaii, the number of Canadian visitors to Hawaii rose over 5 percent between 2006 and 2007. Meanwhile, the number of U.S. visitors to Hawaii has remained flat. Importantly, however, the figure for visitors from California, who make up 25 percent of Hawaii's tourist market, fell more than three percent in 2007. This is partially explained by the downturn in the housing market, which has hit California particularly hard. In short, fewer tourists mean fewer inter-island trips.

As indicated above, unlike the inter-island markets, many other airlines offer service between the West Coast and one or more of the Hawaiian Islands. While the loss of Aloha and ATA Airlines has reduced capacity between Hawaii and the mainland (including Alaska) by about 14 percent, there are still eight airlines providing various levels of service including United, Hawaiian, American, Delta, Northwest, US Airways, Continental, and Alaska.

This market overview clearly shows that the large, inter-island markets have been highly competitive and the most negatively impacted by structural changes in tourist and traffic flows. Record high fuel prices have exacerbated the situation. From time to time, there has been entry by a third carrier focusing on inter-island traffic (Mid-Pacific and Discovery in the 1980s, Mahalo Air in the 1990s, and Go in this decade) in Hawaii. Sustaining three major carriers operating service on the main inter-island trunk routes has proven difficult. According to press reports, Go has lost as much as $20 million since it began service on these routes two years ago.

In part as a result of the substantial structural changes in the aviation markets to/from and within Hawaii over the past decade, both Aloha and Hawaiian have experienced financial difficulties. In the past few years, the carriers have held merger discussions, but the two management teams and their various owners have never been able to agree on how to blend the two airlines. Furthermore, Hawaiian was in bankruptcy from 2003 to 2005, and Aloha was in bankruptcy from 2004 to 2006 prior to going in again last month.

Role of Government

Having outlined the challenges facing the airline industry in general and the Hawaiian markets in particular, I would like to discuss the appropriate role of government in the industry's ongoing restructuring. By deregulating the airline industry in 1978, Congress set the Department permanently on the path away from intervention in the air transportation marketplace. Many, including the Department of Transportation, have a long-held view that deregulation has been a success, producing an abundance of service with low fares – at the same time the industry has achieved a spectacular safety record. Indeed, the fundamental restructuring that we have observed over the last six years is largely the result of market forces that were set in motion prior to the September 11th terrorist attacks. The architects of airline deregulation predicted that new, innovative airlines would enter the marketpalce, establish a significant and sustained market share, and exert competitive discipline on incumbent firms and ensure that savings from efficiencies were passed along to consumers. That is precisely what happened; though it happened differently and somewhat later than expected. With respect to aviation, deregulation has become the default policy around the world.

Airline Industry Restructuring

Since the passage of the Airline Deregulation Act in 1978, which opened our domestic air services to the free market, Congress recognized that the risk of airline failures was possible. Deregulation stimulated air travel, lowered air fares, and created a highly competitive, efficient, and viable air transportation system in the United States. Yet, it is an industry fraught with risks – an industry sensitive to an unstable economic environment, jet fuel prices, and cyclic swings in the economy. The public has benefited from competition provided by new entrant carriers who acquired the aircraft of bankrupt airlines and implemented a new business model with low fares to attract customers. In fact, over the past 30 years, we have seen many air carrier failures. In an uncertain economic environment and with record jet fuel prices, it is not shocking that air carriers -- which depend so heavily on fuel -- are having difficulty surviving in today's price competitive aviation environment.

The Government Accountability Office in a September 2005 Report to Congress said that bankruptcy "is endemic to the airline industry owing to long-standing structural challenges and weak financial performance in the industry." Indeed, bankruptcies in the airline industry are not uncommon. Since airline deregulation 30 years ago, there have been more than 170 airline bankruptcies, averaging almost six a year.

During the last two weeks, three airlines have filed or expect to file for bankruptcy protection. Aloha Airlines, ATA Airlines, and Skybus Airlines have shut down and stopped passenger air services. They attributed their business failure to rising fuel costs and a slowing economy. These carriers could not make a business case to attract more capital in the current economic environment.

