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Testimony

The Global Competitiveness of the U.S. Aviation Industry:
Addressing Competition Issues to Maintain U.S. Leadership in the Aerospace Market

Statement of Nicholas E. Calio
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before the
United States Senate
Committee on Commerce, Science and Transportation
Subcommittee on Aviation Operations, Safety, and Security

July 18, 2012

INTRODUCTION

U.S. airlines compete in a global market for passenger and cargo services. Free trade in the airline sector has grown to include over 100 countries whose airlines have unlimited rights to fly to any market in the United States. Government policy framing the U.S. airline industry, however, has not kept pace with this evolving market. Consequently, U.S. airlines enter the global field of competition at a significant disadvantage compared to their foreign competitors. That disadvantage adversely impacts profitability and growth for U.S. airlines, and all that goes with it – service to smaller communities, jobs, employee welfare and shareholder value, and it adversely impacts the broader value chain that supports the airline industry and related travel and tourism industries. The aviation industry supports 10 million jobs and more than 5 percent of GDP. It could be an even bigger, more productive sector of the economy with the right policy framework.

The U.S. airline industry is a strategic asset. It is an enabler of the broader U.S. economy because it moves the commerce of the country. Simply put, it was the physical internet before the digital internet existed, and it remains the physical internet for American business. U.S. airlines move manufactured goods from small communities across the country to other small communities, to major population centers within the U.S. and to cities and towns across the globe. The sales and service sectors rely on U.S. airlines to deliver their products and services and to meet their customers face-to-face. In the modern global market, U.S. businesses cannot compete without a healthy U.S. airline industry that provides convenient, safe and reasonably priced connectivity to their domestic and international markets and customers.

The same policies that disadvantage U.S. airlines, however, also disadvantage U.S. businesses and the broader economy. A weak U.S. airline industry means fewer flight options to fewer cities, particularly to foreign markets that are on the edge of profitability. Reduced service means greater challenges and fewer opportunities for U.S. businesses in the highly competitive global marketplace.

The solution to these linked problems is simple: adopting a National Airline Policy that provides a comprehensive blueprint to normalize the business environment in which U.S. airlines operate – a comprehensive airline policy that treats the industry like other U.S. industries and that enables U.S. airlines to compete effectively in the global marketplace. U.S. policy must recognize and treat the airline industry as a strategic asset. Failure to do so ultimately may see U.S. airlines

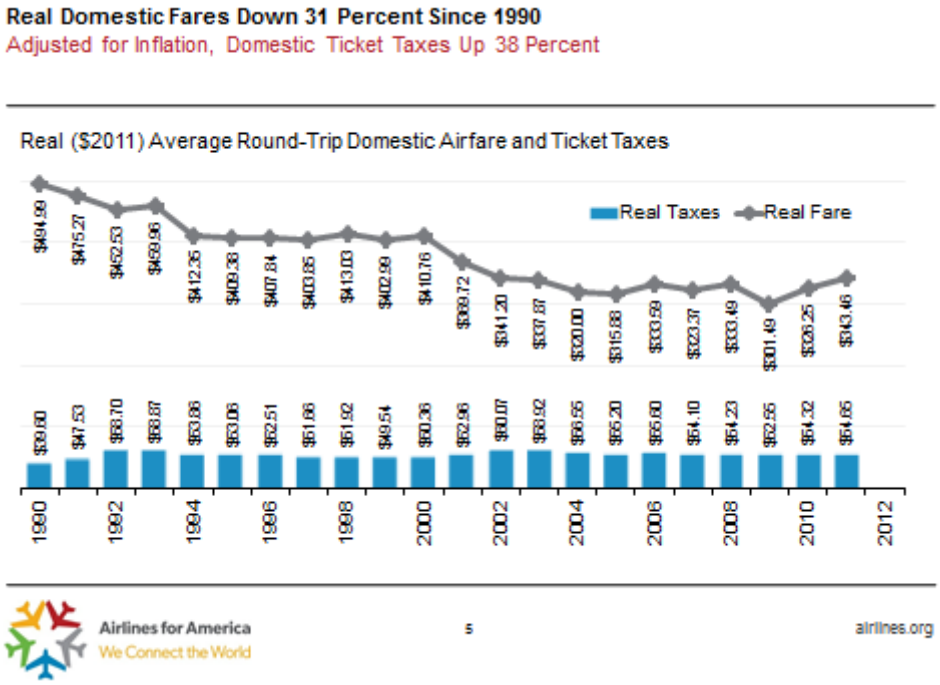
increasingly shifting to feeding foreign-flag airlines at U.S. gateways, with significant adverse impact on profitability and on service that connects smaller cities and communities.

