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before the

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

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Mr. Chairman, Co-Chairman Stevens, and Members of the Committee:

Introduction

Thank you for the opportunity to appear before you to discuss the state of the U.S. airline industry, the role of the federal government in the industry's ongoing restructuring, and the prospect of consolidation. This is an important and timely hearing. Although I cannot discuss the specifics of any potential merger transaction, I can shed some light on our outlook for the industry, the role of consolidation in the context of a deregulated business, and the process the Department of Transportation will use in reviewing an airline merger should a transaction be presented to us.

State of the U.S. Airline Industry: Short-term recovery, long-term challenges

Let me begin with the state of the airline industry. The U.S. airline industry remains in the midst of an historic restructuring. Over the last five years, U.S. network airlines have reduced their annualized mainline costs excluding fuel by more than 25%, or nearly $20 billion. While some of the cost savings were the product of identifying greater operational efficiencies, most of the savings were generated by renegotiation of existing contractual arrangements with creditors, aircraft lessors, suppliers and airline employees and achieved either through the bankruptcy process itself or under threat of bankruptcy. 22 percent of industry capacity is still operated in bankruptcy – down from a high of 46 percent in 2005 but still substantial by any measure. The result is that several carriers that were on the precipice of liquidation just five years ago now have much lower cost structures that should allow them to return to profitability over the short term.

The financial crisis that necessitated this massive restructuring and the sacrifices of our largest airlines and their employees was produced by the confluence of intense competition, structural conditions in the industry, and a series of exogenous events that temporarily depressed air travel demand or increased costs (e.g., the September 11th terrorist attacks, the war on terror, greater security burdens, SARS, and much higher fuel prices). During this difficult period certain sectors of the industry fared relatively better than the network airlines, including low cost and regional carriers and cargo/express operators.

In addition to geopolitical challenges, the industry has also found pricing to be increasingly competitive. Low cost carriers (LCC's) increased their share of the market from 23 percent to 30 percent during this time period, bringing prices down on many origin-destination routes ("city-pairs") to the benefit of air travel consumers. At the same time, the percentage of business travelers willing to pay substantially higher "walk up" or unrestricted fares has steadily fallen. These trends have been enhanced by the growth of the Internet as a mainstream marketing and distribution channel, creating an environment of nearly perfect price information for both leisure and business travelers, further curtailing the ability of network carriers to charge significantly higher prices to the most time-sensitive passengers. As a result, average yields fell from 14.2 cents per revenue passenger mile (RPM) in 2000 to 11.1 cents in 2005, before bouncing back to 12.4 cents in 2006. To put that in more understandable terms, the decline means that the price of a ticket for an industry-average, 882-mile trip has declined from $125 to $109.

This decline in average fares came despite the dramatic increase in the price of jet fuel over the past 18 months. Prior to their recent moderation, fuel prices more than doubled from approximately $1.03/gal jet kerosene in mid-2004 to over $2.23/gal in mid-2005 and remained near $1.91/gal throughout much of 2006. Jet kerosene is now $1.62/gal in the spot market, brought down by the very recent declines in the price of crude oil from which jet kerosene is derived. Fuel is now either the first or second largest expense category depending on the airline, representing on average about 26 percent of cost. Each one-cent increase in the price of a gallon of fuel translates into an additional $193 million annual expense for the industry. U.S. airlines have responded to the challenge of high and increasing fuel prices with operational and technological changes that have cut fuel consumption during the past 5 years, resulting in cost savings for the airlines, and cuts in emissions that benefit the environment. Nevertheless, fuel prices present a major challenge to the health of the industry in an environment in which airlines are obviously not able to pass on the full brunt of these higher costs to their customers. In effect, the growth in the fuel expense burden has masked the tremendous progress made by network carriers in cutting their costs to levels that are much more competitive with low-cost/low-fare carriers. Thus, on the positive side, if the very recent moderation in fuel prices continues, the industry is poised to reap material financial benefit in the short term, although again it is unlikely they would realize the full benefit of such savings. Overall, fuel price uncertainty will continue to motivate industry-wide cost discipline.

Airlines have focused on six areas of cost reductions:

- **Labor** – Taking a clear view of the necessity of cost reductions, labor and management have negotiated contracts that have generated major savings. In some cases, those reductions have been imposed through the bankruptcy process. U.S. network carriers have reduced their annualized labor costs by over $11 billion over the last five years.

- **Fuel** – Fuel saving initiatives such as single-engine taxiing, more efficient fuel-reserve practices, and installation of winglets have resulted in significant cost savings.