In this context, let me briefly outline the recent situations at Aloha Airlines and ATA Airlines.

Immediate Impact of Aloha's and ATA's Cessation of Scheduled Passenger Service

In order to assess the ability of other carriers to assist stranded Aloha and ATA passengers based on existing schedules, we reviewed available services of U.S. and foreign carriers that compete with Aloha and/or ATA on their inter-island routes and between Hawaii and the U.S. mainland. During April, we estimate that just over 90,000 passengers will travel to/from Hawaii or about 3,000 per day. There is competitive service on many of the Aloha and ATA routes between the Mainland and Hawaii. Based on our internal analysis, as many as 9,000 Hawaii passengers were inconvenienced by the sudden termination of air service by both Aloha and ATA. This figure does not take into account the additional seat capacity that was added to the Hawaii market by competing carriers in response to the Aloha and ATA shutdowns.

Despite the high load factors experienced by competing carriers in these markets, most Aloha and ATA passengers were expected to be accommodated, perhaps some taking circuitous and multi-stop routings. Clearly, some passengers encountered more serious inconvenience and delays, especially in the three markets without alternate nonstop service, namely Oakland–Lihue; Las Vegas–Maui; and Oakland– Hilo.

Aloha informed the Department that, on the day it stopped service, about 700 Aloha strandees would need transportation to or from the mainland, and steadily decreasing numbers of such passengers would need to be accommodated each day through April 12.

American, United, Delta, Continental, US Airways, Hawaiian, and Go added aircraft capacity to the market, to help minimize the impact on Aloha's stranded passengers. Hawaiian and Go carried Aloha's inter-island passengers on a standby basis for free for the first four days after Aloha's shutdown and on a confirmed basis for $49 through April 7.

Alaska Airlines recently announced plans for new daily service to Hawaii from Seattle and seasonal service from Anchorage.

Federal Government's Efforts To Address the Situation in Hawaii

There are no requirements for other airlines to accept the tickets of an air carrier that ceases operations. However, when an airline shuts down the Department moves immediately to contact other carriers providing service on those routes to ascertain their policies with respect to carriage of the passengers of the failed airline, to make it clear that consumer harm should be minimized, and to make information about the airline policies readily available to consumers. We then distribute information to affected consumers about their options. This is accomplished via our web site and in responses to telephone and other inquiries.

When the Department learned of the Aloha and ATA shutdowns, my office and the Department's aviation consumer office gathered information from these two carriers via teleconferences and e-mail. The aviation consumer office then contacted other airlines serving the affected markets and posted information and advice on its web site for affected consumers. In general, this involves information about alternate transportation, claiming a refund from the consumer's credit card company under the Fair Credit Billing Act, and filing a claim for a cash refund or baggage claim settlement in any bankruptcy proceeding that may take place.

Other carriers appear to recognize that voluntarily providing affected passengers reasonable options for alternate transportation is in their interest. Carriers are motivated to do this as a competitive initiative, in part as a market-development strategy to attract business travelers and frequent flyers. For example, in connection with the recent shutdown of ATA Airlines, most major carriers are or were offering affected passengers standby transportation for $100 per non-stop segment and/or waiving their own advance purchase requirements on discount fares. In the case of Aloha Airlines, Hawaiian Airlines and Go were offering free standby seats to Aloha passengers for the first four days after the Aloha shutdown (i.e., through April 3). Through April 7, Hawaiian was offering a special $49 fare for inter-island flights. Hawaiian also immediately added 6,000 seats per day to its schedule. United Airlines is offering special discounts to Aloha's Hawaii-mainland passengers, on a confirmed basis, through April 30.

In the case of both ATA and Aloha, as required by contract and by DOT policy, their codeshare partners are honoring tickets issued in that partner's name by providing transportation on a confirmed basis with no additional fare collection where possible. Where that is not possible, those codeshare partners are providing a full refund.