POLICY SCHIZOPHRENIA PREVAILS:
REGULATION AND TAX POLICIES UNDERMINE DEREGULATION SUCCESS

Congress deregulated the domestic airline industry in 1978 to unlock its value to the American public. Congress recognized that removing the strait-jacket of government regulation and allowing airlines to operate competitively like other businesses would make air transportation services affordable for consumers as well as foster innovation and efficiency for businesses.

Congress was right. Passenger and cargo airline services are a tremendous value for American businesses and consumers; they enable the U.S. economy. From 1990 to 2011, real domestic fares fell 31 percent. In contrast, taxes increased 38 percent. (Slide 1). Business travel and cargo movements have grown dramatically, and air service is the favored method of transporting valuable exports. In 2011, the value of U.S. exports by air was 117 times the value of exports transported by sea. (Slide 2). Commercial aviation has grown to become one of the most important drivers of U.S. GDP (Slide 3). Today, U.S. airlines carry approximately 2 million passengers and 50,000 tons of cargo daily on approximately 28,000 flights.

Slide 1



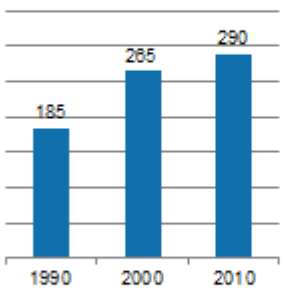
Slide 2

Why Is a Comprehensive Airline Policy in the National Interest?

The U.S. Airline Industry Is a Critical Enabler of Commerce

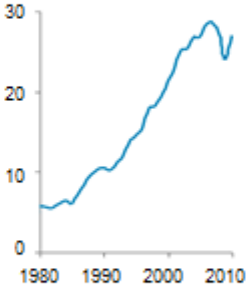
Moves business passengers

Business Passengers (M)



Moves cargo

Freight Revenue Ton Miles (B)

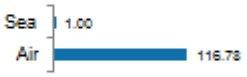


Moves valuable exports

U.S. merchandise exported by air

$424B

Export Value ($/kg)



In 2011, the value of U.S. exports transported by air was 117 times the value of exports transported by sea

Note: Passenger and freight data represent only scheduled service, and 2010 is estimated. Business passengers estimate based on assumption that 40 percent of air passengers travel for business.
Sources: BTS, T1, T-100 traffic data; Census Bureau; BCG analysis

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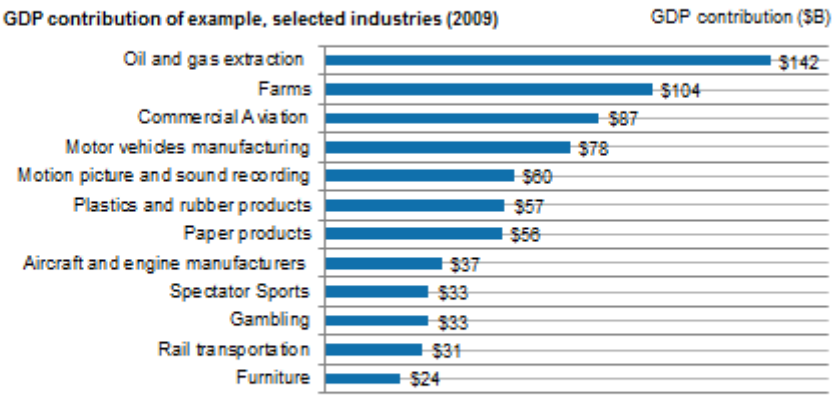
3

Slide 3

Why Is a Comprehensive Airline Policy in the National Interest?

Example Industries, Pulled From GDP Rankings, to Demonstrate Relative GDP Value of The U.S. Airline Industry to These Selected Sectors

Direct U.S. GDP contribution of example, selected industries (2009)



Note: Not intended to be a comprehensive ranking, example industries only to give a point of comparison.
Aviation-related data extrapolated from FAA economic impact report; aircraft and engine manufacturers include Boeing, GE, Pratt, Honeywell, Collins, etc.

Sources: BEA industry accounts; Gambling and Spectator Sports from BEA Travel & Tourism satellite account data; FAA Air Traffic Organization, "The Economic Impact of Civil Aviation on the U.S. Economy" (Dec. 2009); BCG analysis

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4

Despite the unparalleled value the U.S. airline industry delivers to the American economy as a result of deregulation, vestiges of the regulated era remain and new regulatory burdens have been added, particularly in recent years. These regulatory burdens reflect the ingrained view of some that the airline industry is different from other industries and, when controversy arises, regulation is the answer. This parochial view of commercial aviation must end.