- **IT/Reservations/Customer Service** – Technology-driven enhancements to airline websites and self-service kiosks have not only reduced the cost of bookings and passenger handling, but have also improved the ability of carriers to generate additional

revenue at the airport from passengers willing to trade-up to premium services such as service class upgrades, one-day admission to airport lounges, or even exit-row seating.

- **External Distribution/Commissions** – The airlines renegotiated contracts with global distributions systems (GDS), further reduced travel agent commissions, and successfully induced travelers to book directly with carrier websites, which have resulted in substantial annualized air carrier savings. GDS booking fees have declined approximately 15 percent since mid-2003.

- **Fleet/Maintenance** – Fleet rationalization continues at a number of airlines both inside and outside of bankruptcy. Carriers are retiring older, maintenance-intensive, fuel-guzzling fleets with new aircraft that in many cases allow for common type-ratings, thus reducing training, spares, and maintenance expense.

- **Pension** – Bankruptcy has allowed several carriers to significantly reduce pension expenses. Furthermore, recent pension legislation will lessen funding requirements, thereby improving cash flow. The result has been to shift to the Pension Benefit Guaranty Corporation (PBGC) an increasingly large burden of funding the pensions of airline workers. According to the PBGC, airline pensions today represent at least 38 percent of PBGC claims -- but airlines paid just 2.6 percent of premiums.

For 2006, according to Wall Street analysts, the industry will record its first annual profit since 2000, estimated to be $2 billion on revenues of nearly $123 billion, for an approximate return on sales of 2%. The industry is also forecast to post profits this year, estimated to be approximately $6 billion on revenues of approximately $128 billion, or a 5 percent return. Over the short-term, network airlines are expected to maintain capacity and cost control. If the recent moderation in fuel prices continues, airlines will reap even more financial benefits from the structural changes made in their business models.

It is also important to note that over the last several years the significant and ongoing expansion in the scope of low cost carrier operations within the domestic market has not only resulted in lower fares, but has substantially expanded the availability of those low fare offerings much more broadly than ever before. Consumers in many markets where deeply discounted fares were either unavailable or offered with very limited capacity now have a low cost carrier option---and, of course, this service has had the effect of reducing the fares that network carriers offer in these markets as well. The price discipline created by a plethora of LCC offerings is pervasive.

Short-term prospects for the industry this year appear quite favorable based on the following factors:

- Positive revenue trends due to slower domestic capacity growth and very strong demand.
- Higher average yields in part due to less capacity pressure from low-cost carriers.
- Strong economic growth in the United States.
- Continued cost discipline.
- Improved balance sheets with encouraging levels of current free cash flow.

- Recent decline in fuel prices.

With a favorable supply-demand dynamic in place for the domestic airline industry, we expect the positive revenue trend to continue in the near-term. On the supply side of the equation, network carrier available seat miles (ASMs) are expected to increase no more than 3 percent, with the bulk of the growth in international markets. In fact, network domestic capacity is expected to decline. Most capacity increases will come from greater aircraft utilization, another sign of improved productivity. Conversely, according to analysts, domestic ASM growth for the low-cost carriers will continue growing over 10 percent, resulting in continuing share gains for LCCs in the domestic market. Overall, industry-wide domestic capacity is projected to increase 2.6 percent. On the demand side of the equation, load factors have reached record levels, enhancing the effectiveness of airline revenue management systems, which should enable the network carriers in particular to improve the fare mix and thus overall revenues.

Over the long term, however, the outlook for the U.S. airline industry is more uncertain. The industry faces persistent structural problems that must be addressed if we are to avoid facing another wave of bankruptcies in the next economic downtown, and if the industry is to take full advantage of the very substantial progress made in lowering unit costs. These problems are discussed below:

First, many network carriers remain highly leveraged despite shedding significant debt while in or under the threat of bankruptcy.

Second, the two biggest inputs into the industry's cost structure – fuel and labor – are by no means fixed and thus the lower-cost foundation supporting breakeven results in 2006 and modest profitability in 2007 is impermanent. With respect to labor costs, history suggests that organized groups will gradually seek to recoup the wage rate reductions acceded to in economic downturns and will do so at the earliest stages of industry recovery, which we are now seeing. With respect to fuel, given the airlines' inability to pass on the full impact of higher fuel prices to their customers, their bottom line remains quite sensitive to fluctuations.

Third, several of the biggest and most important international markets still have unnecessary constraints on competition – including the United Kingdom, China, Japan, and several countries in Latin America – that effectively protect foreign airlines and raise costs for U.S. carriers and consumers.

