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# CURRENT SITUATION AND FUTURE OUTLOOK OF U.S. COMMERCIAL AIRLINE INDUSTRY

**(109–32)**

## HEARING

BEFORE THE

SUBCOMMITTEE ON
AVIATION

OF THE

COMMITTEE ON
TRANSPORTATION AND
INFRASTRUCTURE
HOUSE OF REPRESENTATIVES

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# CURRENT SITUATION AND FUTURE OUTLOOK OF U.S. COMMERCIAL AIRLINE INDUSTRY

**Wednesday, September 28, 2005,**

U.S. HOUSE OF REPRESENTATIVES, COMMITTEE ON TRANSPORTATION AND INFRASTRUCTURE, SUBCOMMITTEE ON AVIATION, WASHINGTON, D.C.

The committee met, pursuant to notice, at 2:00 p.m., in room 2167, Rayburn House Office Building, Hon. John L. Mica [chairman of the subcommittee], presiding.

Mr. MICA. I would like to call this hearing of the House Aviation Subcommittee to order.

Welcome everyone today.

The topic of today's hearing centers on an important subject: the current situation and future outlook of the United States commercial airline industry. We only have one panel today so I am going to let the panelists go a little bit longer and talk about eight minutes. We have assembled hopefully some of our Country's best minds on the subject and we will hear what the professionals have to say.

The order of business will be opening statements by members. I will start and then we will hear from the panelists.

I do have a request. We have Ms. Schmidt, a member who has requested to participate in our hearings. The normal procedure is I will ask for unanimous consent for you to participate and in doing so, also you will be the last to be heard or last to offer questions. So, welcome. I ask unanimous consent to allow Ms. Schmidt to participate in today's hearing.

Mr. COSTELLO. Without objection.

Mr. MICA. So ordered. Thank you and welcome.

We will start with my opening statement. Today's hearing will focus on the current situation and future outlook of the United States commercial airline industry. Looming changes in our Federal bankruptcy law and fuel prices helped send Delta and Northwest into bankruptcy earlier this month. Unfortunately, this is just the tip of an iceberg of challenges that America's airline industry has experienced over the past four years.

The airline industry in the United States lost some $32 billion during this time period and it may face an additional $9-$10 billion loss which is projected for this year, 2005. An economic slowdown, declining business travel, increased competition from low cost carriers, the 9/11 terrorist attacks, the SARS epidemic and rising fuel costs have all contributed to the industry's unprecedented losses. After surviving all of these challenges, despite these great obsta-

cles, in the last quarter, American, Continental, United and several discount carriers reported small operating profits.

Until yesterday, when US Airways emerged from bankruptcy to merge with America West, almost half the capacity of the airline industry was flying in bankruptcy. Most legacy carriers have made cuts in labor, operational and also their administrative costs. Unfortunately, their only other option to bring about further reforms has been bankruptcy.

While the airline industry is no stranger to bankruptcy, having so many major carriers in bankruptcy certainly does get everyone's attention and it has. Historically, airlines have failed at a much higher rate than most other types of businesses. The airline industry has the worst financial performance of any of our major business sectors. While the industry has enjoyed some profitable years, airline operators as a whole have lost money since deregulation in 1978.

This instability has been attributed to the highly cyclical demand for air travel as well as the structure of the industry, which has very high fixed costs and few barriers to entry. Some argue that the industry's current problem is over-capacity and the bankruptcies, to the extent that they reduce capacity, will help solve the problem. While such capacity reductions may offer temporary relief, history has shown that the growth of airline industry capacity has continued unaffected even by major liquidations.

According to the Government Accountability Office, only recessions, which curtail the demand for air travel, and the September 11 terrorist attacks appear to have caused the airline industry to reduce its capacity. This indicates that other airlines quickly replenish capacity to meet demand. Low cost carriers, in particular, are continuing to take delivery of new aircraft and expand their capacity. For example, Southwest Airlines continues to grow at an 8 to 10 percent annual rate and Jet Blue at almost 30 percent annually. In addition, there are 17 new entrant airlines currently awaiting certification by the Department of Transportation.

One bright spot for legacy carriers is the continued profitability of international routes where there is less competition from low cost carriers. In adjusting to their new economic realities, legacy carriers have made flying abroad a priority and sometimes they shift aircraft from domestic to international flights and start new service to foreign destinations as we have seen. For example, Delta's plan for recovery included reducing mainline capacity by 15 to 20 percent and increasing their international flying by 25 percent.

Under President Bush, negotiators from the Department State and Transportation have reached agreements with countries such as India, Vietnam and Mexico as well as others to open international routes to U.S. carriers. These efforts are important and hopefully will be of assistance to our legacy carriers.

The airlines' financial woes may also impact our airports. Sometimes their financial problems do go beyond just the legacy carriers. Airports that serve as secondary hubs for financially weak airlines are particularly at risk because reductions in connecting passenger traffic can end up leaving a void too large for other carriers to fill. For example, flight schedules have been reduced by US Airways at its Pittsburgh hub and more recently by Delta at its

Cincinnati/Northern Kentucky hub, leaving these airports with decreased revenues.

An airline's withdrawal from a hub can also leave an airport over-extended relative to its remaining passenger and revenue base. They take on pretty significant obligations and we see the results for these airports. For example, when US Airways withdrew from Pittsburgh, that airport was left with a financial responsibility for the new terminal building that it had built specifically for US Airways operations. In addition, Fitch Ratings recently revised its outlooks for the Detroit, Minneapolis and Memphis Airport bond ratings from stable to negative based on their concerns that the risk to financing at those airports may increase during Northwest's bankruptcy.

I think this also poses an issue for this Subcommittee and our efforts to improve infrastructure at various airports across the United States and we are putting hundreds of millions and some billions of dollars in improving the facilities and airports themselves. This does raise some serious issues that our Subcommittee needs to address.

For our hearing today, we have assembled a panel of airline industry, financial experts and academic professionals. I look forward to hearing the views of our witnesses. We don't have any associations here. I do welcome any associations that want to submit for the record. We will leave the record open for a period of two weeks so they may submit commentary on this important hearing and their recommendations.

With those lengthy but necessary comments and caveats, I would now recognize the outstanding Ranking Member of this subcommittee, the gentleman from Illinois, Mr. Costello.

Mr. COSTELLO. Mr. Chairman, thank you and thank you for calling this hearing today. I also welcome the witnesses that are here. I will submit my statement for the record and summarize it.

As you indicated, since the terrorist attacks of 2001, we have seen the airline industry lose about $32 billion, staggering fuel prices, thousands of people have lost their pensions and health care and in the last two weeks, Northwest and Delta both have filed bankruptcy. I have no doubt that thousands more will lose their pensions and health care in this coming round of the bankruptcies that were just filed. With close to 50 percent of our domestic aviation capacity in bankruptcy up until yesterday, we need a frank assessment of the short and long term condition of the industry.

It is difficult to gauge how much the industry's current conditions can be attributed to September 11. We all know that legacy carriers were in trouble before September 11. The legacy carriers, in my judgment, failed to adjust their business plans to economic trends that began long before September 11, including business models that depended on extracting a premium fare from business travelers.

In fact, the premium fare for business travelers amounted to a significant amount of revenue for the legacy carriers. When the economy started to tighten in 2000, the business traveler shifted and went from the legacy carriers to the low cost airlines. Indeed, low cost carriers are a significant force in the aviation industry today with a combined domestic Origin and Destination (O&D)

market share of about 30 percent up from 23 percent just a few years ago.

In addition, the aviation industry and the Nation as a whole is faced with record high fuel cost which has stymied growth. According to the ATA, the Air Transport Association, the industry's jet fuel expenses could increase by $9.2 billion in 2005 alone. The ATA also projects industry-wide net losses this year of approximately $9-$10 billion.

Some have suggested ways to save the airline industry. ATA has called for a repeal or the suspension of certain taxes and fees, a move, in my opinion, that would wreak havoc on our Aviation Trust Fund and does not take into account the fact that other modes of transportation and consumers are also suffering from high fuel prices. In fact, the amount paid in fuel taxes for 2005 is expected to be $600 million, well short of the $10 billion projected net industry losses. We should not make such policy decisions in a vacuum.

Some current and former airline CEOs and others have suggested other ways to save the industry. Robert Crandall, the former Chairman of American Airlines, wrote an op ed recently in the Wall Street Journal suggesting that the bankruptcy laws need to be changed. He suggested, "You say, look, if you fail, you liquidate."

In addition, Mr. Crandall and others have suggested that we have too much capacity in the system. Crandall states, "The capacity never comes out. It takes all the guys that haven't gone bankrupt and drives them into bankruptcy." He and others have suggested that in addition to changing the bankruptcy laws, we should remove perceived barriers to consolidation. In fact, ATA agrees that consolidation and capacity reductions are needed. Yet, it is still not clear to me that any one of these proposals or all of them together will provide the much needed fix for this ailing industry.

I hope that our witnesses today will address those issues. In addition, I hope that the witnesses will talk to us about what this subcommittee or what the Congress should be doing in the future for the industry. When we get into questions, I will be interested in knowing not only how you feel about the proposal from ATA about the temporary suspension of the fuel tax, about the capacity issue and also interested in knowing if the Congress did nothing substantial for the industry, what would happen in the long and short term.

Last, in addressing all of these issues, the suspension of the current fees and taxes, current bankruptcy laws and capacity issue, I hope to hear what solutions you provide and will suggest to this subcommittee.

Mr. Chairman, again, I appreciate you calling this hearing. I welcome the witnesses and look forward to hearing from them.

Mr. MICA. I thank the gentleman.

Mr. Coble?

Mr. COBLE. Thank you, Mr. Chairman. I will not take the five minutes.

I commend you and the gentleman from Illinois for having scheduled this hearing and express appreciation to the panelists for their attendance.

The future outlook of the United States commercial airline industry is an area of our commerce that needs thorough examination. I like to avoid use of the word "crisis" because it is so obviously laced with pessimism. There are many people and colleagues who believe that the U.S. commercial airline industry is standing in the shadow of a critical situation.

Someone said to me the other day airports are what bus stations were four decades ago, 45 years ago. By that, I think he meant the obvious overcrowding, wall to wall people. Oftentimes when you go to an airport today, and I am not pointing accusatory fingers at anyone, but a cancellation or a delay in flight almost becomes the rule rather than the exception.

I appreciate your scheduling this, as I said, because we need to examine this before it does become a crisis.

I yield, Mr. Chairman.

Mr. MICA. I thank the gentleman.

Ms. Norton?

Ms. NORTON. Thank you, Mr. Chairman, for trying to stay ahead of the curve on the airlines and it is very difficult to do but I appreciate the hearings, and this is not the first, on the state of our commercial airline industry. It is kind of like a physical exam, only the airline industry has had to take these physical exams often.

When two major airlines, not the ones most traditionally troubled, now find themselves in bankruptcy, it is very hard to know where to go from here or what to think of the industry as a whole. This much we know. This industry, even more than every other industry in the Country as a whole, did not need two hurricanes, Katrina and Rita, and especially not Rita which has put very special pressure on all of our resources, gas and fuel resources.