Vestiges of economic regulation include mandatory reporting of: traffic data ("O&D" data); revenue and expense data; income taxes; maintenance expenses; profit and loss data; performance data such as on-time performance, baggage handling, and involuntarily denied boarding; and on-demand examination of financial data and records. Industries that were never regulated – the rental car and grocery industries, for example – are not saddled with these kinds of reporting burdens.

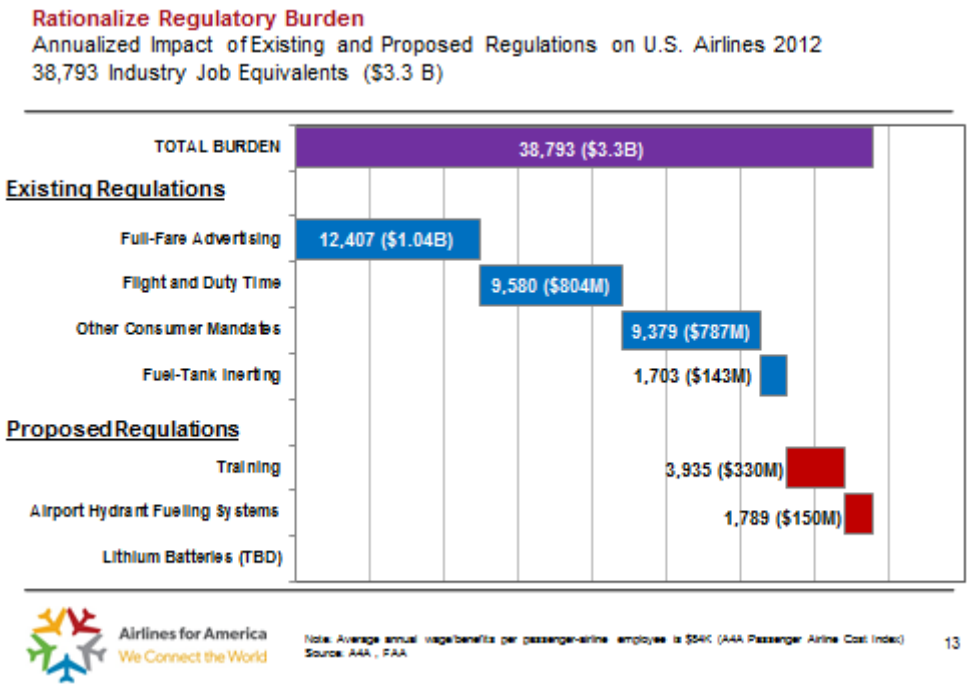
To make matters worse, the Department of Transportation (DOT) has proposed a rule that would require airlines to report new revenue information related to 19 separate items, including how much they collect for meals, drinks and upgrades. In addition, DOT is considering a rulemaking to "modernize" the O&D data it collects from airlines. The DOT proposal not only would greatly expand the financial and operational data elements it collects, it would also begin collecting personal identifying information from airline reservations systems – raising obvious and significant privacy concerns. Does Amtrak have to report to the government how much it made on selling Cokes, and how much revenue from tickets? Does the cable industry have to report how much it made selling HBO versus ESPN?

Likewise, more recent regulatory initiatives substitute the government's judgment for the working of the marketplace and manifest a philosophy that favors re-regulation over market discipline. These new regulatory burdens run counter to the Airline Deregulation Act, which specifically stated that market forces should determine and drive consumer options and services. The Department of Transportation's "Enhancing Airline Passenger Protections" Rule 2 (April 25, 2011) is such a rule. In it, DOT mandated that airlines, unlike virtually every other U.S. industry, must include taxes and mandatory fees in advertised prices. Even though airline customers purchase other products and services and understand that taxes and fees will be included in the final price, DOT insisted that airlines and travel agencies spend millions of dollars to reprogram their systems to display "full" prices. The rule also goes so far as to specify that any breakout of taxes, which are considerable, must be in smaller font than the total price. In addition, the rule creates an impossible burden by prohibiting an airline from raising the prices of optional on-board services for that particular customer after he/she purchases a ticket. That is like saying a ball-park or stadium cannot raise the price of a hotdog for an individual once he/she purchases a ticket. On game day, it is impossible for vendors to know what price to charge which patron if prices have changed. Although DOT has backed off of enforcing this rule, it has stated it will still be part of its next rulemaking.

