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before the

AVIATION SUBCOMMITTEE

of the

TRANSPORTATION AND INFRASTRUCTURE COMMITTEE
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Chairman Costello, Ranking Member Petri, and Members of the Committee:

Introduction

I am grateful for the opportunity to appear before you to discuss the current and future state of the airline industry, issues related to consolidation, and the role of the Department of Transportation (DOT) in the industry's ongoing restructuring. This hearing is in response to the proposed Delta/Northwest merger, a potential combination that has understandably captured the interest of this Committee and the American people.

Although it would not be appropriate for me to discuss the specifics of any proposed transaction that is currently before the federal government, I hope I can shed some light on the process of reviewing an airline merger.

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, one that was precipitated by a fundamental change in passenger demand. This change in demand had begun prior to September 11 and continued even as the industry adjusted to the subsequent security measures and made operating and workforce changes.

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. Legacy carriers had successfully restructured and adapted their business models to compete in a more price-sensitive environment with low-cost carriers that have continued to expand throughout the decade. In 2008, however, persistent record-high fuel prices have eclipsed the benefit of legacy carrier cost reductions and other efficiencies obtained through restructuring, both in and out of bankruptcy, and are changing the fundamental economics of the industry. In the first quarter of this year, the industry posted a net loss, excluding special items, of about $1.7 billion, compared to a profit of $58.9 million in the first quarter of 2007.

Going forward the outlook for airlines has certainly become cloudy. The industry faces three major challenges in 2008: significantly higher than expected fuel prices, a potentially weaker economy, and labor cost pressures. Wall Street currently estimates that, with oil at $110 per barrel, the U.S. airline industry will lose approximately $4.5 billion this year. Let me briefly address each of these major concerns.

Clearly, the major challenge for the industry remains record high fuel prices, hovering around $120 per barrel. Fuel 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 for fuel on a system basis. This figure 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 rising cost to the airlines becomes much more understandable. Between 2004 and May 2008, the New York spot market jet fuel price increased approximately 247 percent from $0.98 to $3.40 per gallon. While the industry posted an operating loss of approximately $1.7 billion in the first quarter 2008, it would have posted an operating profit of $3.61 billion in that quarter had fuel prices remained at 2004 levels. More recently, Gulf Coast jet fuel prices, driven by jet fuel "crack" spreads in excess of $33/bbl, have surged as high as $3.57 per gallon. Although current crack spreads are not nearly as high as they were during the period following Hurricanes Katrina and Rita in the fall of 2005, the all-in price of jet fuel is still at a record high. The increase in the price of jet fuel is demonstrated by the proportion that it represents of a carrier's total operating expenses. Fuel has increased from 19 percent of total operating expense in 2004 to 28 percent in 2007 and may be nearly 40 percent for 2008 based on current trends. It is unclear, however, the degree to which carriers will be able to pass at least part of the high fuel cost to consumers.

Soaring fuel prices have masked the tremendous progress legacy carriers have made in reducing their costs to levels more competitive with those of low-cost/low-fare carriers and eclipsed gains that could have been used to fund essential long-term capital expenditures. Ongoing fuel price pressures have motivated industry-wide cost and capacity discipline. All carriers are trying to adjust their business models to cope with yet another significant challenge.

With respect to the second challenge, passenger carriers report that demand currently remains fairly strong going into the busy summer travel season. There is, however, some regional weakening in domestic markets and greater concern for the fall and winter. Airlines continue to cut unprofitable capacity, rather than focusing on maintaining or increasing their market shares. Most legacy carriers are planning to substantially reduce domestic capacity after the summer travel season. Should economic conditions fail to improve, carriers will likely make additional capacity cuts when finalizing their fall schedules. Even low-cost carriers, which seek to expand their networks to appeal to a larger customer base and establish more broad-based networks to compete with larger legacy carriers, have significantly trimmed their growth rates.