I am concerned that the fuel crisis which does not seem to abate is putting great pressure even on the lower cost airlines. You remember at our last hearing there was particular interest in whether all of them would become low cost and maybe somehow the industry would be saved that way. I heard the President say people should not take trips they don't need to take. Of course the airline industry wants you to take as many trips as you can.

It is one indication of how the airline industry, every economic change appears to negatively affect the airline industry. Conservation, for example, does not appear to be any kind of solution there, although there is much to be said for why the Country ought to have an explicit conservation policy which might then free up some energy for industries like our airline industry which certainly can't do that.

I just think we need to talk to folks out there and notice that these are not Government witnesses, so that we can get the best information and the best thinking we can at this time.

Again, I thank you, Mr. Chairman, and yield back.

Mr. MICA. I thank you.

Mr. Ehlers?

Mr. EHLERS. Thank you, Mr. Chairman, and thank you for having this hearing.

I would just like to comment. Everyone knows the airlines are in trouble and are having serious problems. It is perhaps no an appropriate business model as it has been traditionally practiced, but

I encourage us also to look on the positive side and what a tremendously positive impact the airline industry has had upon this Nation over the past half century.

I recall my first flight in a jet airplane, a 707, in the late 1950s, early 1960s, and that was an incredible experience. Little did I realize that the first of over a million miles of travel I would perform on jet airplanes. It has transformed American life, it has brought families closer together with more frequent visits, it has changed the very nature of the Congress.

When I first took office, one of my predecessors, former President Ford, commented to me that when he was elected in 1948, he moved to Washington with his family and they went home twice a year, the August recess and the Christmas recess. Today, most members of Congress go back to their districts every week and have maintained much closer ties with the public and I think have been much more responsive to the public as a result of that.

Air travel has been a very positive thing for the integration of this Nation, of bringing people together, developing better understanding and we have to make sure whatever we do as we discuss these issues we recognize what a strong, positive effect that has been and that we work together to maintain a strong airline industry which can continue to keep the bonds of our Nation firm, but not only that, but give us opportunity to visit other lands frequently and become better acquainted with other countries and therefore, make us a better country in dealing with the problems of the world.

I yield back the balance of my time.

Mr. MICA. I thank the gentleman.

Mr. DeFazio?

Mr. DEFAZIO. Thank you, Mr. Chairman. Thank you for the timely hearing on this issue.

My goal in debating this issue over the years has been to see that we continue to have a system of universal air transport which serves not only major hubs or profit centers in the United States' large urban areas, but also medium and smaller sized cities. I am concerned about whether continuing total deregulation, a hands-off attitude with perhaps some liquidations in the industry of so-called legacy carriers, is going to provide that sort of service to the traveling public, not only to leisure travelers who seem to be the target model of many airlines, but to the business travelers.

We are moving toward a very inefficient system where more and more corporate travel is being done on fractional ownership. I was riding with a fellow from a not particularly large company out of Eugene last week, crammed into a 50 seater from Phoenix to Eugene. He was waxing about how as soon as they could justify it on the books, which he thought would be real soon, they were buying a private jet.

So it is that desire to drive out all the people who used to pay or were willing to pay a premium for access to that kind of a system and just run a low budget system which may or may not have international links of any good significance for leisure travelers who don't quite pay for their cost of transport. That doesn't seem like a sustainable model.

There are other issues raised or touched on by the testimony. It seems that the so-called rents attributable to the refiners have tripled in a year. That is interesting. People are wondering why is jet fuel so expensive. Well, because our refinery capacity has been squeezed down to the point where it is just about adequate to demand and the slightest burp allows an Exxon-like jacking up of the prices saying oh, my gosh, we just can't meet the demand, we will have to jack up prices. The head of the largest refinery in America, Valero, said the system was working real well for them. Their stock is up 263 percent a year.

We want to blame the environmentalists and the regulatory system. It wasn't the environmentalists or the regulatory system. It was the lack of a regulatory system that allowed the mergers, the closures and the downgrading in refining capacity and nothing has been built. Even when George Bush offered to make military bases available with no environmental restrictions, the industry said no, we are not really interested. We are doing well where we are. So we have to look at those sorts of things.

I am concerned about the idea that somehow we should let the market squeeze and squeeze and squeeze and squeeze until we get all the costs out of the system. I think the recent Jet Blue incident points to the problems there when planes are maintained in El Salvador by people who may or may not be qualified mechanics, who may or may not be using approved parts, who may or may not be enlisted in terrorist networks because we can save money by maintaining planes in El Salvador. Meanwhile, mechanics here are put out of work who are doing a good job, who were regulated, who were overseen, that is good for the system. That is squeezing out the inefficiencies.

That is pretty essential, your plane can land and you will live, your plane can't land and you won't live. Most Americans are willing to pay a slight bit more to know their pilot and the mechanic are trained and qualified and the plane doesn't have unapproved parts on it.

I am concerned about how we are squeezing and pushing the system. I am not sure that cutthroat competition will give us the service the American people need, particularly many small and medium sized cities, and it is not going to give us the safety that we need, particularly with an Administration that is so derogatory of government and regulation that led us to the point where we no longer even have a functional Federal Emergency Management Agency let alone an FAA that has enough people to oversee the maintenance work being farmed out more and more.

I think there are a lot of questions raised by this model and I hope the panel can respond to some of these points and tell us why it is so great that most carriers are flying full and still losing money.

Thank you, Mr. Chairman.

Mr. MICA. I thank the gentleman.

Mr. Ney?

Mr. NEY. Thank you, Mr. Chairman and the Ranking Member. I will be brief.

I want to thank you for the hearing. I think it is important. The airline industry is important. We have seen that through Katrina.

I have to credit the brave pilots of Jet Blue last week and the plane they safely landed with 140 people on there.

Also mentioned before were the bankruptcies and an issue I would like to know about is if some of the bankruptcies occur, what happens with the pensions versus those who didn't go into bankruptcy. Is there a level playing field? Does that have future repercussions? I think that is important.

Also the airlines are being asked to have cost saving measures or to increase customer service which I know they want to do, I still think that has to be analyzed. There are delays, baggage lost. On a personal note, and I am not going to say the airlines but I will take it up privately, but our office books my flights through CATO, the service we have, and then I had to change it so I called myself and had a lengthy conversation, about 20-25 minutes.

I arrived at the airport where they asked me to produce my employee ID because I was booked employee rate. Thank goodness I didn't accidentally travel on employee rate, and that would have given people things to look at of, how did you get the employee rate traveling to Washington. I didn't have an employee badge, obviously, and then I asked, where did I call. I can't remember whether it was India or Ecuador but I called somewhere overseas. The past couple of times I have called there.

If you talk to the employees, they will tell you that this may be cost saving to outsource to India or Ecuador or wherever it was outsourced to but at the end of the day, they said there are hundreds of mistakes they see coming in as a result of this outsourcing.

I would like to know has anybody ever looked, in the quest to save money, does outsourcing overseas come back to haunt the very airlines that are trying to save money? I don't know if small issues like that are looked at or not but I think it should be because saving a dollar but costing the airlines a lot may not be good for them.

Again, would the bankruptcies result in reduction in services, cities served and the fate of the thousands of airline employees? I think it is a topic of utmost importance to the citizens of the United States.

Again, I want to thank the Chair and the Ranking Member for the hearing.

Mr. MICA. I thank the gentleman.

Ms. Millender-McDonald?

Ms. MILLENDER-MCDONALD. Thank you, Mr. Chairman and the Ranking Member, for holding this very important hearing.

I would like to say to the committee, Mr. Ehlers, a physicist, after his positive stand on this hearing today, it was very enlightening, however, the issues facing the U.S. airline industry are indicative of the challenges that face all of us. Many of the issues that we will be discussing today, hopefully, will be issues confronting our national economy in some capacity and that would be pension reform, bankruptcy reform, rising fuel costs and a changing and evolving marketplace.

So I would like to commend our leaders, both the Chairman and the Ranking Member, today for putting in front of us such a distinguished and focused panel. The panelists before us now are not industry representatives, but I am told from leading financial institu-

tions that offer an outside perspective with an investor's eye, and that is good.

As we prepare to reauthorize the aviation bill, this hearing is an excellent first step and I commend the Chairman and the Ranking Member and look forward to hearing from these experts on what the next step for the airline industry could be. Of course I would like to know what the impact of the most recent wave of bankruptcies will have on the airline industry as a whole, to what point it will bring us and there are arguments made that major network carriers are unprofitable now because their business models are no longer functional.

These are some of the issues that I would like to hear from you regarding our airline industry. As the Chairman and the Ranking Member have stated, the industry has lost over $32 billion and it is projected they will lose an additional $9 billion to $10 billion. This is astounding. We do understand our airline industry is flying in bankruptcy, so it is not a healthy industry.

I look forward to hearing from all of you today, outside of the bronchitis that I have. Thank you, Mr. Chairman and Ranking Member.

Mr. MICA. Thank you.

Mr. Kennedy?

Mr. KENNEDY. Mr. Chairman, Ranking Member, I want to thank you for holding this hearing today and I want to thank all the witnesses for attending.

We are currently experiencing a time of financial crisis with the commercial airline industry. As a representative from Minnesota's Sixth District, this concerns me. As you know, Northwest Airlines based in my home State of Minnesota declared bankruptcy two weeks ago. The airline industry is an enormous economic engine in Minnesota. Northwest Airlines represents approximately 80 percent of the flights to of the Minneapolis-St. Paul Airport, they employ thousands of Minnesotans and tens of millions of passengers fly into and out of Minnesota each year.

The pensions of tens of thousands of Minnesotans are foremost on my mind. Over the past four years, U.S. commercial airlines have lost over $32 billion collectively and it is estimated that the industry will experience another $10 billion in loss in 2005.

We all know that skyrocketing fuel prices have become a burden on everybody, individuals, families and businesses. Northwest Airlines is no exception. In 2003, Northwest spent $1.6 billion on fuel. It is estimated that the airline will spend $3.3 billion on fuel in 2005. When fuel costs are combined with the climbing cost of pension plans, the results are a perfect storm. Over the next three years, Northwest must contribute $3.3 billion to its pensions plans in order to meet their obligations. The airline has already missed a $65 million payment to the fund.

Northwest is only the latest of a string of airlines which have sought bankruptcy protection for these same reasons. United Airlines and USAir's decisions to terminate their pension plans gave those airlines an enormous competitive advantage as they plot to emerge from bankruptcy protection. United's shortfall of $9.8 billion and USAir's shifting of further billions in liabilities not only puts the Pension Benefit Guarantee Corporation at risk, but cuts

the guaranteed benefits for thousands of employees and retirees. Statistics like this explain why until yesterday almost half the capacity of U.S. airlines is flying under bankruptcy protection.