Fourth, cross-border investment restrictions artificially raise the cost of capital to U.S. carriers. Those restrictions also prevent U.S. carriers from optimizing their business models and taking advantage in international flying of their inherent network strength (a result of operating out of the world's single largest aviation market) and their newly minted, lower cost structures.

Fifth, the continuous cycle of domestic bankruptcies has required U.S. carriers to reduce capital expenditures substantially in order to bolster beleaguered balance sheets. This has meant delaying much needed investments in fleet renewal, new technologies, and product enhancements to remain competitive. This deficiency is becoming increasingly serious, especially as our carriers must vie with foreign rivals that have surged ahead in making such investments.

Finally, any discussion of the structural challenges facing the U.S. airline industry must also include mention of the apparent effects of the bankruptcy process not only on those firms that are forced to seek protection under the bankruptcy code, but also on the rest of the industry that attempts to operate without those protections. Respected airline industry analysts have frequently observed that the airline industry is, paradoxically, relatively easy to enter and hard to leave – sometimes characterizing this phenomenon as an "exit barrier" for failed firms that is the inadvertent consequence of the Chapter 11 reorganization process. They point out that airline stakeholders (lenders, suppliers and employees) – any one of whom could singly cause an air carrier's demise – rarely force such an outcome and instead trade in old contractual arrangements and debt for new ones. And the net result of those decisions is, perversely enough, that those carriers who manage to avoid bankruptcy eventually find themselves at a serious competitive disadvantage.

The airline industry is particularly susceptible to this phenomenon because the business is highly responsive to economic cycles. Just as most network airlines are now expected to turn an operating profit, most lost substantial sums in the last several years; when one carrier finds itself in trouble, typically most others do. Consequently, when one firm falls behind on its aircraft lease payments, its lessors may lack the economic leverage to reclaim assets (because they cannot redeploy them profitably elsewhere) – and thus don't. This is compounded by the ability of airlines operating in Chapter 11 to win significant savings on their leases and postpone reconfirmation of leases, allowing bankrupt airline managers to 'time' the bottom of the market and gain a capital cost advantage over their competitors. Airports that are reliant on large airline tenants face a similar bargaining dynamic in difficult financial times for the industry and must also make concessions that keep failing companies afloat. Organized labor usually makes the same decision; that it is better to keep their employer alive even at much lower wage rates than suffer the job and retirement benefit losses of failure. Similarly, the liquidation of an airline will ordinarily leave a debtor far worse off than a restructuring in bankruptcy – even one in which creditors get relatively little on the dollar -- because even the prospect of a major airline shutting down will practically halt ticket sales, forcing assets to be sold at "fire sale" prices. Yet precisely because of the underlying volatility of the industry, the airlines in effect offer a huge "option value" to their stakeholders; that is, the risk of continuing to invest in or extend credit to a bankrupt or near-bankrupt airline is outweighed by the potential reward if the company should survive. All of this ensures that even failing airlines will almost always have access to capital, thus perpetuating the cycle of failure.

While these structural conditions cloud the long-term outlook for airlines, once they are addressed, the industry can more easily meet the public's expectation of low fares, reliable service for smaller communities, and innovative product offerings that are competitive in a global marketplace. Indeed, the role of international markets and the growth opportunities they now present for U.S. network airlines should not be underestimated. I am confident that if we can avoid another cycle of bankruptcies, there is every reason to expect U.S. airlines to succeed in exploiting their advantages to profit from the tremendous growth opportunities offered by the liberalization of international aviation markets through "open skies" agreements. And ultimately, this will redound to the benefit of U.S. consumers in the form of more service to more destinations at lower fares.

Role of Government: Consolidation in the context of complete deregulation

These observations about the short- and long-term state of the airline industry necessarily implicate the question of the appropriate role of government in the industry's ongoing restructuring. By deregulating the airline industry in 1978, Congress set the U.S. Government permanently on the path away from intervention in the marketplace. This was a wise choice. The Department of Transportation has long believed that deregulation has been a success in producing widespread service with low fares, while achieving a spectacular safety record. The American people continue to enjoy the most abundant, most reliable, safest, and most affordable air transportation in our Nation's history. Noting the success of airline deregulation, Congress went on to deregulate motor carriers, railroads, electricity, energy, telecommunications, and financial services. As governments around the world have increasingly opted for market-based approaches, deregulation has become the default policy of the global economy.

As we examine developments in the airline industry and consider the appropriate policy response toward them, the Department of Transportation strives to apply a "value-added" test for regulatory burdens. Simply put, at a time when the industry is buffeted by so many forces – some attributable to the marketplace, some to geopolitical challenges – government needs to ensure that each of its regulatory requirements continues to serve a valid public purpose, and the interests of the American people and the U.S. economy.