Both carriers indicated that well over 90 percent of their passengers used credit cards to purchase air travel. Those passengers should be able to recover from the credit card companies payments for any air transportation services that were not provided.

Essential Air Service Implications

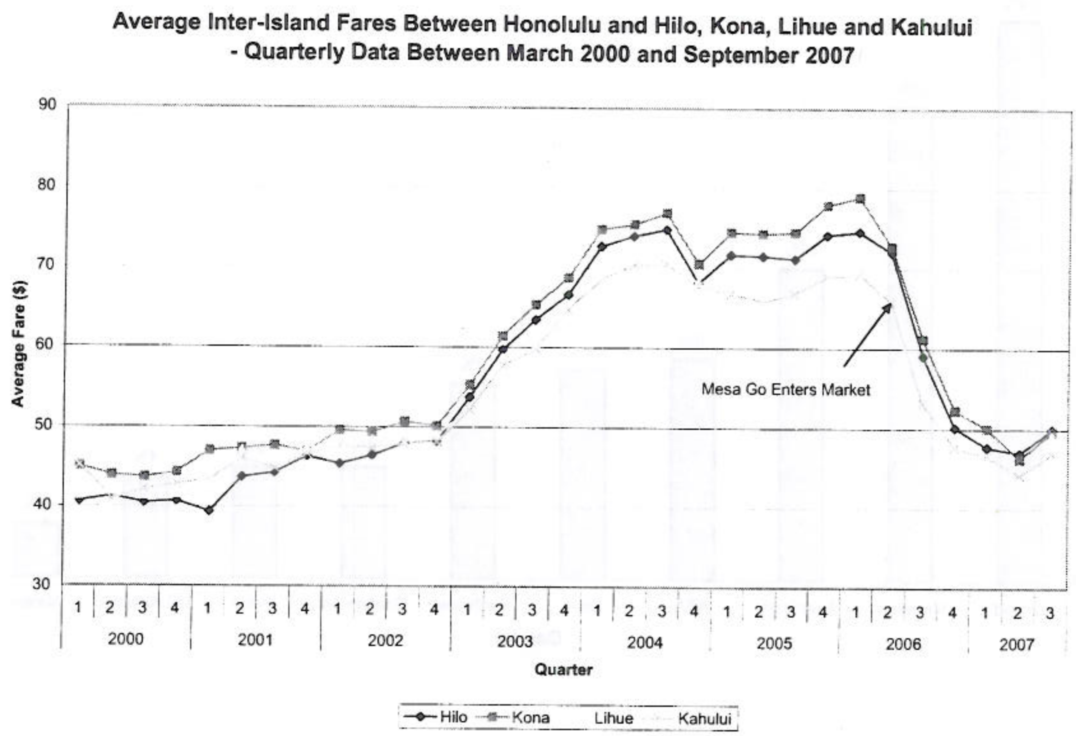
We have also examined Aloha's shutdown in the context of the Essential Air Service program and find that there are no issues. All five communities that Aloha served -- Hilo, Kona, Kauai, Kahului, and Honolulu -- are served by at least two other carriers, Hawaiian and Go. No market will be without service. The smallest market in terms of service (Hilo – Honolulu) has at least 13 non-stop round trips per day.

Also in the context of EAS, the Department's is fully aware of Hawaii's dependence on air service, and the EAS program provides a safety net to ensure that eligible communities receive continuous, uninterrupted air service. Up until April 1, 2007, the communities of Hana, Kalaupapa and Kamuela had received subsidized service under the EAS program for about six years. As the end of the then-current EAS contract was nearing, the incumbent carrier, Pacific Wings, announced that it would continue to serve all three communities, but without the need for further federal subsidy. I wish to point out that, even though the communities no longer receive subsidized EAS, they are all still protected against losing service. That is, even if the incumbent carrier wanted to suspend service, it would first have to file a notice of intent to suspend service and we would hold the carrier's service in place while we sought and procured replacement service.

Thank you, and I would be pleased to take any questions.