Looking forward, DOT is planning a third "passenger protection" rule. Among other things, this rule would require airlines to make all of their products available through global distribution systems. In no other industry is this required. Are the passenger rail or cable industries *required by law* to turn over all of their products and services to a third party duopoly that can then mark-up the products for their own financial gain?

Again, other industries are not subjected to such irrational rules. These and other regulatory burdens weigh heavily on the airlines and, with the tax burden discussed below, conspire to hold them back from stability and profitability. When safety rules are taken into account, we estimate the annual regulatory burden of existing and proposed rules exceeds $3 billion. (Slide 4).

Slide 4

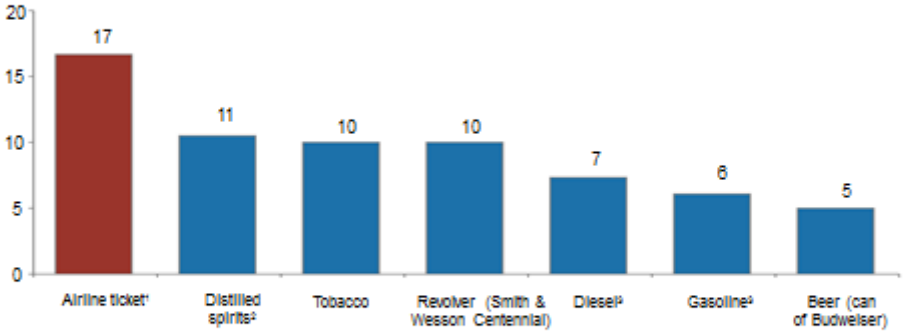


U.S. airlines and their customers are subjected to voracious taxes and fees that add up to 20 percent of the total price of an average domestic round-trip ticket. That is a 38 percent increase since 1990. No consideration is given to the impact of these government impositions on demand. In fact, commercial air transportation is taxed at a greater rate than products – alcoholic beverages and cigarettes – that are taxed in part to discourage consumption. (Slide 5) In 2011, airlines and their customers paid nearly $18 billion in taxes and fees, more than $11 billion of which went to the FAA Airport and Airway Trust Fund, more than $3 billion to the Department of Homeland Security, and more than $2.5 billion directly to airports. (Slide 6)

Slide 5

Rationalize the Tax Burden

Federal Taxes on Commercial Aviation Are Comparatively High, Comparable with Many "Sin" Taxes



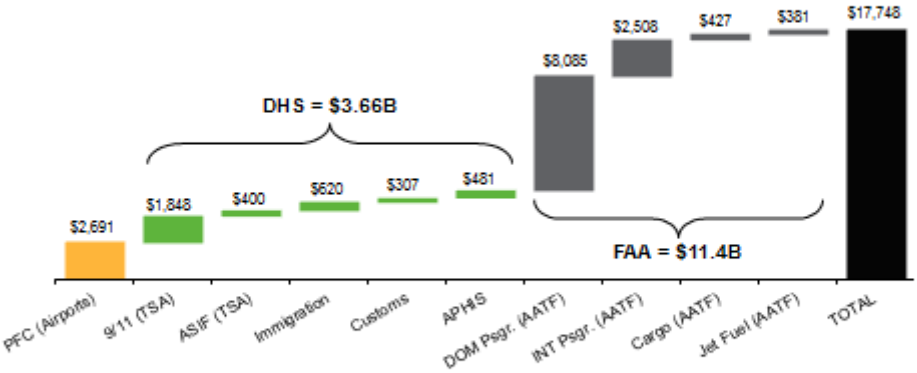
1. Average tax rate, source MIT, Airline Ticker Tax Project summary results, 2009.
2. Based on $20 sale price per 750ML bottle.
3. Federal tax percentage (18.4 cents per gallon gasoline, 24.4 cents per gallon diesel) based on March 7, 2011 prices (including state and federal taxes) of $3.32/gallon gasoline, $3.87/gallon diesel.