Mr. Chairman, we must continue to work with the airline industry, its workers and retirees to find solutions to this crisis. I look forward to the testimony of the witnesses today and I am hopeful that we can determine how to go forward to protect the ticket buying public, workers, retirees and the airline industry as a whole.

I yield back the balance of my time.

Mr. MICA. Thank you.

Any other members of the Subcommittee seek recognition? If no other members of the Subcommittee seek recognition, we will recognize Ms. Schmidt from Ohio.

Ms. SCHMIDT. Thank you, Mr. Chairman, for allowing me to participate in this important review and outlook of our Nation's commercial airline industry.

I know I am not the only member of Congress with constituents who have been directly affected by the serious difficulties facing many of our commercial airlines. Delta Airlines, which filed for Chapter 11 bankruptcy on September 14, has its second largest hub in my local area at the Cincinnati-Northern Kentucky International Airport.

According to a 2005 study by the University of Cincinnati, the airport contributes $4.52 billion annually to the Ohio-Kentucky-Indiana tri-state economy and supports more than 55,000 jobs through the region. Delta accounts for about 83 percent of the passengers at the airport annually.

When I was sworn in on September 6, I was notified by Delta of its intention to accelerate its overall transformation plan which includes realignment of Delta and its subsidiary, ComAir's services at the Cincinnati-Northern Kentucky International Airport. Locally, this will result in the loss of nearly 1,100 jobs in my area. A week later, as I mentioned, Delta and its subsidiaries filed for Chapter 11 bankruptcy.

I am a strong believer in competition and free enterprise. I am also concerned at what appears to be difficult economic conditions including pension costs and the rising cost of fuel that confront virtually every airline in our Nation. A vibrant, safe and reliable airline industry is vitally important to our Country.

I look forward to learning more about the outlook of our airlines at today's hearing.

On a personal note, as I flew up here yesterday morning, one of the flight attendants came to me and thanked me for serving and said that she loved working with Delta, was willing to take another pay cut in order to keep her job and was very, very worried about her pension, and asked for my consideration on that. I am just bringing that to this committee's attention.

Thank you once again, Mr. Chairman, for the opportunity to participate and for holding this most important hearing.

Mr. MICA. I thank the gentlelady.

If there are no further opening statements, we will recognize our panel of witnesses today. As I said, we have assembled some of hopefully the Country's leading experts on this topic. We have Mr. Mark Kiefer, Associate Principal, CRA International, Inc.; Mr. Phil-

ip Baggaley, Managing Director, Corporate and Government Ratings, Standard and Poor's Ratings Service; Mr. Steve Morrison, Professor and Chair, Department of Economics, Northeastern University; Mr. Stuart R. Sokel, Director, Deutsche Bank Commodities Group and Ms. Maria Matesanz, Senior Vice President and Team Leader, Infrastructure Finance Team, Public Finance Group, Moody's Investors Service. Welcome to all of you.

As I said, normally we go five minutes. We won't run the clock in the normal fashion. We will let you go seven or eight minutes. We want to leave time for questions. We will start with Mr. Mark Kiefer of CRA International, Inc. Welcome and you are recognized.

**TESTIMONY OF MARK KIEFER, ASSOCIATE PRINCIPAL, CRA INTERNATIONAL, INC.; PHILIP BAGGALEY, MANAGING DIRECTOR, CORPORATE AND GOVERNMENT RATINGS, STANDARD AND POOR'S RATINGS SERVICE; STEVE MORRISON, PROFESSOR AND CHAIR, DEPARTMENT OF ECONOMICS, NORTHEASTERN UNIVERSITY; STUART R. SOKEL, DIRECTOR, DEUTSCHE BANK COMMODITIES GROUP; AND MARIA MATESANZ, SENIOR VICE PRESIDENT AND TEAM LEADER, INFRASTRUCTURE FINANCE TEAM, PUBLIC FINANCE GROUP, MOODY'S INVESTORS SERVICE**

Mr. KIEFER. Thank you, for the opportunity to appear before you today to hear my comments on this very important subject.

I have a Power Point presentation for you although I would ask that my prepared statement be made a part of the record.

Mr. MICA. Without objection, the entire statement will be made a part of the record.

Mr. KIEFER. I will speak directly to the issues that brought us all here today, namely the current situation facing the U.S. commercial airline industry, the impact of the recent bankruptcies and high fuel costs, and also the outlook for the future of this industry.

I do believe it is fair to characterize the current situation in this industry as the greatest crisis it has faced in its nearly 100 year history. We have heard from several members of the Subcommittee the number, $32 billion in losses since 2000 and I agree with the assessment, that loss is expected to reach $40 billion by the end of this year.

At the same time, the millions of shareholders among the American public that own these publicly traded companies have experienced over $24 billion in losses in the market value because of the steep declines in the prices of their shares. We have also heard that five of the ten largest airlines in the industry have entered Chapter 11 to this point since the year 2000.

At the same time, well over 100,000 jobs have been lost in this industry since that time and just recently, in concert with their announced bankruptcies, Delta and Northwest have announced the likelihood of additional layoffs. Pay and benefits have been cut very substantially. You may recall before their bankruptcy, Delta pilots negotiated pay cuts of over one-third, and significant cuts in benefits. The failure of the pensions at United and USAirways have resulted in the largest pension default in U.S. history. Those airlines that continue to have pension plans now have unfunded liabilities of over $14 billion.

The effect of this crisis is felt not just in the airline industry itself, but in other sectors of the economy. Those institutions engaged in aircraft finance are having to accept less favorable terms just to have any business from the airline industry, aircraft manufacturers and parts suppliers are facing canceled or foregone orders or delayed orders for their equipment, and as mentioned, the current environment has caused a potential funding shortfall in supporting the FAA and its infrastructure because that system is funded through taxes and fees paid by the carriers, a large portion of which are based on air fares.

Not all of the news is bad. I would share the optimism of Mr. Coble in this regard. The low cost carriers are very profitable and growing. Southwest has had 57 consecutive quarters of profit, Jet Blue has had 18. They have weathered this storm remarkably. In fact, the resulting low fare environment has produced tremendous benefits to consumers because they are paying lower prices as a result.

I would like to talk a bit about how we got here and add to the comments that have gone before. I think there are three basic factors that have contributed to the current situation. Business travel has undergone a fundamental reorientation since 2000. At that time, a weakening economy had already begun to dampen travel and business travelers were becoming increasingly intolerant of very expensive tickets.

After September 11, 2001, there was a disproportionate drop in business travel as many corporate travel departments restricted travel altogether. As a result, there is much more cost consciousness among the traveling public but among business travelers as well.

We have heard there have been an unprecedented combination of challenges that have buffeted the industry since the year 2000, the economic slowdown, the events of September 11, the outbreak of SARS, the war in Iraq and the dramatic increase in fuel prices now at a historic high at least in nominal terms.

At the same time, advances in technology have reshaped the demand for travel. Improvements in teleconferencing and related facilities have made it less necessary for business people to travel. At the same time, the growth in online ticket sales has created much greater, really unprecedented price transparency so that business travelers are more easily able to seek and find lower cost alternatives to the traditional legacy carrier business model of charging much higher fares. At present, low fares are not the exception but really the rule.

The other important contributing factor in that regard is that low cost carriers have become an integral and significant part of the industry. Their market share has almost tripled in the last ten years and is expected to constitute about one-fourth of the domestic industry by the end of this year.

The largest domestic airline in the United States is Southwest Airlines at this point. Jet Blue and Air Tran are now classified as major carriers by the Department of Transportation, earning more than $1 billion in annual revenue. Most of the cities served by legacy carriers are served by at least one low cost carrier. At the same

time, legacy fare carriers face low cost competition in most of their city fare markets.

As a result of this significant market penetration, low cost carriers are now able to dictate price in many markets. It is important to point out the low cost carrier business model is not really predicated so much on low cost, but on low fares. These carriers were designed from the beginning to charge low prices and their low cost structure is a result of that imperative.

At the low cost carrier prices, legacy carriers simply cannot make money with their higher cost structure. The chart you see before you reflects a measure of the operating profitability of Southwest and Jet Blue compared to the major legacy carriers. You can see in the last calendar year, there was a remarkable difference in that regard.

I would submit to you that deregulation of the industry in 1978 has finally caught up as it were with the legacy carriers. The legacy carrier cost structure is even today to a significant extent, a remnant of the regulated era where routes and fares were regulated by the Civil Aeronautics Board and in effect, cost increases could be passed on to customers through higher fares. This made possible higher wages and lucrative benefits such as pension plans. In effect, there was to some extent a disincentive to reduce costs because the profits were in effect a function of costs.

Until recently, legacy carriers faced only limited price and route competition on a national scale. The legacy carriers competed mostly with other legacy carriers and hub dominance and limited competition for nonstop service are a feature of the hub and spoke networks that the legacy carriers employ. In the current market environment, the high labor costs which were possible under the regulated environment have become unsustainable such that the unfunded pension liabilities now exceed $14 billion.

You can see from this chart just how much they have grown in the last four years. That is a reflection in part of the poor investment performance of these plans. At the same time, the rising cost of health care, which we have talked and heard so much about, has produced large unfunded liabilities in the post-retirement insurance benefits offered by many of the legacy carriers.

I would submit that conversely, low cost carriers are ostensibly post-deregulation carriers. They have been designed from the ground up to compete on price and their cost structure is fundamentally different, fundamentally lower and their operating model likewise is designed for low cost.

I would quickly add that I think with respect to the impact of the recent bankruptcies, I think we will see further wage reductions at Delta and Northwest, elimination of the pension plans are likely. Going forward, I think the other legacy carriers that have not yet gone into bankruptcy will have no choice but to eliminate their pension plans as well should Delta and Northwest do so.

I think the low cost carriers are indeed vulnerable because of higher fuel prices but finally, I would say new aircraft on the horizon promise greater increases in fuel efficiency and significant growth in air travel is forecast which I think will return this industry to financial health in the long term. I think the prospects are very good in the long term.

Thank you very much for the opportunity to appear before you today.

Mr. MICA. Thank you.

We will wait until we have heard from all the panelists to start questions.

Mr. Baggaley with Standard and Poor's Ratings Services, welcome, and you are recognized.

Mr. BAGGALEY. Thank you.

Good afternoon. Thank you for the opportunity to testify today.

I am the Managing Director with Standard and Poor's Ratings Services and Senior Credit Analyst for the airline industry. Please see my written testimony which I ask be included in the record.

Mr. MICA. Without objection, so ordered.

Mr. BAGGALEY. This afternoon I hope to provide some perspective on the airline industry's problems by addressing three related topics: first, what are the principal causes of the U.S. airlines' current financial problems; second, how are airlines responding to that situation; and third, what broader changes might improve the industry's prospects.

First, why are most airlines reporting losses and bleeding cash in a strong economic environment? Numerous factors have contributed to the problem and Mr. Kiefer mentioned some of them. I would say that three stand out in the current environment: very high jet fuel prices, intense price competition in the domestic market; and heavy debt and pension burdens.