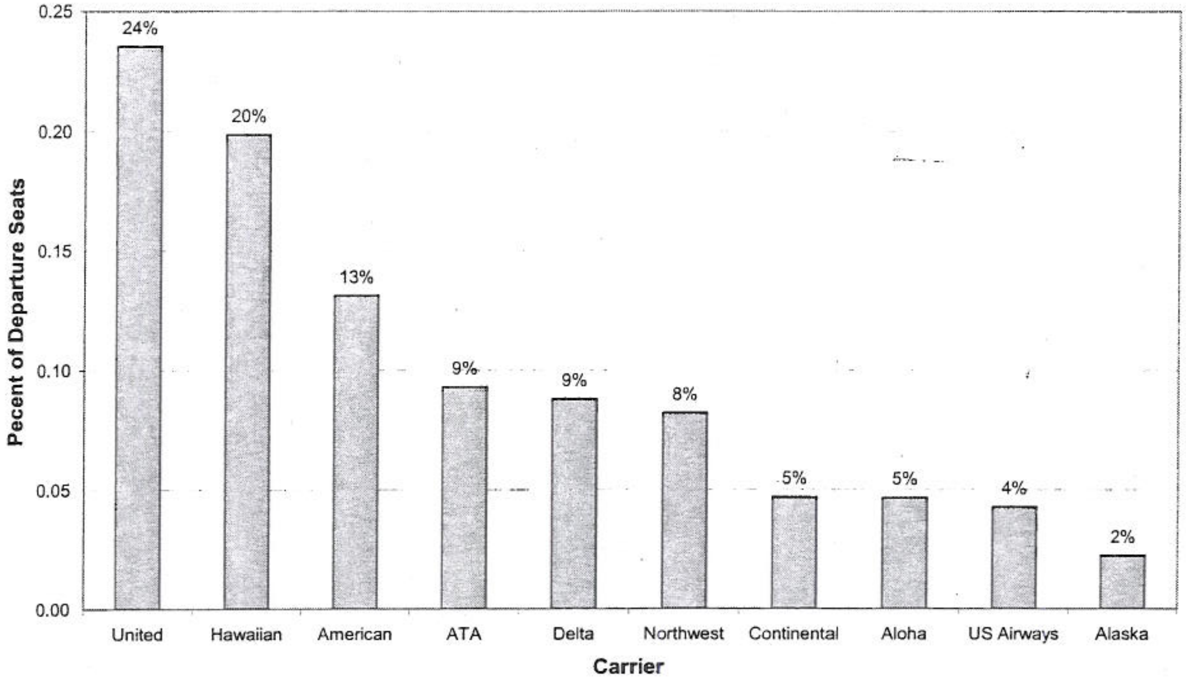
Attachment: 5 Charts

Attachment

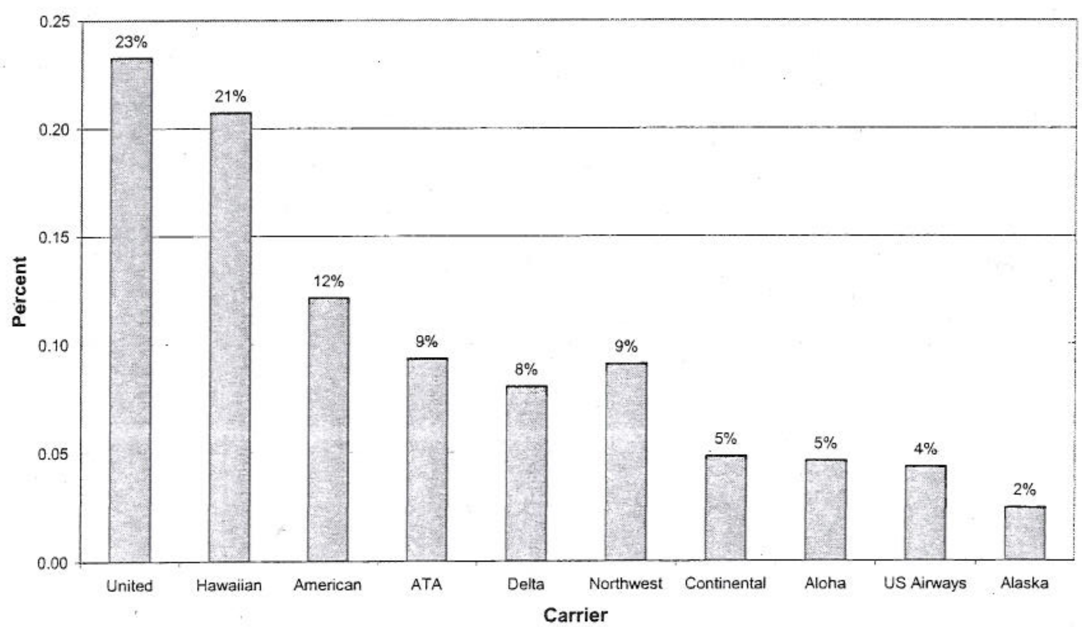


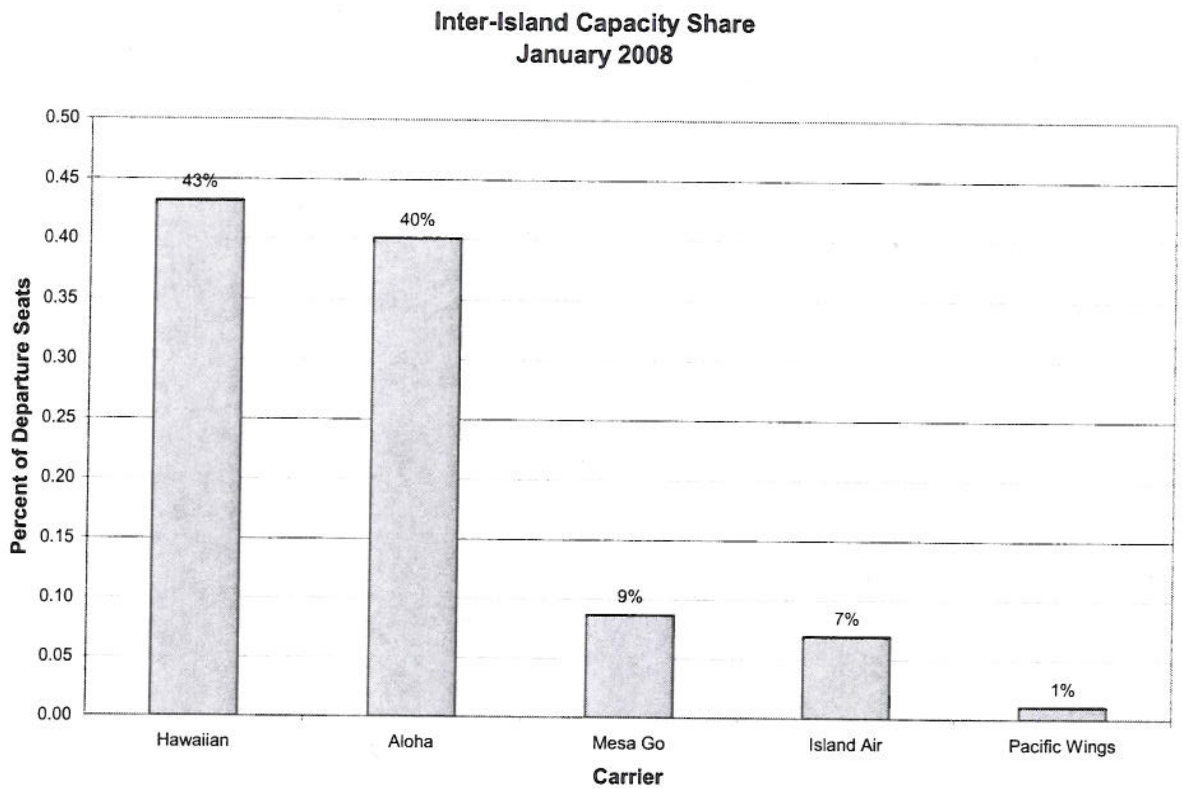
Average Inter-Island Fares Between Honolulu and Hilo, Kona, Lihue and Kahului
- Quarterly Data Between March 2000 and September 2007
90
80
70
60
50
40
30
Average Fare ($)
Mesa Go Enters Market
1 2 3 4 1 2 3 4 1 2 3 4 1 2 3 4 1 2 3 4 1 2 3 4 1 2 3 4 1 2 3
2000
2001
2002
2003
2004
2005
2006
2007
Quarter
Hilo
Kona
Lihue
Kahului