Sources: BCG research; U.S. Department of Treasury; TTBgov; Tobacconist University; Gaspricewatch.com; U.S. Energy Information Administration; BCG analysis

Slide 6

Rationalize the Tax Burden: Nearly $18 Billion* in 2011

Rising Tax Burden on Airlines and Their Customers Undermine Industry's Economic Viability



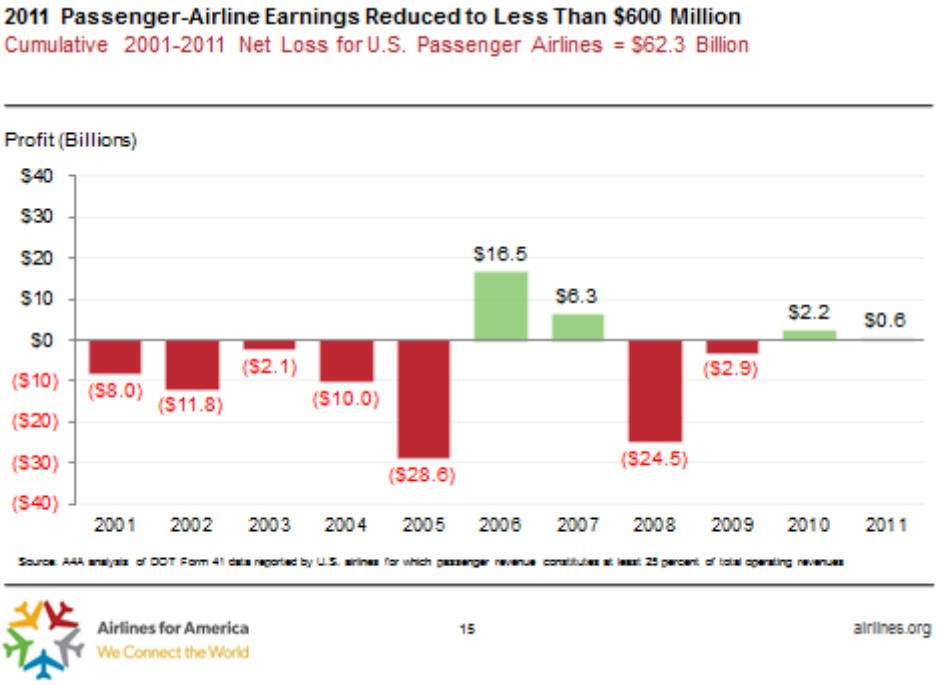
* Federally levied/approved commercial aviation taxes/fees only; some taxes/fees shown include collections from non-U.S. carriers

Sources: Department of Homeland Security; FAA, Office of Management Budget, Transportation Security Administration, AAA

More recently, there have been attempts to have airlines and their customers pick up the tab to reduce the federal budget deficit or to cover the cost for a payroll tax-cut extension. Last year and earlier this year, on multiple occasions, the administration offered a proposal that would triple the security tax we all pay on each flight, as well as impose on airlines a $100 tax on every plane departure. In the end, the proposals were rejected – but they are back. The White House budget proposal for Fiscal Year 2013 again proposes to triple the security tax and add a $100 departure tax. These new taxes alone would cost the airline industry $36 billion over the next 10 years.

The importance of these burdens is illustrated by comparing them to recent airline earnings – remembering first that U.S. airlines (passenger and cargo combined) ***lost*** $53 billion during the period 2001-2011. In 2010, U.S. passenger airlines earned a total of $2.2 billion, and in 2011 less than $600 million, a mere 0.4 percent profit margin. (Slide 7) Put another way, in 2011 U.S. passenger airlines earned just $0.81 per passenger.

Slide 7



Finally, as the Committee knows, the European Union continues to press ahead with its Emissions Trading Scheme, despite the widespread condemnation of it as a unilateral measure that is an unprecedented transgression of national sovereignty, including that of the United States.

A4A and its member airlines are committed to reducing greenhouse gas emissions from aviation and, with fuel-efficiency improvements have saved more than 3.3 billion metric tons of CO2 emissions since 1978, have a strong record of meeting that commitment. By investing billions of dollars in fuel-saving aircraft and engines, innovative technologies and advanced avionics, the U.S. airline industry improved its fuel efficiency by 120 percent between 1978 and 2011, resulting in emissions savings equivalent to taking 22 million cars off the road each of those years.

Our commitment is clear. The question is how to proceed? Our firm belief is that the United Nation's International Civil Aviation Organization is the proper, multilateral venue to develop a worldwide policy to reduce GHG emissions from commercial aircraft. We fully support ICAO's efforts and urge Congress and the Administration to oppose the EU's unilateralism.

U.S. POLICY HAS NOT EVOLVED WITH THE CHANGING GLOBAL MARKET WHILE OTHER COUNTRIES SUPPORT THEIR AIRLINES

The United States has championed free trade in the airline sector, and the U.S. airline industry has supported that effort. Our members are efficient, effective enterprises and are anxious to compete in the global marketplace.