Fuel prices are the most serious concern at the moment. Oil prices have increased sharply over the past year and the future outlook is for an extended period of high prices. Added to that is limited refining capacity which has widened the normal price difference between oil and jet fuel. Exhibit 1 of my written testimony shows the movement of oil and jet fuel prices this year with the levels of January 1st set to equal 100. You can see the heavier line, jet fuel prices, jump above the lighter crude oil line over the past month due to damage to refineries in the wake of Hurricane Katrina.

The Air Transport Association estimated recently that the U.S. airlines will spend $30.6 billion on fuel in 2005 compared to $21.4 billion in 2004 and double 2003's $15.2 billion. These and other years are shown in my Exhibit 2.

Even low cost airlines are under pressure. Southwest Airlines would be operating around break even without its fuel hedges and Jet Blue recently warned that it could report losses. Standard and Poor's last week placed our ratings on Jet Blue on credit watch for a possible down grade.

Most airlines don't have the credit profile that would allow them to hedge fuel prices without putting up cash collateral, thereby depleting their reserves of cash. In any case, hedges cannot undo current price levels, only protect against further increases. Airlines are trying to raise fares in response. However, unlike railroads, trucking companies and shipping lines, airlines don't have corporate contracts that allow for automatic fuel surcharges. Rather, they must try to raise fares, a move that requires all the major players to go along or the attempted fare increase will fail.

The second major cause of the airlines' financial problems is intense price competition, particularly in the domestic market. Exhibit 3 in my remarks shows domestic yield and revenue per available seat mile. Both measures turned sharply downwards starting in 2001 and have improved little despite several years of economic recovery. The rapid spread of low cost airlines and excess seat capacity have prolonged the pricing weakness.

Over the past year, airlines have managed to raise their fares somewhat in response to high fuel costs. However, if high oil prices cause the U.S. economy to slow, that momentum towards higher fares will likely stall.

The third big financial problem for the airlines currently is debt and pension deficits. Airlines tend to operate at higher leverage than manufacturing companies even in the best of times. Starting in 2001, the legacy carriers had to borrow heavily to fund losses and maintain adequate cash reserves even with Federal aid. On top of that, pension plans that were fully funded in the stock market boom of the late 1990s fell into deficits when share prices and interest rates fell. Exhibit 4 in my remarks shows the effect for Delta Airlines.

What have airlines been doing in response to all these problems? First, airline employees have been asked to take substantial pay cuts, trim their benefits and in some cases, lose their jobs. Exhibit 5 in my remarks shows broad expense categories for AMR, parent of American Airlines, in 2002 and in the second quarter of 2005. Over that period labor costs declined from 41 percent of total expenses to 32 percent. Exhibit 6 shows the dollar value of the labor concessions and of significant other cost initiatives and the large negative effect of higher fuel costs that offset much of that progress.

The final question that I posed at the outset of my remarks is perhaps the most important one. Are there broader trends or changes that could provide an answer to the industry's financial problems? I will consider three such possibilities: bankruptcies, mergers and reductions in capacity. Obviously, bankruptcy signals financial failure but it also gives an airline tools to correct that situation. Exhibit 7 shows selected financial data for United Airlines in 2002 when they entered bankruptcy and from the forecast in their reorganization plan.

Three items are shown. First, there is some reduction in debt, mostly through canceling unsecured obligations. The scope for cutting secured debt and leases is rather less unless United wants to turn back planes to their creditors, some of which they have done. Second, the pension deficit was eliminated by terminating the defined benefit plans. Lastly, United's forecast shows much lower labor costs by 2006. Bankruptcy makes it easier for an airline to secure labor concessions because ultimately the Bankruptcy Court can impose them.

Delta and Northwest will face similar opportunities and constraints as they proceed through Chapter 11. Bankruptcy can help an airline improve its financial prospects, but the struggles and continued losses of United and the fact that USAirways paid a second visit to the Bankruptcy Court shows this is no panacea.

Mergers are a second change often suggested as a cure for airline problems. Such combinations do allow the merged airline to capture more passengers but diversion of traffic is by its nature a zero sum game. What the merged airlines gain, others lose. Furthermore, these mergers have tended to drive up labor costs because union cooperation is needed for smooth integration.

For example, United's proposed acquisition of USAirways in 2000 led management to negotiate an expensive pilot contract that later helped push the airline into bankruptcy. For these and other reasons, the track record of airline mergers has been discouraging.

Fortunately, mergers in the current environment may fare better, particularly if the acquired company is in bankruptcy. Consider America West acquisition of USAirways just completed yesterday. USAirways had already lowered its operating costs to levels approaching those of America West. As a bankrupt company, USAirways had the flexibility to rid itself of aircraft and facilities not needed in the combined airline, and America West managed to attract significant outside investment and loans to bolster its cash reserves.

The merged company will still face difficulties in integrating its two labor forces over the next several years. Also, outside forces such as high fuel costs could certainly cause a renewed financial crisis. Even so, acquiring a bankrupt but potentially viable airline appears to avoid some of the pitfalls that have plagued previous mergers.

From the perspective of the airline industry as a whole, the main benefit of airline bankruptcies and mergers is that they can reduce overall capacity. This should is often suggested improve the balance of supply and demand and allow for increased fares to cover added fuel expense. One of the most frequent criticisms of the bankruptcy process is it has allowed struggling airlines to survive to the detriment of their solvent competitors.

There is no doubt that liquidation of a major airline in bankruptcy would allow the survivors to raise prices somewhat, however, whether that revenue gain is sustainable would depend on where the parked aircraft end up and whether the surviving legacy airlines have competitive cost structures. If the liquidated airline's planes simply change hands or if low cost airlines still have a huge cost advantage, then the revenue benefits would likely erode over time. In other words, consolidation, whether through bankruptcy, liquidations or mergers, will help the industry only if accompanied by withdrawal of planes from the U.S. market and by competitive cost structures at the survivors.

To conclude, let me summarize my answers to the questions posed at the beginning of my testimony. First, the dire financial condition of most U.S. airlines is due principally to high fuel costs, intense price competition in the domestic market and heavy debt and pension burdens.

Second, legacy airlines have undertaken significant steps to trim their losses but these have so far been insufficient to restore profitability, largely because of the fuel prices. Lastly, bankruptcy, restructuring and mergers have the potential to improve the industry's financial health, but only if accompanied by reduced capacity and most important, by lower operating costs.

Thank you for your attention.

Mr. MICA. Thank you for your testimony.

We will now hear from Dr. Steve Morrison, Professor and Chair, Department of Economics, Northeastern University.

Mr. MORRISON. Thank you. It is my pleasure to be here today.

I should note that the statement I submitted was co-authored with my longtime collaborator, Cliff Winston. When I say "we" in the testimony, I am referring to he and I.

Mr. MICA. Thank you, and we will include the entire statement in the record without objection.

Mr. MORRISON. The airline industry has always been a cyclical one because the demand for air travel is sensitive to the level of economic activity and carriers must invest in capacity well before they know the level of economic activity and demand. In the current down turn from 2001 to 2004, the U.S. airline industry lost $13 for each of the nearly 3 billion passengers it flew resulting in the $32 billion number we have heard several times here today but the causes of the current financial state of the airline industry are more complicated than mere cyclicity.

What the industry is experiencing is unprecedented and is due to a confluence of factors which have exacerbated the longstanding and underlying challenge that carriers have of aligning capacity with demand over the business cycle. To understand the current situation better, we need to look at what has happened during the last several years to some of the key components that determine an airline's profitability, the number of travelers, the fares those travelers pay, the price of fuel, wages and salaries of employees being of particular interest.

As far as the number of passengers goes, the good news is the traffic in 2004 exceeded its previous peak in 2000 before the down turn began. I should note that month to month traffic turned down in February 2001 before the recession began in March 2001. The recession ended in November 2001 so this situation goes well beyond cyclicity as I said.

Although the industry is cyclical, year over year traffic declines are relatively rare and the latest down turn is unprecedented in that it took four years for traffic to rebound, but traffic did rebound. The question there is why. One is the GDP is growing, about 3 percent a year since the end of the recession.

Another reason is more travelers are feeling that flying is safe enough for them to travel by air, but perhaps most important, is that airlines responded to the drop in traffic by significantly reducing fares. That is good news for travelers and bad news for airlines. Fares have fallen by 25 percent from 2000 to 2004 after adjusting for inflation. This substantial decline in fares has only occurred one other time in the U.S., namely right after World War II when capacity restrictions were eased.

Because of the dramatic decline in fares, the rebound in traffic masks underlying changes in passengers demand for air travel. Our back of the envelope calculations suggest that air fares in 2004 generated 17 percent less traffic than those same low fares would have generated in 2000. Demand has changed. This raises the question of what has caused this change in passengers underlying willingness to pay for air travel.

Plausible reasons are that the airlines product has changed. Increased security leads to earlier arrival at airports and longer trip times. To quantify this with another back of envelope calculation, if passengers now arrive at the origin airport one half hour earlier than previously, then under plausible assumptions, travel would decline by 7 percent.

Fuller planes, now over 75 percent full on average, the highest since right after World War II, make travel more unpleasant. An alternatives to air travel, teleconferencing and rail travel at least in the northeast corridor, have become more attractive options. In addition to these considerations, the traveling public, especially the formerly lucrative business travelers are less willing to pay fares many times higher than their fellow leisure travelers.

Fuel, we have heard a lot about fuel. In addition to unanticipated reductions in travel demand, the industry is vulnerable to unanticipated increases in costs. Jet fuel makes up 10 to 30 percent of airlines costs and its price can fluctuate widely which can have a significant effect on airline profits.

Relative to the price of jet fuel that prevailed in 2000, the last so-called good financial year for the airline industry and one in which the price of fuel was relatively high by previous historical standards, in 2003 and 2004, the industry lost an estimated $8 billion due to the higher price of jet fuel. Given the higher prices in 2005, especially the post Hurricane Katrina price spike, the industry is estimated to lose even more.

Before discussing labor costs, it is important to note the change in the competitive environment of the industry. Since deregulation low cost carriers have expanded more or less steadily to the point where in 2004 low cost carriers competed on routes between metropolitan areas that accounted for over 50 percent of the Nation's domestic air travel. This increased competitive presence by low cost carriers has put increased pressure on legacy airlines to reduce their fares and costs.

I should add here that the surprise here is that it has taken so long for low cost carriers to have this role. Advocates of deregulation looked at the performance of Southwest Airlines in Texas and PSA in California and saw that as the model that would prevail in the Country and it may well be the case but it has taken 27 years for that to happen.

Labor represents the biggest single category of airline costs, about 28 percent. Legacy airlines were, by definition, those that existed during the period when airlines were regulated. In the regulated environment, there was what economists call rent sharing as unionized workers and others sought and received a share of the profits that the regulated firms earned. Low cost carriers adopted a different style of labor relations that resulted in lower pay and/or higher worker productivity than legacy carriers were able to achieve with their work force.