Labor costs pressures constitute a third challenge facing the airline industry. As airlines returned to profitability over the past two years, labor groups have sought to restore much of the estimated $6 billion in annual wage reductions shed in recent years. High fuel prices and low-cost carrier competition are making it extremely difficult for airline managements to address labor's concerns.

In addition to the major challenges already described, airlines are also confronted with institutional investors who have become frustrated with lagging stock prices and have suggested ways to unlock stockholder value. These suggestions include the sale of frequent flyer programs, regional airline operations, and carrier-owned heavy maintenance divisions – as well as mergers, which I will address in a moment.

During this period of adjustment to high fuel prices, cash and liquid assets are essential to an airline's survival. It is important to note, however, that unlike the situation during the last recession, which led to large operating losses, legacy carriers are now generally better prepared to weather an economic downturn. Not only have carriers significantly reduced their cost structures and become more efficient, but their cash balances are substantially higher than they were in 2001. On the cost side, according to one study, there are over 450 aircraft in the legacy carrier mainline fleets that are either nearing lease expiration or are otherwise unencumbered. These aircraft could be grounded, without significant cost, to further cut capacity.

With record high fuel prices, the U.S. economy slowing down, and credit and financing more difficult to secure, some observers suggest that consolidation is the only route the industry can take to address the challenging short-term environment and to achieve long-term stability. Industry consolidation – regardless of the business sector – fundamentally occurs in two different ways: through the exit of failed companies or through the combination of companies. Historically, both forms of consolidation have been part of aviation since the industry was deregulated.

The first form of consolidation is already well underway as Aloha Airlines, ATA Airlines, Skybus, MAXjet, and EOS Airlines have all filed for bankruptcy and ceased passenger operations. While each of these airlines also experienced difficulties unique to its particular business, all of them noted that record high fuel prices played a primary role in their demise. Concerns about the implications of slowing demand on the industry's fortunes led the credit card processor for Frontier Airlines to increase holdbacks on tickets purchased using credit cards. In turn, the larger holdback led the carrier to file for Chapter 11 protection in order to protect its cash position as it continues to operate while restructuring.

Delta and Northwest have proposed the second type of consolidation -- a merger combination. Other, similar announcements may follow in response. One stated goal of this merger is the reduction of costs through operating efficiencies and synergies.

In the current environment of record high fuel prices and a slowing economy, however, mergers are unlikely to ease the short-term financial pressures on carriers for a number of reasons. While mergers might help reduce capacity and cut costs in the medium- to long-term, they are unlikely to be a short-term solution to the industry's current challenges unless the merging carriers plan to immediately and drastically reduce capacity and increase fares. Even if the merging carriers take such action, short-term results would be limited because capacity comes out of an airline's system much faster than costs; while grounded aircraft do not accrue some variable and fixed costs, many such costs remain in the system. Few short-term benefits therefore result from any capacity cuts facilitated by a merger. In short, past experience with airline mergers suggests that they may bring large, up-front costs while any benefits are not realized until several years later.

Historically, even over the long-term, past mergers have been expensive and time-consuming, as diverse components including fleets, computer systems, and cultures are combined. Labor integration has been among the most challenging hurdles to overcome. Merging unions in the past has proven to be difficult and costly, with the most expensive features of each contract becoming the standard in the combined labor agreement. Though often overlooked, systems integration – the heart of vital airline planning and operating functions – is also enormously costly and complex. Even the most ardent proponents of consolidation (most notably the hedge fund managers who are less concerned about the long-run financial health of the industry) recognize the significant risks of execution and poor track record of past airline industry mergers.

The value to the carriers in any merger would primarily result from the synergy and cost cutting that could be obtained. Ultimately however, consolidation through mergers as a successful endgame for the legacy carrier segment of the industry must result in lower costs, the ability to profitably charge relatively low fares, better service, a rationalization of high-cost capacity, and hence a more efficient and viable industry. If a merger agreement does not result in lower costs for the merged entity – in the short, medium, and long term – the merged carrier will still be unable to compete with low-cost carriers, which continue to steadily gain market share as well as enter additional markets.