The U.S. has entered into 107 Open Skies agreements with aviation trading partners. These agreements liberalize the aviation relationship and allow airlines to decide route, frequency, capacity and pricing decisions based on commercial considerations free from government interference. As the State Department notes on its website, "Open Skies agreements have vastly expanded international passenger and cargo flights to and from the United States, promoting increased travel and trade, enhancing productivity, and spurring high-quality job opportunities and economic growth." http://www.state.gov/e/eb/tra/ata/index.htm.

U.S. policy for its airline sector has not kept up with the evolution of the global market for airline passenger and cargo services. As discussed above, regulations are not grounded in the Airline Deregulation Act's fundamental policy goal of encouraging "efficient and well-managed air carriers to earn adequate profits and attract capital" by "placing maximum reliance on competitive market forces." 49 USC § 40101(a)(6). Instead, regulatory initiatives are *ad-hoc* and are guided by the government's perception of the issue-of-the-day and the vestigial but disproven view that government judgment is superior to the discipline of the marketplace. Likewise, the government's ever-growing appetite to tax the airline industry has increased the number of taxes and fees airlines and their customers pay and, of course, the amount paid – with no regard for their impact on demand.

These factors illustrate that the U.S. does not have a coherent airline policy that recognizes the strategic value of the U.S. airline industry and seeks to advance its global competitiveness. Rather than "strengthening the competitive position of air carriers to at least ensure equality with foreign air carriers…to maintain and increase their profitability in foreign air transportation," another of the Airline Deregulation Act's specific policy goals (49 USC § 40101(a)(15)), the *ad-hoc* approach to the U.S. airline industry has hobbled it.

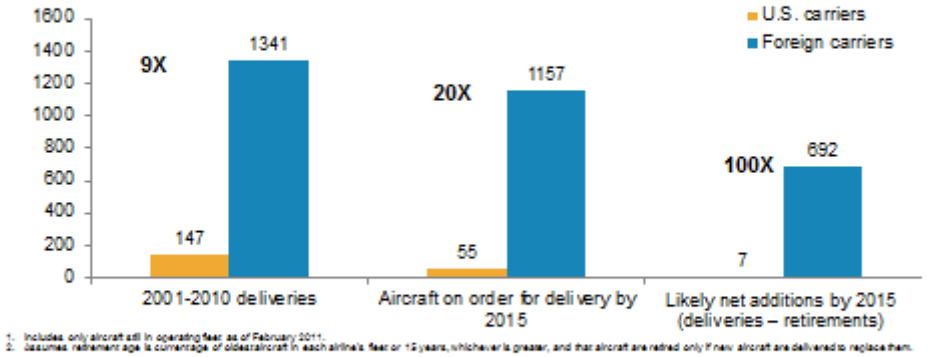
Other countries have championed their airlines. This is particularly true in South America, Asia and the Middle-East, areas that have seen strong growth and expansion by their airlines and where future demand is expected to be strong. Asian and Middle Eastern countries, in particular, have encouraged their airlines to grow and supported that growth with policies that reduce costs and encourage capital investment. Emirates and Singapore Airlines, for example, not only have large, young fleets of widebody aircraft, they also have considerably more widebody aircraft on order than U.S. airlines. (Slide 8) In fact, only one U.S. airline is on the list of the 15 airlines with the largest widebody orders. (Slide 9) With the greatest amount of growth forecast to be in the emerging economies, foreign airlines, not U.S. airlines, are poised to succeed. (Slide 10)

Slide 8

Enhance Global Competitiveness

Foreign Airlines' Widebody Aircraft Orders Dwarf Those of U.S. Airlines

Widebody passenger aircraft



1. Includes only aircraft still in operating fleet as of February 2011.
2. Assumes retirement age is current age of oldest aircraft in each airline's fleet or 15 years, whichever is greater, and that aircraft are retired only if new aircraft are delivered to replace them.

Note: Excludes orders by lessors where operator is unknown.