Legacy carriers have been cutting costs where they can and since labor is the largest category of airline costs, it has been the target of cost cutting and enhanced productivity through negotiation as well as in bankruptcy as the legacy carriers seek to reduce costs to compete with low cost carriers.

As a result of these demand and cost shocks, the U.S. airline industry finds itself with more capacity, high cost capacity in particular than can be profitably supported at the fares passengers are willing to pay. This problem will be rectified if when demand increases, costs are reduced or high cost capacity leaves the industry. Competition among carriers will reduce such capacity and may well lead to at least one if not more carriers to contract, undergo liquidation or be absorbed by another carrier.

Successful carriers, those that are cost efficient and responsive to passenger preferences, will be poised to pick up any slack. Indeed, travelers will gain if legacy carriers make the required changes to be effective competitors in the new environment or are replaced by lower cost carriers.

We looked at competition between carriers through the year 2000 that low cost carriers tended to enhance traveler welfare much more than legacy carriers. That sounds obvious but there are factors other than fares that affect traveler welfare like frequency of service. This is an important finding because it indicates airline markets are working in the sense that those carriers that enhance traveler welfare are rewarded with higher profits.

Some have argued that our bankruptcy laws need reforming because carriers operating under Chapter 11 are able to artificially reduce their costs and thus drag down healthier carriers. In previous work, we found the effect of bankrupt carriers competing against healthy carriers was mixed. For some bankruptcies competing against bankrupt carriers were helped, competing against a weakened competitor and others, healthy carriers were hurt by such competition. On net, the effects did not merit reevaluation of current policy.

The current situation with nearly 50 percent of carriers in bankruptcy could well be different but analysis that we have done so far suggests that is not an area in which to look for a solution.

Thank you.

Mr. MICA. Thank you for your testimony.

Now we will hear from Mr. Sokel, Director of Deutsche Bank Commodities Group. Welcome and you are recognized.

Mr. SOKEL. Good afternoon.

My name is Stuart Sokel. I am a Director at Deutsche Bank in New York City. Having spent the last 14 years in the oil trading industry, my testimony today will attempt to provide insight into the logistical and economic forces currently in place today.

Without a doubt, high energy prices are having a major impact on the Nation's economy and it is imperative to understand the core issues which are significantly affecting the United States' commercial airline industry. I invite questions and comments at any point should further clarity be required.

In brief, the oil market today reflects a composite view of global macro economic strength, environmental concerns and demographic changes, all of which have contributed to dramatically higher energy prices over the past year. Most Americans are keenly aware of how limited refinery capacity in the United States, a point that has been pronounced due to the damage wrought by the hurricanes in the Gulf Coast region has meant higher refined product prices.

This point only gives a partial explanation and I believe it needs greater scrutiny.

To start, let us remember what has taken place in the world since 1998. At precisely the same time that a number of emerging market countries, for example, India and Thailand, were rapidly expanding domestic refinery capacity, a financial crisis in Asia coupled with over capacity from OPEC pushed oil prices to levels that seem like a mere memory today. Ten dollar oil was just another session away and many respected journalists and pundits alike predicted the end of reliance on oil, Middle Eastern or otherwise. Thus, there was no perceived financial pressure for airlines to change their operating procedures.

In retrospect though, this period was a mere blip on the trend line of growth that has taken place in the world today. Today, the major United States airlines are competing for the same marginal barrel of jet fuel that Singapore Airlines, Quantas and British Airways need for their own fleets.

Seven years ago, domestic passenger demand in India and China alone was a mere pittance compared to today. In addition, the environmental regulations of lower sulfur gasoline and diesel fuel in Europe and the United States have only served to take the jet fuel market into further deficit given the continuing difficulty of refiners to adopt to changes in product specification. In short, the situation would appear to be dire and it becomes critical to develop a strategy that serves the industry in the coming years while addressing the immediate need to remain solvent.

To start, we have to acknowledge that the lack of investment in refiner and terminal capacity over the past 30 years will not likely suffice for the next 30 years. To be critical of the oil industry, however, neglects a very important point. I would like to address one of Congressman DeFazio's points. The logistical hurdles of building a new refinery coupled with the questionable return on investment given history poor margins did not exactly provide the integrated companies with any major incentives.

It is true that the stock of Valero, for example, has risen 260 percent though I forget the precise number. However, from 1985 to 2000, if you had been managing an equity portfolio, similar returns would not have been made. So it is a recent phenomenon that the oil and gas sector in terms of the equity market has rewarded the sort of returns we have seen over the last one to two years.

This point may be small consolation for the aviation industry but it does provide a bit of historical context to the current dilemma. In order to remedy the supply bottlenecks, the coastal areas of the United States will need investment in the downstream sector. By that, I mean the refinery sector and will also need support from the Congress in order to educate an electorate which seems very comfortable with the notion of affordable oil as long as the infrastructure is not in their specific backyard.

Storage facilities need to be in close proximity to high volume airports and major markets. Such projects will need to be environmentally and economically sound but without a reasonable commitment from all interested parties, the burden of supplying jet fuel will fall exclusively into the hands of market forces which will lead to a continuation of higher prices in years ahead.

I should point out currently it is very likely that a carrier flying into LAX airport is utilizing jet fuel supplied from a Korean refiner given the nature of the physical arbitrage that we see in the oil industry today.

Management of energy risks is an area that many carriers have neglected in recent years and unfortunately the blame may be spread around in no short order. Most of the airlines which did hedge for the current fiscal year have not hedged their exposure for 2006 and beyond.

In addition, a large percentage of the hedges were placed in crude oil as opposed to their actual exposure which is jet fuel. In trading jargon, this differential is commonly referred to as basis risk. Given the potential for jet fuel to out pace the rise in crude oil prices, in effect, that is precisely what has happened this year and the market expectation is that this will continue.

Anecdotally today, the price of jet fuel has risen by seven cents a gallon and by virtue of the Air Transport Association's statistics, each penny increase in the price of a gallon of jet fuel drives an additional $190 million in annual fuel costs for the United States airlines.

For airlines that did not hedge or for those which liquidated hedges due to court ordered instruction, the outlook remains very severe given the current forward price of approximately $2 per gallon for 2006. I understand that the forecast by United Airlines for their 2006 jet fuel costs is roughly $1.50 per gallon.

It is fair to say that Wall Street can be critical of hedging activity which is unprofitable or deemed to be speculative as exemplified by certain refiner activity. However, the incremental cost of fuel and labor will continue to play the largest role in the future outcome of the industry. While labor costs cannot be hedged, oil prices certainly can be managed in the same manner in which companies monitor their foreign exchange, interest rate and credit exposure.

There is an adage in financial markets which states the only thing that can cure high prices is high prices. The airline industry however suffers from the burden of having to pay high prices without the flexibility of necessarily receiving higher fares. Historically, carriers have been loathe to pass on higher fuel costs in the form of any additional tariff for fear of being undercut by competition. This has led to a vicious cycle within the industry, an important matter left for an airline industry expert to discuss as opposed to an oil trader.

From my perspective, however, the potential solutions aforementioned are sound and will allow the forces of supply and demand to act to the advantage of consumer and industry alike.

Thank you very much.

Mr. MICA. Thank you.

Now we will hear from Maria Matesanz, Senior Vice President and Team Leader, Public Finance Group of Moody's Investor Service. Welcome, Ms. Matesanz. You are recognized.

Ms. MATESANZ. Good afternoon. I am Maria Matesanz and I manage the team at Moody's that rates debt issued by U.S. airports. Thank you for inviting me to speak today.

Moody's Investors Service is the oldest bond rating agency in the world. We have been rating bonds since 1909. Today we have more

than 1,000 analysts in 19 countries around the world. Our ratings and analysis cover approximately 10,000 corporations and financial institutions, more than 20,000 municipal debt issuers, over 12,000 structured finance transactions and 100 solvent issuers.

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Moody's does this by publishing forward-looking rating opinions publicly, freely and broadly and by publishing credit research about debt securities and their issuers. Our credit ratings are opinions about the future probability of full and timely repayment of debt obligations such as bonds, notes and commercial paper. Our opinions are communicated to the market through a symbol system originated almost 100 years ago which rank orders relative credit risk on a scale with nine broad categories ranging from AAA to C.

My comments today will focus on the impact of airline bankruptcies on U.S. airports. Moody's has ratings on 166 debt issues at 114 publicly owned U.S. airports. The median airport rating is A2. This contrasts sharply with the median rating of B3 for airlines.

Airlines have had a very unprofitable number of years as a result of extremely low air fares, high labor costs and increasing fuel costs. The combination of low fares and the growth in capacity by both the legacy airlines and the low cost carriers has resulted in very strong passenger and revenue growth at airports and stable outlook for airport sector issuers. In most markets, passenger volumes have now exceeded pre-9/11 peak levels and many airports are experiencing flight delays due to capacity constraints.

In Moody's opinion, credit quality in the airport sector has stabilized due to the maintenance of solid liquidity levels, growth in non-airline concession revenues, management control over operating and capital budgets and the strength of the underlying origin and destination service area economies. Moody's analysis focuses on these factors as key explanatory variables for the increasing gap between the median airport and the median airline rating.

Air transportation remains an essential service in our economy and Moody's believes that because of the difficulty in building new airports and the long lead time needed for environmental approvals, existing airports will generally be able to pass justifiable operating and capital costs on to airlines and passengers despite financial turmoil in the airline industry. Given the strategic importance of hub facilities for legacy carriers and their large investment in local facilities, certain hubs may even benefit from route restructuring by their dominant carrier.

For example, when Delta chose to de-emphasize its Dallas-Ft. Worth hub last year, Atlanta Hartsfield Jackson saw significant increases in its connecting traffic. Likewise, when American scaled back its hub at Lambert St. Louis, Chicago O'Hare saw an increase in connecting traffic. We define a hub as having more than 30 percent connecting passengers.

With three of the six legacy airlines in the U.S. now operating in bankruptcy, our focus is on identifying those airports that may

suffer financial stress as a result of cuts in service, reductions in passengers and revenues as well as those airports that may suffer a rejection of key airline leases. Airlines operating in bankruptcy generally continue to pay airport rates and charges and in most cases do not radically downsize their operations. These are two important offsetting factors that help buffer the impact of an airline bankruptcy on the ability to generate revenue at an airport.

Our analysis will continue to weigh the credit impact of the bankruptcy filing of an airline on the ratings of its hub airports. We will also consider such credit fundamentals as the size and economic health of the origin and destination base, the financial strength of the airport and the operating agreements for airlines at each facility.

Hub airports served by airlines in bankruptcy often have agreements that allow the airport to charge the airlines fees to recover all operating and debt expenses. The so-called residual agreements often include a credit for all non-airline revenue such as parking and rental car fees and food and beverage concessions as an offset to airline charges. While some airlines may not wish to pay increased fees, Moody's believes that the opportunity to serve many of the larger local markets and the higher fares in some of these markets would be an incentive for the remaining or new carriers to increase service and continue to pay the agreed upon rates and charges.