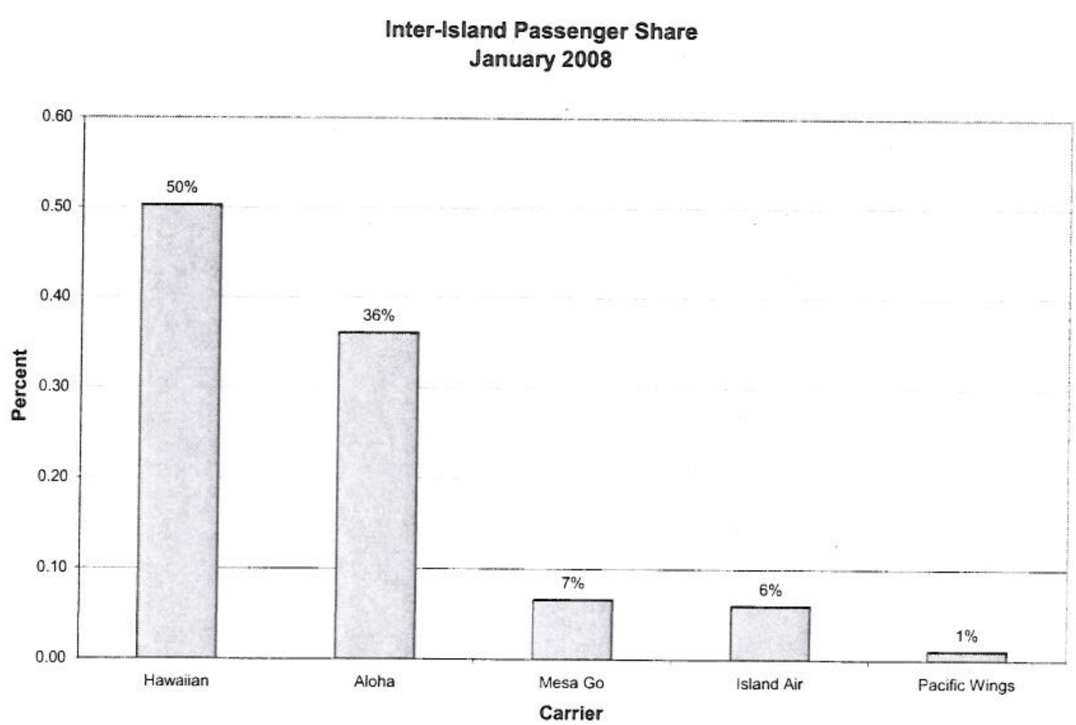
Capacity Share Between the U.S. Mainland and Hawaii
January 2008



Passenger Share Between the U.S. Mainland and Hawaii
January 2008




Inter-Island Capacity Share
January 2008
Percent of Departure Seats
0.50
0.45
0.40
0.35
0.30
0.25
0.20
0.15
0.10
0.05
0.00
43%
40%
9%
7%
1%
Hawaiian
Aloha
Mesa Go
Island Air
Pacific Wings
Carrier


Inter-Island Passenger Share
January 2008
Percent
0.60
0.50
0.40
0.30
0.20
0.10
0.00
50%
36%
7%
6%
1%
Hawaiian
Aloha
Mesa Go
Island Air
Pacific Wings
Carrier