Sources: ACG and BCG analysis

Slide 9

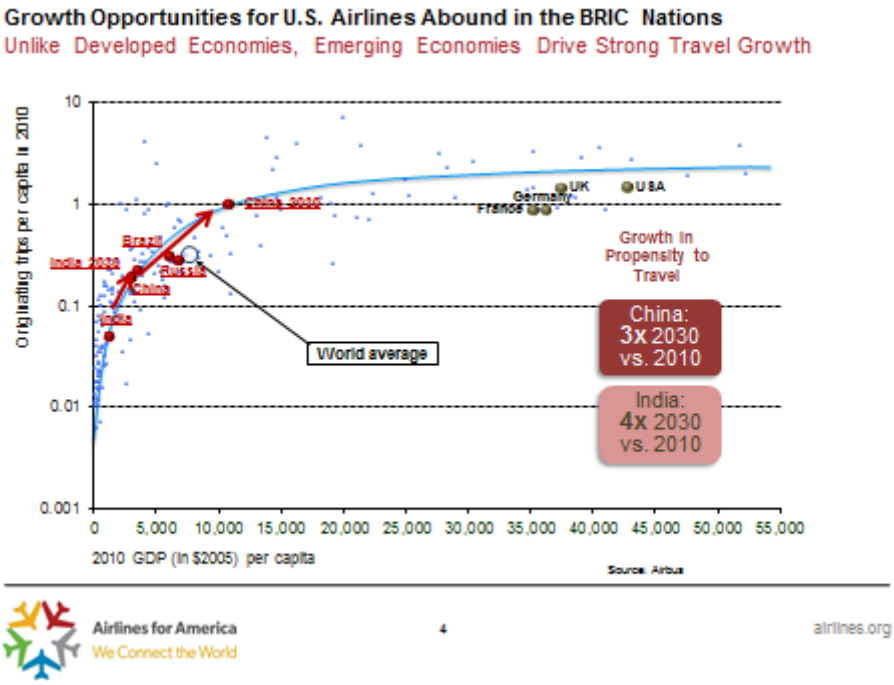
Despite Older Widebody Fleets Than Many of Their Global Competitors, U.S. Passenger Airlines Have Comparatively Few Widebody Aircraft on Order

	Widebody Aircraft in Service	#	Age
1	FedEx	255	21.3
2	Air France-KLM	178	10.1
3	Emirates	171	6.6
4	Lufthansa-SWISS-Austrian	160	10.8
5	**Delta**	**159**	**13.6**
6	IAG (BA-Iberia)	158	14.2
7	**United**	**155**	**14.4**
8	UPS	154	11.9
9	Cathay Pacific	133	10.4
10	All Nippon	127	11.7
11	**American**	**120**	**16.6**
12	Singapore	113	7.1
13	Korean	106	10.9
14	JAL	98	9.7
15	Thai	81	11.2

	Widebody Aircraft on Order	#
1	Emirates	238
2	Qatar	132
3	Cathay Pacific	88
4	LATAM	79
5	Etihad, **United**	75
6	Aeroflot	71
7	Singapore	65
8	Air China, All Nippon	51
9	IAG (BA-Iberia)	44
10	Korean, Qantas	43
11	Air Canada, Thai	42
12	FedEx, Hong Kong	40
13	Asiana	37
14	Gulf	36
15	Lufthansa	35

Source: Ch Av fleet data for June 2012

Slide 10



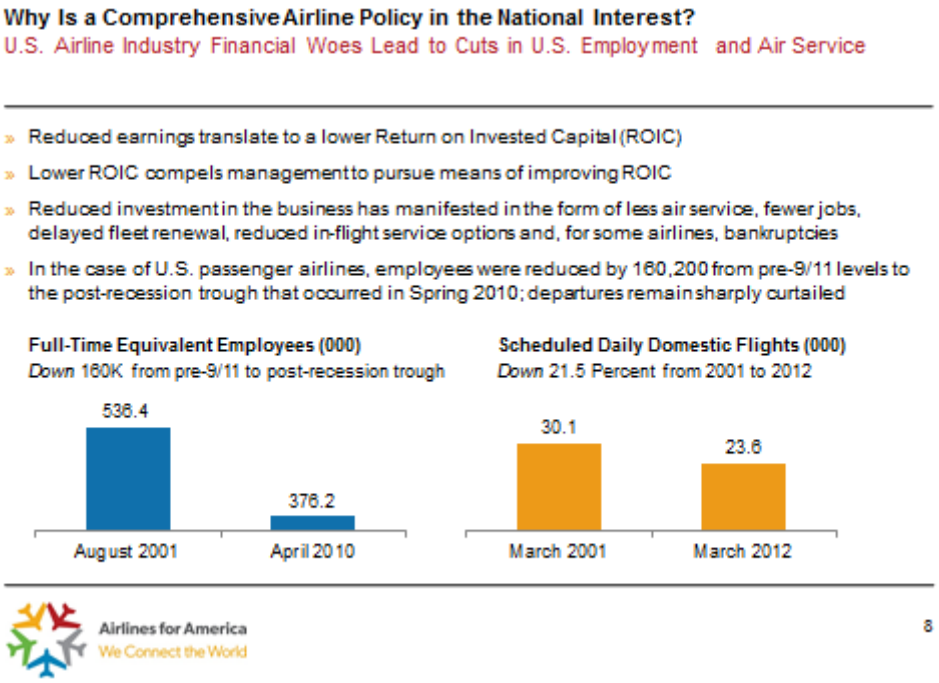
The international carriers who are buying the majority of planes today are providing the connectivity their governments envisioned – and driving economic growth in the process. This includes flying to the United States in increasing numbers – to our major cities – which has caused U.S. carriers to pull down capacity in some international markets, which is the most profitable part of the business and a part of the business that subsidizes – to a great degree – our domestic routes.