While the bankruptcy filings of Delta and Northwest are partly the result of certain pressures common to all airlines such as high fuel costs, rising labor costs, low yields in the aftermath of Hurricane Katrina, the circumstances surrounding each filing differ significantly and the resulting impact on airports may be different. Both airlines will look to regain their long term business viability by seeking to lower their costs in a variety of areas. Some of these, for example, labor costs, are neutral to airports. Strategic decisions about route structure and capacity reductions on the other hand can have a significant operational and financial impact on airport credit.

Airports may also be affected by the legal strategy the airlines adopt regarding their airport leases. Airlines may choose to reject comparatively expensive or older leases, especially at airports they are also considering for service cuts. On the other hand, and as we have seen time and again, airlines are likely to affirm other leases at airports they deem strategically vital to their network.

In conclusion, we continue to focus on those airports that in our view lack one or more of the credit strengths that support the divergence in credit quality of airports and airlines. In Moody's opinion, the increased risk that the airline restructuring process implies will be borne by those airports with less favorable routes, a high reliance on airline-derived revenues, a service area that is below the median in terms of generating demand for air travel, below average liquidity levels and limited ability to cut airport operating costs and/or scaled back capital programs.

Thank you again for the invitation to testify. I would be happy to respond to any questions.

Mr. MICA. Thank you and thank all the panelists. It took a little time to get through but we don't have any other witnesses today

and we wanted to hear from each of you involved in looking at the industry and give you an opportunity to make presentations.

I have a few questions. Unfortunately, there is a conference going on so we have lost at least half of the membership but I want to go ahead since you have been patient and continue with the hearing.

My question for each of you, first of all, is do you expect additional bankruptcies in the short or the near term and the long term? Mr. Kiefer?

Mr. Kiefer. I would have to say I am optimistic at the prospect of American and Continental, the two major legacy carriers that have thus far avoided bankruptcy. I am optimistic at the prospect of them avoiding bankruptcy. Certainly in the near term, there is not a likelihood of that. Their cast positions are such that it is not likely in the near term.

I think in the long term, American was among the first of the major legacy carriers to negotiate major concessions with their union early on in this crisis. Continental has probably the reputation as the best labor relations among the legacy carriers and I think the combination of those two things implies they are likely to be able to negotiate further concessions in order to avoid bankruptcy.

However, as I mentioned, should Delta and Northwest elect to terminate their pension plans or convert them to defined contribution plans, American and Continental will find themselves to be ostensibly the only major legacy carriers remaining that offer pension benefits. I think those costs will prove unsustainable to those carriers in the long term. So their ability to negotiate those potential reductions in benefits and costs will be a key factor in their avoiding bankruptcy in the long term.

Mr. MICA. You answered part of my next question. Let me give Mr. Baggaley a chance.

Mr. BAGGALEY. In the near term, I think the most likely bankruptcy candidate is an airline you are familiar with in this area, Independence Air. I don't expect that American or Continental are likely to file unless there are further shocks to the system such as a further major increase in fuel prices or terrorism.

Over the longer term, I think I would agree with Mr. Kiefer that the pressure of the benefits and pensions might cause them to file for bankruptcy. I would expect what they would try to do is negotiate outside of bankruptcy to at least reduce those benefits. Their pension deficits are not nearly as large as those of Delta and Northwest, so they are not under quite as much pressure.

Mr. MICA. Dr. Morrison?

Mr. MORRISON. I should add that my study of the industry is not at the firm level and my fellow panelists may be much better informed than I am, but I will say it wouldn't surprise me to see another bankruptcy.

Mr. MICA. Mr. Sokel?

Mr. SOKEL. I think if the situation in terms of high jet fuel prices continues in the next fiscal year, it is difficult to see how you wouldn't have additional bankruptcies unless the additional costs of operation were passed on to the flyer because at this point, it strikes me that most of the major carriers have very little sense of

what the outlook really is in the sense that if they had to hedge at this precise moment. I don't think any increases in refinery capacity are going to meet the short term needs of the industry.

Mr. MICA. Ms. Matesanz?

Ms. MATESANZ. I would defer answering that question to our airline analyst at Moody's and I would be happy to report back his views.

Mr. MICA. I have a question for you and you are sort of our airport expert. Did you say the airport bonds were at what rating?

Ms. MATESANZ. The median rating for airport bonds is A2.

Mr. MICA. And airlines were B2?

Ms. MATESANZ. B3.

Mr. MICA. Do you see any change in that rating for airports as a result of the current bankruptcies or financial problems that we have seen over the most recent period of time?

Ms. MATESANZ. The median rating is something that moves very, very slowly.

Mr. MICA. So it would take a while to impact that?

Ms. MATESANZ. Exactly, and we don't see any radical changes in the profile of the sector. We have a stable outlook on the airport sector as a whole.

Mr. MICA. What should Congress do and Mr. Kiefer, you said the pension was the big enchilada.

Mr. KIEFER. I think with respect to the question what should Congress do, with respect to the pension benefits I suppose one piece of guidance I would offer is that I think it is likely if not certain in the long term that pensions will no longer be a feature of the U.S. airline industry. The low cost carriers have never had them and never will. I think any efforts at pension reform ought to be aimed at preserving benefits for existing employees rather than trying to maintain them for potential future employees because I think they are likely to go away in that regard.

Mr. MICA. Mr. Baggaley?

Mr. BAGGALEY. Standard and Poor's has a policy of not recommending for or against any public policies. I would just make a note as to the pensions.

Mr. MICA. You have also provided the charts on AMR that reflect also industry. They cut labor.

Mr. BAGGALEY. That was $1.8 billion.

Mr. MICA. Right. They are getting hit in the shorts here with the fuel and they have cut some of their overhead.

Mr. BAGGALEY. There were various other cost reductions on the order of $2.2 billion, so one can see just how much of their progress has been wiped out by the rise in fuel prices.

Mr. MICA. Again, pensions would still be sort of the big enchilada in obligations and fuel?

Mr. BAGGALEY. Actually, the largest portion of American and other airlines' obligations are secured debt and leases. Pension deficits are significant but they are a minority of the total.

Mr. MICA. The only way you can restructure those would be through bankruptcy or negotiation?

Mr. BAGGALEY. Yes.

Mr. MICA. Dr. Morrison?

Mr. MORRISON. I mentioned in my testimony that an extra half hour early arrival at the airport is estimated at 7 percent.

Mr. MICA. Seven percent. That was interesting. I am going to use that because I am trying to get them to do in-line systems and some other things, faster screening.

Mr. MORRISON. That is my suggestion precisely. It seems to me that in the scheme of suggestions, it is relatively uncontroversial.

Mr. SOKEL. I am not entirely sure what can be done in the short term and the longer term. The Congress should look into the initiative offered by the Kuwaitis with regards to their offer to build a refinery within the United States because it would seem it is a bit of robbing Peter to pay Paul at the moment.

Mr. MICA. Interesting. Ms. Matesanz?

Ms. MATESANZ. Again, I would limit my remarks to the impact on airport credit and would be happy to provide an answer.

Mr. MICA. So you don't see a big problem and you don't see that Congress has to step in at this point?

Ms. MATESANZ. Again, with respect to the airlines, I would defer answering that question.

Mr. MICA. Right, but I meant airports.

Ms. MATESANZ. As far as airport credit, again, our outlook is stable for the sector. While airline bankruptcies are something that we look at closely, particularly for hub airports, we look at a whole host of other factors that airports have under their control such as the ability to offset airline revenues with other sources of revenue, the ability to cut their operating and capital budgets, their ability to attract other carriers to those markets through efficiencies in their own operations as offsets to the credit impact of an airline bankruptcy on their own operations.

Mr. MICA. I thank all of you for your comments. We don't have jurisdiction over fuel prices, we don't have jurisdiction over the four cent jet fuel tax and we don't have jurisdiction over pensions, but I think it is important that we review the impact of all of these on the airline industry and if necessary, take steps where we can assist, but don't underwrite a failing business operation or model. I have been sort of the tough guy on the block on this because I think that subsidies would only temporarily delay the inevitable as far as the airline business is concerned.

Last, I thought we were doing a pretty good job in increasing fares and the airlines have increased fares from February to some time this summer about eight times. That has helped some of them see at least a minimal operating positive. I think one of you said all failed to institute price increases as a competitive area they won't touch. They have done that. Does anyone want to comment? I just don't see any other way for them to survive if they don't increase their fares.

Mr. KIEFER. I think one thing that is important to point out is if we observe any recent fare increases that in addition to being very cyclical, this business is also quite seasonal. Fares typically, both for domestic travel and international travel, will increase in the summer because that is a higher demand season. That may be something we are observing there.

I would offer one other further comment to the prior question. I think it is important when Congress looks into this issue and when

you are thinking of what you may do about it, to think of this issue in the broader industry context which is to say that some of the same factors that are causing the large financial losses in the industry, the low cost competition and so forth, are also affecting the ability of the system to fund its future infrastructure needs.

I think issues like the proposed fuel tax holiday or proposals that may soon be on the table to restructure the Federal Aviation Administration and so forth need to take into account not only the current but the long term financial health of this industry. Those proposals that might threaten that should be considered in that light.

Mr. MICA. Thank you. I agree with that.

Mr. Baggaley? Anyone else?

Mr. BAGGALEY. Historically, it has been very difficult to pass through fare increases in the domestic market but this year the pattern has changed somewhat. As you said starting in February, there have been a series of increases. I think the level of fuel prices reached the pain threshold even for the low cost carriers and they went along with these fare increases.

The bankruptcies of Delta and Northwest will probably result in some further withdrawal of capacity and probably out of the Country because there are other areas where there is strong demand and that should help that a bit further.

Mr. MORRISON. It is safe to say that fares over the longer term have to rise but it is hard for them to rise in the current environment with the capacity that is there. Unilateral action by one carrier won't do it and we generally frown on collusive behavior which might be in their collective interest but not in the interest of passengers.

Mr. MICA. Mr. Sokel?

Mr. SOKEL. I suspect the problem is that the rate of fare increase doesn't match the rate of the jet fuel price increase ultimately.

Mr. MICA. Mr. Costello?

Mr. COSTELLO. Mr. Baggaley, you addressed the issue of capacity in your statement. In fact, you refer on I think the last page of your testimony to that where you say "Consolidations, either through bankruptcy or liquidation or mergers will help the industry but only if it is accompanied by the withdrawal of planes from the U.S. market and by competitive cost structures." What do you mean by that? In other words, regardless if you have mergers, if you have bankruptcies, whatever takes place, we have too much capacity? Is that what you are saying?

Mr. BAGGALEY. Capacity is a partial problem. If you look at the percentage of seats filled, it is actually quite high and to the extent that some planes of a high cost carrier are simply moved out, low cost carriers will expand to fill the void.

The thing that gives some hope for the current situation is that with strong demand overseas, some of these planes will be redeployed there and the legacy carriers are lowering their costs to be closer to the low cost carriers. Over capacity is a problem but it is not the sole problem and some of the changes that have been suggested as potentially helping the industry work only if it is accompanied by cost reductions.