As low-cost carriers continue to expand, legacy carriers must find ways to become more efficient producers, particularly given the commodity nature of the airline seat. In short, the fundamental restructuring of the airline industry that occurred in the first half of this decade revealed an outdated industry structure built around an unsustainable cost structure. Today's airline industry economics can be boiled down to one irreducible fact: carriers with high costs and a weaker product offering lose market share; carriers with low costs are able to gain market share – almost without exception.

Role of Government

Having outlined the challenges facing the airline industry, I would like to discuss the appropriate role of government in the airline industry. By deregulating the airline industry in 1978, Congress set the DOT permanently on the path away from intervention in the marketplace. Many, including the DOT, have a long-held view that deregulation has been a success. It has enabled carriers to produce an abundance of service with low fares – while achieving 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 11 terrorist attacks. The architects of airline deregulation predicted that new, innovative airlines would enter the market, 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, although it happened differently and somewhat more belatedly than expected.

While deregulation has been a success – adjusted for inflation, the average fare in 2005 was half of what it was in 1979, the industry continues to undergo restructuring as a result of dynamic market forces.

A healthy industry that is responsive to the needs of passengers and shippers is important. September 11 showed us how the effects of a disruption in air commerce reverberate throughout the economy. Over the longer term, an industry that perennially either loses money or makes suboptimal returns cannot consistently offer the quality and breadth of service that consumers demand.

We therefore need to fully understand and address the challenges facing airlines. If we want a healthy airline industry – and not just a few quarters of positive earnings, we need to ensure that government is not advertently or inadvertently preventing the industry from undertaking the restructuring demanded by market forces. Providing a regulatory environment in which U.S. carriers can compete and leverage their strengths in perhaps the most obviously global of industries must remain one of our policy objectives. Put differently, the rules and policies we follow domestically should not inadvertently tilt the playing field against American companies in the global marketplace.

The history of deregulation has shown quite clearly that American travelers and shippers are best served by a mix of carriers 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, or other commercial responses.

In a dynamic market, new entry acts as a force that disciplines incumbents and thus ideally fosters innovation and efficiency. But just like new entrant carriers need to be afforded the access they require to satisfy marketplace demands, so too do incumbent firms need to be able to adapt and adjust to the market, and perhaps even exit the market when market forces decide that assets should be reallocated to more efficient firms. As I noted earlier, carriers with high costs and a weaker product offering lose market share; carriers with low costs are able to gain market share – almost without exception. When incumbent carriers are able to achieve the changes necessary to compete – through whatever legal means - they can, and do, succeed. This cycle of market entry and exit 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.

The issue of "consolidation" should thus be understood in the broader context of allowing deregulation to address the airline industry's perennial challenges. In an industry that is truly subject to marketplace forces, we will inevitably see restructuring resulting in consolidation. This can occur in a variety of forms – not necessarily just mergers and acquisitions. The airline industry is very dynamic and government policy should take into account cyclical economic conditions, the competitive environment, infrastructure access and capacity, and industry innovation. Each proposed transaction must be considered on a case-by-base basis. The airline industry should be held to the same antitrust standards as every other industry and there will inevitably be transactions that fail to satisfy a rigorous antitrust test.

DOT's Role in Merger Transactions

Since the sunset of DOT's authority to approve airline mergers on January 1, 1989, the Department of Justice (DOJ) is responsible for reviewing proposed airline mergers, due to its primary jurisdiction over the antitrust laws. The DOT typically provides the DOJ with advice and analysis on airline competition issues. This practice is consistent with Congress' determination that the deregulated airline industry should generally be subject to the same application of the antitrust laws as other unregulated industries. The DOT is committed to ensuring an environment that both allows airlines to adapt to rapidly changing economic conditions and embraces competition and provides consumers with the price and service benefits that competition brings. In order to make it more transparent, let me explain how the review process might transpire.