The impact of the Open Skies initiative coupled with the absence of a coherent airline industry policy is plain. 107 foreign airlines will fly to the U.S. from 98 countries in the third quarter 2012. This compares to 11 U.S. airlines scheduled to fly to 77 countries. Today, Emirates operates to Houston, Dallas, Los Angeles, San Francisco, New York JFK and Seattle, and just announced plans to launch service to Washington, D.C. in September. Etihad operates to New York JFK and Chicago. And they start service to Dulles in 2013. They are not alone. Dozens of foreign-flag carriers serve the United States today and more are looking to add service, including Brazil's Gol, which has announced plans for service to Miami.

Why is this important?

A strong airline industry drives high-quality, middle-class American jobs within the industry and is the foundation for jobs in the broader aviation industry. As we learned from the post-9/11 and post-recession years, an unprofitable airline industry translates directly into job loss, reduced service and reduced investment in airplanes, facilities and equipment. The entire value chain suffers. In August 2001, industry employment exceeded 536,000 full time equivalent employees. By April 2010, that number had dropped to just over 376,000, a loss of 160,000 good paying jobs. Likewise, an unprofitable industry cannot sustain the level of service America needs. In March 2001, there were just over 30,000 daily scheduled domestic flights. That number dropped more than 21 percent, to 23,600 daily scheduled domestic flights, in March 2012. (Slide 11)

Slide 11



Foreign carriers will not directly serve smaller U.S. markets. They will cherry pick profitable cities and rely on others to provide connectivity, at whatever cost, across the rest of the country. That is not good for American businesses or consumers.

The U.S. network carriers have a vested interest. Their business model accommodates connecting every part of the country with the revenues from the more profitable segments subsidizing the much less profitable, smaller communities. To continue to provide such service, U.S. carriers need a more rational, normalized business environment, with less government interference, and with a fair tax and fee structure. Our airlines want to compete head to head with their international competitors but on a more level playing field.

A4A Calls for a National Airline Policy

For all of the reasons discussed above, A4A is calling for enactment of a National Airline Policy – a comprehensive approach to putting the U.S. airline industry in a position to survive and thrive; a policy in keeping with the fundamental role it plays in the U.S. economy and that gives substance to the aspirations for the industry articulated in the Airline Deregulation Act.

These are the five core components that together form the basis of an effective National Airline Policy:

1. Reform our tax structure: Reduce taxes on this industry and our already overburdened customers.

2. Reform our regulatory environment: Ensure rules are based on sound science and cost analysis and eliminate rules that drive excessive costs or inefficiencies while doing nothing for safety or consumer benefit.

3. Fix the infrastructure – NextGen: Accelerate the deployment of the most cost-beneficial elements of NextGen by implementing policies and procedures to use the equipment we have in place today.

4. Enable global competitiveness: This industry needs to compete on a level playing field with global competitors. Endorse global strategies to address issues that affect us all, like the EU-ETS plan, and put in place the policies, resources and structure to promote business and leisure travel and tourism in the United States; and

5. Mitigate fuel costs and volatility: We need the Commodity Futures Trading Commission (CFTC) to follow its mandate and curb excessive speculation in the oil futures market and, at the same time, we need to bolster domestic fuels production and alternate fuels development in an environmentally sound manner.

This is a significant list with a great deal of work required on each part – and it will take time and unified engagement with Congress and the administration to get it done. A4A is committed to doing just that.

In conclusion, there is much to do but there can be no question that we need a holistic approach that addresses the fundamental tax, regulatory and infrastructure challenges that prevent this industry from being sustainably profitable – and globally competitive.