Mr. COSTELLO. You also say that broader trends and changes could heal the industry. Elaborate on that.

Mr. BAGGALEY. They could help somewhat but I think the industry is going to be financially stretched for the foreseeable future. The best case scenario is that the legacy carriers lower their costs, are modestly profitable in the best of times but still highly leveraged and at risk in a down turn. The best case is not terribly bright but it is certainly better than the worst case.

Mr. COSTELLO. The hub and spoke system, is it still an effective model for the legacy carriers?

Mr. BAGGALEY. The hub and spoke system can generate more revenue and there are some very successful carriers overseas who use it. Also some of the low cost carriers use it, so it is not pure dichotomy between a Southwest model and an American Airlines or United model. The problem is that the extra revenues generated by the system have been shrunk by the low cost competition and that still leaves them with the higher costs. So they have been trying to shift more of their flying overseas, shift more to local markets and lower the costs at which they operate the hub and spoke system.

All the low cost carriers, they don't have international operations, they don't have regional feeders so if we are to serve the Country, there is a place for a hub and spoke system but it has to operate at lower costs.

Mr. COSTELLO. Mr. Kiefer, I mentioned in my opening comments about the argument that the legacy carriers are operating under a business plan that may no longer be effective, in particular the business traveler, the premium ticket price made up in the past a major portion of the revenue going to the legacy carriers. I am wondering if you agree with that and if so, what changes will have to take place in the legacy carriers business plan in order for them to get back into the market?

Mr. KIEFER. I think I would agree with it at least in part which is to say that the composition of the traveling public that now exists is fundamentally different than it was four or five years ago. There is much more price consciousness and so it is true if the business model is predicated on the ability to charge much higher fares on business travelers, it is proving problematic. I think there are business travelers willing to pay those higher fares out there; the problem is there are simply not enough of them to sustain the legacy carrier's profitability.

At the same time, however, legacy carriers do offer certain premium services such as first class, airport clubs and so forth which are attractive to business travelers and provide benefits that are desirable to the extent I don't see them going away in the long term. They also offer international services which as we discussed because of their continued regulation largely do have much higher profitability than domestic services and so forth. I don't think the business model is completely broken but I think it is much more difficult to apply in the current environment.

With respect to the operating model to address some of the comments of Mr. DeFazio earlier, I think the hub and spoke system likewise provides some very significant benefits to the traveling public. It allows the connection of far more origins and destinations

than would be possible with strict point to point service, it allows the connection to international gateways which is vital to the air transport system and finally, perhaps most importantly, it provides connection for small communities to the air transport network that simply might not be possible otherwise. So I think it has a lot of benefits that will probably keep it around for some time.

Mr. COSTELLO. You also mention in your testimony that the low cost carriers are quite vulnerable to some of the challenges that face the legacy carriers, obviously high fuel costs being one. What other challenges do you see for the low cost carriers and what does the future look like for the low cost carriers?

Mr. KIEFER. I think certainly fuel is the most significant of those challenges. Southwest hedges a significant 85 percent this year at I think $26 or $28 a barrel. Those hedges will subside in the next few years. They are only hedged I think about 28 percent on average. I could be corrected on that but for the other low cost carriers.

I think the other big issue is labor costs. Ironically, just as we have talked about the very significant cuts in wages and benefits that the legacy carriers have instituted, if anything, low cost carrier wages are likely to increase. I don't ever see them instituting pension plans or post-retirement, health insurance but it is likely that pay for those carriers, particularly as they grow and continue to be profitable, will increase. Labor being upwards of a third of the total operating costs of the carriers, that will begin to bear on their future profitability.

Mr. COSTELLO. Mr. Sokel, it is my understanding that a large percentage of the airlines hedges were in crude oil as opposed to their actual exposure which is jet fuel. Why was that?

Mr. SOKEL. I think there are a few reasons. The first is that there was the perception at the CFO level within many of the carriers that WTI, which is the benchmark in the United States, is the liquid most actively traded index and therefore because it is liquid and because it is screen based, New York Mercantile Exchange based, there was a belief that this would seem to be a benchmark that was more suitable versus something that was strictly traded over the counter.

The problem in that perspective is that it doesn't recognize accurately the fact that in times of extreme demand or supply restriction or both, such as we have now, you can have this increasing basis risk and companies that are only hedged in crude oil lose out on this increase in price in the actual product. I think another reason is that once one airline hedges in WTI and another reports that they are hedging in WTI, it almost becomes the standard for the industry.

Without going into specifics, I would debate that the jet fuel index as traded in the over the counter market is very liquid. It takes a little bit more of an understanding of how it is traded and what the basis is but clearly the difference between hedging in jet fuel or heating oil or crude oil probably makes the difference on the bottom line of tens of millions of dollars.

Mr. COSTELLO. Final question for the panel. Just a brief response, if you will.

The Chairman asked the question about what Congress should be doing. I would ask, as I made mention in my opening statement

that Mr. Crandall and others have asked, regarding the issue of bankruptcy, what he thinks should be done as far as the bankruptcy laws are concerned, capacity issues and so on. My question is, what if Congress does nothing? What if we take no action whatsoever with the issue of bankruptcy, with capacity, with fees and taxes, what happens to the industry? Mr. Kiefer?

Mr. KIEFER. I think as I stated earlier, there are additional job losses that are likely, there is the real prospect of additional loss of pension benefits for significant numbers of employees and I should point out in the case of pilots, this is a very substantial reduction in benefits from perhaps as much as over $100,000 a year in benefits being reduced to less than $30,000 a year in benefits.

Having said that, I think inevitably if Congress does nothing, I do believe this industry will right itself in the long term and perhaps additional consolidation whether it be liquidation or even just the renegotiation of benefits will ultimately provide for the long term financial health of the industry.

Mr. COSTELLO. Mr. Baggaley?

Mr. BAGGALEY. If fuel prices gradually decline, that can be partly covered by fares, I think the legacy carriers will struggle through. They will shrink, some of them will merge and as I indicated earlier, they will be financially weak, but still flying. If there are further price shocks or other outside shocks, I could certainly see some major carriers shutting down in bankruptcy.

Mr. COSTELLO. Dr. Morrison?

Mr. MORRISON. What if Congress does nothing? I am an economist so the perspective that I take is one of is there a market failure that needs correcting? I am unaware of a market failure in the sense that economists mean it, that needs correcting. I would agree with my colleagues as to what would happen in the absence of action.

Mr. COSTELLO. Mr. Sokel?

Mr. SOKEL. If Congress does nothing, then the average American can expect to pay a lot more for their privilege to fly. In absence of that, you will have increased bankruptcies.

Mr. COSTELLO. Ms. Matesanz?

Ms. MATESANZ. Speaking from the standpoint of the airport sector, the capacity issues that are strained by the hub and spoke model are something that need to be focused on as far as facilitating airport expansion at those airports that are capacity constrained already. That is an area that potentially need some more study and some more scrutiny as far as how to expedite the building and development of additional capacity to support the efficiency and fuel economy by extension of the airport tenants that serve the airports.

Mr. COSTELLO. Mr. Chairman, I have another question or two but my time is up and there are other members here. Hopefully, we can come back.

Mr. MICA. Mr. DeFazio?

Mr. DEFAZIO. Thank you.

Mr. Kiefer, you seemed to indicate a little sensitivity to the concern I raised about connectivity of the system. It obviously can profit the system if it works properly in dealing with small or midsized cities.

What I would like to understand both from you and others is what do you think is a policy role? I am not sure that markets are enough to continue to serve those areas especially since, if we want to talk like economists, we don't take into account external diseconomies, the external diseconomy being the people who live in the second largest city in Oregon have to drive 120 miles to the airport in Portland because all of the little planes that now fly out of our market are overbooked. They are 100 percent full.

So it is kind of a problem. You can't get there at night any more, but other than that, it is working pretty good. That is happening to people outside of virtually every major urban hub in America and most of us do not represent major urban hubs.

If you look at the GAO studies, that is where the big drops in air fares have come but in a lot of your smaller, mid-sized cities, air fares have not been as generously discounted into those markets and the service is crummier.

The question is as a policy maker, what is the vision for the system? Are we ultimately going to abandon everything but say SEATAC and San Francisco and LA on the West Coast and I don't know what it will be in the middle and a few on the East Coast because that is where the market takes us? So, you have to drive 400 miles, that is your problem if you want to fly? We are losing something here.

Does anyone have any ideas on what we should do as policy makers as opposed to pointing fingers in terms of dealing with us?

Mr. KIEFER. I think as policy makers, the Congress has already addressed the issue of service to small communities through the Essential Air Service Program.

Mr. DEFAZIO. It is a pretty lame program and I keep asking people for a better model.

Mr. KIEFER. I just offer that as context but I think you raise an important point that while at the same time the hub model allows more frequent service or connects to more destinations, the small community, often it does so through perhaps one airline. That is why I think you observe the much higher prices that you do in your community or elsewhere from these smaller communities to the large hubs and so forth.

I am not sure I can offer a direct policy prescription for that issue but I agree with you that it is not to say that there are not other issues with respect to the hub and spoke system and its ability to serve small communities because it does indeed do it perhaps more frequently but more expensively as well.

I don't see in the long term however, a reduction in the number of airports that serve passenger traffic or serve it at any significant volume because air travel is forecast to grow over time and if anything, the trend has been particularly through the advent of regional jets and so forth to add more point to point service to medium-sized airports rather than service at very large hubs.

So I think the future is not necessarily bleak for the smaller or medium-sized cities with respect to their air service, but I agree that it may not be ideal at present and it may look a little different in the future. As for how to reinvent that from a policy perspective, I am not sure I have a prescription for you at this point.

Mr. DEFAZIO. Thanks. Anybody else have a comment or idea?

Mr. BAGGALEY. There is an interesting experiment which will be rolling out shortly and that is Jet Blue, a low cost airline, will be deploying large 90-100 seat regional jets and they expect to expand those throughout much of the eastern half of the Country. If that works and there are some new larger regional jets that are very efficient and the pilot unions at the major airlines, the contracts have been changed to allow that in many cases, you could see a greater seat capacity available to some of these communities and therefore, lower fares. They wouldn't be 100 percent booked anymore.

Mr. DEFAZIO. Mr. Morrison?

Mr. MORRISON. The issue of service to small communities is something I looked at ten years or so ago and the issues may well have changed or the situation may have changed, but what I found then was the level of service and the fares charged which are certainly higher than others, were based on the less demand and higher costs attended with lower capacity aircraft, that they are more expensive to fly, there are fewer passengers flying so frequency is less, service is definitely less but there are fewer passengers.

As far as some regulatory type solution or a non-market solution, I know some local communities make contracts with airlines guaranteeing some minimum.

Mr. DEFAZIO. My largest city pioneered that, so it is a market-based way of attracting people.