The Bush Administration has been applying that test rigorously, and finding ways to reduce further the regulatory burden while protecting the traveling public. For example, we eased the requirements on airports relating to the filing of competition plans. We repealed in their entirety DOT's 20-year-old regulations governing the use of computer reservation systems. We created an expedited, simplified procedure to award "route integration authority" for five years to all U.S. carriers who apply for it. We have eased tariff filing requirements for the airlines of countries with which the U.S. enjoys a liberal aviation relationship. And we simplified the requirement for disclosure of code-share and long-term wet lease arrangements in print advertising.

Our efforts to get unnecessary government constraints out of the way of innovation are further evidenced by our persistent pursuit of liberalized bilateral air services agreements, adhering to the open skies model wherever possible. Working with the Department of State, and with the support of other agencies, we now have over 70 open skies partners. The U.S. government has thereby created new commercial opportunities for U.S. carriers while bringing the benefits of affordable air travel across the world to American consumers and to foreign citizens desirous of spending money here.

We need to fully understand the problems affecting airlines and should take advantage of the current environment – in which the domestic airline industry appears to be in the midst of a robust cyclical recovery – by completing the work of deregulation. If we want a sustained recovery and the benefits that will bring to consumers we need to ensure that government does not purposefully or inadvertently prevent the industry from undertaking the restructuring demanded by market

forces. This may necessitate a reexamination of regulatory and policy assumptions in key areas like bankruptcy, pension funding, labor relations, and aviation infrastructure financing and development. Our policies in each of these areas undoubtedly come with burdens and benefits not only for the flying public, but also for taxpayers, investors, and employees. We need to better understand the aggregate impact of these policies and ensure that they do not inadvertently create obstacles to an efficient and competitive industry in the long run.

This same philosophy will inform the Department's approach to larger policy questions involving the issue of "consolidation." The history of deregulation has shown quite clearly that American travelers and shippers can support a mix of carrier types with different business models. The challenge we face is to ensure that our regulatory regime does not stand in the way of marketplace forces that would otherwise result in new entry, business combinations, asset sales or even exit. In a dynamic market, new entry acts as a force that disciplines incumbents and thus ideally fosters innovation and efficiency. Just as new entrant firms must be afforded competitive access to satisfy marketplace demands, we must allow failing firms to exit the business if market forces decide that assets should be reallocated to more efficient firms. This is a natural consequence of a deregulated industry and the mechanism by which market forces ensure that the needs of American travelers and shippers are met in the most efficient way possible.

Industry consolidation – regardless of the sector – fundamentally occurs in three different ways – through the combination of firms, through asset sales or through the exit of failed companies. Business combinations are not necessarily an elixir for any industry, much less the domestic airline business. Merging two air carriers is a demanding and extremely complex endeavor that requires effectively combining route networks, information technology systems, aircraft fleets, and perhaps most daunting, two different work forces. As a result of these many complexities, mergers usually fail in the airline industry, but some don't, and we should be open to both possibilities.

Completing the work of deregulation – the centerpiece of our policy – means better understanding the role that applying our competition laws has played, if any, in impeding market forces that may benefit the public interest. In this context, it is important to emphasize that the Department of Transportation must fulfill a broader set of statutory policy objectives than does competition law. While protecting the interest of U.S. consumers in having access to low airfares remains paramount, Congress has also instructed the Secretary of Transportation, in carrying out the Department's responsibilities to consider other important goals: including the use of marketplace forces to encourage efficient and well-managed air carriers to earn adequate profits and attract capital, to ensure that consumers in all regions of the United States have access to affordable, regularly scheduled air service, to promote a viable, privately-owned United States air transport industry, and to strengthen the competitive position of air carriers to at least ensure equality with foreign air carriers. Our analysis of a proposed merger will necessarily be informed by all these considerations.

However, before I leave this discussion on the role of government, I want to note that there is an important area where government can, and must, play a major role in driving change and innovation. Infrastructure constraints, and the resulting congestion problems are a significant long-term difficultly facing the airline industry. Congestion problems are widespread: travelers

are delayed, airlines incur additional costs, and economic activity reliant on air service is slowed. Air traffic is expected to approximately triple by 2025 and, without action, congestion will become crippling.

In order to address this problem, the Department of Transportation is working along side several other federal agencies including the Departments of Defense, Homeland Security, Commerce, NASA, and the White House Office of Science and Technology Policy to develop the Next Generational Air Transportation System, what is known as "NextGen". These efforts, spearheaded by the Federal Aviation Administration, are being coordinated through the Joint Planning and Development Office (JPDO), which is staffed by officials from all of these agencies.