The proposed merger would be reviewed by the Antitrust Division of the Department of Justice under the antitrust laws. The Antitrust Division would consider whether to challenge the transaction in the courts. The DOT could examine the proposed merger and submit its views to the Antitrust Division privately.

If the Antitrust Division does not challenge a transaction between major airlines, DOT would then consider a wide range of issues that fall within its jurisdiction, including international route transfers, economic fitness, code-sharing, and possible unfair or deceptive practices.

With respect to international routes transfers, 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 also 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, route transfers are important only when the acquired airline holds route authority in limited-entry markets.

We would only decide whether to approve the international route transfer after we had established a formal public record and given all interested persons the opportunity to comment. If the DOT determines that the transfer would not be consistent with the public interest or would be inconsistent with international aviation policy, the DOT could disapprove the transfer in whole or in part. Alternatively, the DOT may condition its approval on requirements that would protect the public interest.

Because a proposed merger of major carriers would involve either a new entity created to acquire one of the carriers or a significant change in the structure of one of the existing carriers, the DOT would institute a fitness review of both carriers. In addition to a review of airline management, financials and compliance disposition, the merging carriers would have to file a joint application requesting that the DOT transfer the economic authorities under 49 U.S.C. 41105. The transferred authority will not become effective until such time as evidence supporting the actual integration of the merger carriers' operations into a single entity is received by the DOT or until such time as the integrated air carrier’s authority is surrendered to the DOT and/or the Federal Aviation Administration, whichever occurs earlier.

The DOT may also review any code-share arrangements involving the merging carriers under 49 U.S.C. 41720. In the DOT’s experience, code-share arrangements would likely be necessary during the early phases of integration post-merger.

The DOT 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 a proposed merger's arrangements to protect the rights of consumers. For example, it might be necessary to assess whether the merging airlines plan to give consumers reasonable notice and an opportunity to adjust to any changes in their frequent flyer programs.

With respect to Federal Aviation Administration (FAA) oversight of an airline merger, the agency will set up a Joint Transition Team to ensure that changes at the two merged carriers will not have negative safety impacts and to coordinate activities between FAA organizations. The surviving airline is expected to submit a “transition plan” to the FAA, the purpose of which is to outline changes to be made and establish a timetable for those changes. The FAA acceptance of the merger transition plan represents a commitment by the principal inspectors to make reasonable efforts to accommodate the controlling airline’s planned changes in a timely and responsive manner. When the FAA finds that an airline merger transition plan is acceptable, it will issue Operations Specification (OpSpec) A-502 to both carriers involved in the merger. This OpSpec provides legal authority for the merging airlines to operate during the transition period and specifies which airline will have operational control authority over the combined operation.

During the transition from two separate airlines to one, the FAA will monitor and verify the current operations of the separate entities and validate the new operations and procedures that will be adopted for the “new” airline. The FAA will ensure that management personnel at the controlling airline are aware that it must continue to operate with current approvals. Once changes required by the transition plan are completed, and FAA approvals obtained, the airline can then implement those procedures. FAA surveillance is increased during and following airline mergers in order to ensure that operations are conducted in accordance with the transition plan.

Conclusion

Airlines are the circulatory system of national and global communities – linking friends and family, suppliers and producers, retailers and manufacturers, and fostering educational and cultural exchanges of all types. Every American has both a personal and an economic interest in access to safe and affordable air service. In addition, the U.S. airline industry employs over half a million people. It is therefore easy to understand why so many people who otherwise have little interest in corporate mergers and acquisitions in other industries, have opinions on airline mergers.

Our consideration of aviation economic policy must necessarily focus on what is best for both a healthy and a competitive industry. Our goal must be to strike what is admittedly a very difficult balance in the face of a complex and dynamically changing industry. It must also embrace not just a short-term view of the impact on a particular group of stakeholders, but must consider the longer term, collective impact on all stakeholders.