NextGen promises to revolutionize the way in which air traffic moves by using networked information, satellite-based navigation, enhanced aircraft capabilities, new flight procedures, and automation among other things. These technologies will allow more efficient use of physical aviation infrastructure, thus boosting the capacity our system and facilitating greater economic growth. We believe that, in creating NextGen, the federal government is contributing an essential element to the long-term success of the U.S. airline industry.

DOT's Role in the Review of Merger Transactions

Now that I've provided some insight into our perspective, let me explain how the review process within the Department might transpire should any proposed transaction move forward.

In addition to requiring bankruptcy court approval, the proposed merger would be reviewed by both the Antitrust Division of the Department of Justice and the Department of Transportation. The Antitrust Division is responsible for determining whether the transaction will be challenged under the antitrust laws. The Department of Transportation would conduct its own competitive analysis of the proposed merger and by practice will submit its views and findings to the Antitrust Division privately.

DOT would also consider a wide range of public interest issues involving, among other things, route transfers, economic fitness, code-sharing, and possible unfair or deceptive practices. In practice, we would not formally consider such issues until the Antitrust Division advised us that it did not intend to challenge the transaction.

If a proposed transaction involved the acquisition of international routes, consummating the merger might entail the transfer of certificate authority to a new entity. By statute, 49 U.S.C. 41105, we may approve a transfer only if we find that it is consistent with the public interest. We must analyze the transfer's impact on the viability of each airline party to the transaction, competition in the domestic airline industry, and the trade position of the United States in the international air transportation market. As a practical matter, transfers are important only when the acquired airline holds route authority in limited-entry markets. We would only decide whether to approve the transfer after we had established a formal record and given all interested persons the opportunity to comment. Our discussions with the Antitrust Division on a proposed merger would likely include a discussion of the competitive effects of the transfer of any

international routes. If the Department determines that the transfer would be contrary to the public interest on competitive grounds or for another reason, the Department could disapprove the transfer in whole or part. Alternatively, the Department may condition its approval on requirements that would protect the public interest.

Usually, a proposed merger will result in a new corporate entity under new ownership, and when that is the case, the Department would conduct a fitness review, including a review of airline management, financials and compliance disposition. The Department would also review any code-share arrangements concluded between the merging carriers under 49 U.S.C. 41720. In the Department's experience, code-share arrangements would likely be necessary during the early phases of integration post-merger. Meanwhile, the Department would also have to evaluate the impact of a merger on any domestic marketing agreements or international alliances. As U.S. airlines participate in all three worldwide alliances, some of which enjoy antitrust immunity from the Department and some of which don't, we would need to review how the changes in alliance memberships affect airline competition.

The Department has the obligation under 49 U.S.C. 41712 to protect consumers from unfair and deceptive practices by airlines. In carrying out that responsibility, we could, if appropriate, review the proposed merger's arrangements to protect the rights of consumers. For example, it could be necessary to assess whether the merging airlines plan to give consumers reasonable notice and an opportunity to adjust to any changes in the frequent flyer programs.

Conclusion

The issue of "consolidation" should thus be understood in the broader context of allowing deregulation to address the airline industry's problems. An industry that is truly subject to marketplace forces will often go through phases of restructuring or consolidation. This can occur in a variety of forms – not necessarily just mergers and acquisitions. The airline industry is very dynamic. Thus government policy should evolve in parallel constantly taking into account in rapidly changing economic conditions, competitive environment, and industry innovation. The government, absent a clear and convincing need to protect the traveling public, should not stand in the way of market forces acting to address structural problems within the industry.

To be sure, mergers are not a panacea for the industry's long-term problems. Because of the complexity of integrating different labor forces and fleets, many mergers in the airline industry have failed to fully achieve their creators' objectives. But we should not assume that having fewer network carriers necessarily translates into detriment to consumers. To the contrary, an industry populated by several successful firms could contain intense and diverse forms of competition as we can see in other industries, such as the cargo/express delivery business in which a few large firms compete vigorously not only on price but also on product innovation.

Let me be clear, however. My remarks today should not be interpreted as an endorsement or rejection of any particular transaction or combination of transactions, or of mergers as the optimal way to address the structural conditions that have impeded innovation. Each proposed transaction must and will be considered on a case-by-base basis. The airline industry should be held to the

same antitrust standards as every other industry and certainly there will be transactions that fail to satisfy a rigorous antitrust test. But as the Department of Transportation examines such transactions, it will do so with a variety of statutory policy objectives in mind, not the least of which is our obligation to ensure a viable airline industry that can meet the transportation needs of the American people.

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