If we could, someone referred to going to Europe, people are going overseas. The question is how are fares set overseas. My understanding is in Europe everybody is charging a fuel surcharge and somehow that happens.

I guess it is not a market-based system or it is a market-based system that somehow tolerates getting a premium for higher fuel costs and so American airlines have to go over there to operate so they can make money when the planes are full as opposed to losing money when their planes are full here. Can you help me out with that? What is the difference?

Mr. BAGGALEY. The legacy carriers have expanded their flying to foreign destinations, they are not flying within those destinations but transatlantic flights, transpacific and so forth. There are as yet no true low cost carriers serving many of those markets, so the fares, at least in the summer, are higher, the planes are full there are fewer participants on each route, so they are more attractive.

However, that has its limits. In the past, the transatlantic market airlines have dumped in too much capacity and the fares have fallen. At the moment that is the relatively good area.

Mr. DEFAZIO. On the issue of fuel, Mr. Sokel, I have been looking at some analysis of what has happened to refining. It is pretty interesting. You talked about the historically low rates of return and I grant you from 1999 to 2004, refineries were making 22.8 cents for every gallon refined.

By the end of 2004, they were making 40.8 cents, almost twice as much, and this year they are making $1.10 or somewhere between $1.00 and $1.10. That is up five times. Were you talking about the 22.8 cents for historically low rates of return, the 40.8 cents or were you talking about today's $1 rate of return?

Mr. SOKEL. I was talking about really prior even to the 22.8 cents because if we go back to the example of what took place in the mid-1990s and even in the late 1980s, the downstream sector has been in a period of significant consolidation probably for the better part of the last 15 years and it is really only in this last three or four years that companies such as Valero, Exxon-Mobil, British Petroleum are showing significant returns in the refiner sector.

Mr. DEFAZIO. Would you say at $1 a margin per gallon that would be enough incentive economically to build a refinery?

Mr. SOKEL. That is a very interesting question but I guess if I listen to Lee Raymond or Sir John Brown, it would seem the logistics of actually building a refinery in a place that is commercially viable is still a question that needs to be answered. There are not too many people sitting in this room who would like to have a refinery or a terminal capacity put near where they live.

I think it is a combination of things. How much environmental legislation needs to be passed if it is particularly in California, in New York, in Florida and in some of the major markets. I would imagine in the State of Oregon, it would also be difficult to hurt the pristine vantage point that people have by putting a refinery there.

Mr. DEFAZIO. We are looking at several liquefied natural gas facilities in Oregon. We are connected to the gas lines. We aren't connected to the gasoline lines except for one very small pipeline. That is why they tell us we on average always pay more than Washington and California. So bringing it into Oregon wouldn't do you a lot of good because you can't get it out again.

The point becomes as I understand the President's proposal which may or may not have been serious but he said that he would work to waive all environmental laws or could potentially in an executive manner waive environmental laws to put a refinery on a closed military base which could likely be in one of those areas.

It seemed there was a resounding silence from the industry and when you see quotes like Valero's chief operating officer, a quote in the Post saying, basically it is working pretty well the way it is. It kind of reminds me a bit more of California in the days of the former Enron where our plants are down for maintenance, markets up, so if we run right on the edge of refinery capacity, when they shut down, we see a little blip. We went up 30 cents a gallon in Oregon, even though we are not in the East Coast network, because of Katrina. That was interesting.

I guess I am questioning whether there is a market here and whether we need to look at a little bit of disaggregation in this industry when you look at the concentration. I would be curious if you think this is adequate that we have gone to the point now from 34.5 percent being the top five refineries in 1993 to 56.3 percent and 83 percent in the top 10. I am beginning to wonder whether we have real market characteristics here or whether we are seeing a little bit of manipulation and excess rents or price gouging as some of us call it?

Mr. SOKEL. I would almost argue that price gouging occurs more when the price is low in terms of gasoline than when the price is high because the level of sensitivity is that much higher when the

prices are high. I think there are more than a number of national oil companies that would love to be able to put a refinery in the United States if for no other reason than to have an outlet for their additional crude oil. Whether that would be Saudi Arabia or Kuwait or the Emirates, and I can name a host of others, I suppose it has 30 years or thereabouts since the last refinery was built in the United States, so most of the executives who have been with these companies for a long time can't even remember.

Mr. DEFAZIO. They don't know how to build them any more.

Mr. SOKEL. They might have forgotten or if they do, the building prospects are mostly in the emerging market countries. That is kind of the perspective that I have. It is precisely in the countries that are considered emerging markets now where most of the refinery capacity has increased over the last decade.

Mr. DEFAZIO. The interesting thing there is what are the profit margins over there?

Mr. SOKEL. They are good but they are not as good because of the simple fact that people don't drive in the same way that they do in the United States.

The one point I would like to make is that in terms of the waiver of sulfur, that is an interesting proposal from the President because a number of the refineries in the Middle East, for example, produce a higher sulfur of gas oil that currently does not come into the United States in its natural form. Were sulfur requirements to be removed, a lot of that product by normal market forces would find its way into the United States.

Mr. DEFAZIO. I think there is a problem with the outfall of burning the higher sulfur fuels particularly with catalytic converters and other things I don't think we are going to recommend we step back from.

Mr. SOKEL. The problem is, given the environmental legislation that would be needed to do that, that is probably a non-starter.

Mr. DEFAZIO. Thank you.

Mr. MICA. Mr. Larsen?

Mr. LARSEN. Thank you.

A little more about hedges. We are doing our part in Washington State out of the four refineries located from northern California to Washington State to the border, four of them are in my district, so we are doing our part on refineries.

Mr. Sokel, with regards to hedges, Mr. Costello asked a question about why hedge on crude oil and not jet fuel and it seems to me in terms of that regard, nothing government did stopped or prevented or forced people to hedge into the crude oil market versus jet fuel, that the decisions made by airlines based upon whatever advice they got, they made those decisions to go into crude oil and not jet fuel.

Why make that choice versus Southwest Airlines, if I am not mistaken, has a better hedge in jet fuel versus crude. What is the decision-making process that takes place within an airline so we can understand that because it is not something we are going to be able to address, nor should we interfere in a market like that.

Mr. SOKEL. It is an interesting set of questions. I guess you could start by saying that unto each individual airline goes their own rationale of how to hedge, when to hedge, whether to hedge at all.

There are a lot of concerns that go into the matter, not the least of which is what happens if we put on a hedge that loses money and Wall Street says, well, we didn't invest in your company because we thought you were a good oil traders, we wanted a pure view on the positive prospects of the industry.

Just to step away from the aviation industry for a moment, that is exactly what happened recently with Valero. Valero lost $300 million on their refinery hedges and more than a few analysts did say to William Grehee, we didn't invest in your company because we thought you were good oil traders. We wanted a pure view on the refinery sector. It didn't matter that the stock price has gone from $40 to $120 in the last year, people always found something to moan and groan about.

If I can make a comparison with one of the European carriers that Deutsche Bank does a great deal of business with, the way they set it up is they try to mirror the hedging program actually with their route structure. For example, if they know they are going to be refueling 70 percent in the northwest European market, that is where 70 percent of their hedges go. If it is 10 percent in the Gulf Coast or related pricing to the Gulf Coast, then that is where they would do it.

In terms of the American carriers, I think Southwest is probably the best example of having instituted a hedge program at least that in percentage terms goes out to 2009, I believe between 30 and 40 percent hedged between 2007 and 2009. Ultimately it comes down to an individual or group of individuals saying, we really don't think there will be that much demand for jet fuel relative to crude and we are trying to place our hedge in something that will at least reflect the broader price of oil.

Again, the question of liquidity and transparency typically is one reason because a typical CFO is not only hedging oil, they are hedging interest rates, currency, so familiarity may go to the heart of the matter of how hedges are placed and certainly when they are placed.

Mr. LARSEN. In your view, for future planning for individual airlines, has the econometrics model that has existed for the price of the barrel oil permanently shifted up, is the delta steeper now and should they be thinking about that?

Mr. SOKEL. I think it is a very delicate point because arguably most airlines are now on the more optimistic side of their view of what jet fuel prices will be for the next two years. I am a little bit conservative in my view but I believe you have to estimate the price of jet fuel as to what the price would be if you had to hedge 100 percent of your fuel today.

Many in this room would argue that is not necessarily indicative because the analyst community did not expect to see $70 right now, they were forecasting much lower price and it is now for next year they are predicting $60 prices, so the contrarian in me says maybe there will be lower prices just because everyone now has suddenly gotten onboard that the prices of energy are high.

Having said all that, an absent a recession, global reduction of growth, it is hard to see given the global situation in jet fuel and with global airlines. I did mention the demand for the marginal barrel of fuel. It is a fungible market, the barrel of jet from a Ko-

rean refiner to LAX airport, so on and so forth, has its way of when one market is in deficit, the other market in surplus provides that market but all that means an increasing demand period, it just means higher prices for the extended period.

Mr. LARSEN. Mr. Baggaley had some comments about hedging and Southwest. Do you want to comment on any of this?

Mr. BAGGALEY. Yes. It is certainly the case that many airline managements are regretting that they didn't try to put more hedges in place but the biggest difference between Southwest Airlines and the legacy carriers is Southwest Airlines is rated A, a solid investment grade credit. They can do business in setting up hedges with others because counter parties will take their credit risk.

For most of the legacy carriers, for all of the legacy carriers, they would have to put up cash collateral and they are trying to conserve their unrestricted cash. That is their last line of defense against bankruptcy. So their choices at this point have narrowed.

Mr. LARSEN. Thank you, Mr. Chairman.

Mr. MICA. I thank all of our panelists. I think you have answered the question of what should Congress do and what if Congress does nothing.

I guess that is sort of the question. It looks like we are headed toward some type of assistance with pension reform which is also spilling now into other aspects and segments of our economy. Regarding fuel, we must increase refining capacity and supply on an expedited basis. Not much is going to happen there. I think we are at sort of a standoff as to what Congress can do.

I am glad you all raised the four cents and the ticket tax, and financing the infrastructure. We talked a bit about capacity of the airlines interns of seats but we also face a capacity crunch with airlines as far as a place to land planes. We can only fit so many planes in so much air space and we are back to the pre-September 11 capacity issues facing the industry.

I am concerned about the impact of leaving airports and others holding the bag so to speak, particularly when it is necessary to continue increasing capacity for more planes to land. If you can't have more revenue and you can't do more business, there is not much hope for the future. That is just a couple final comments.

I appreciate your participation. We may have some additional questions. Some of our members were called away for a conference but we do appreciate your insight and sharing your opinions, your knowledge, your experience with us. Again, on behalf of the Subcommittee, we thank you for your participation today.

We will conclude the hearing. There being no further business before the Aviation Subcommittee, this hearing is adjourned.

Thank you.

[Whereupon, at 4:15 p.m., the subcommittee was adjourned.]

# Testimony before the Subcommittee on Aviation
# U.S. House of Representatives
# Committee on Transportation and Infrastructure

## "The Financial Outlook for the U.S. Airline Industry"

September 28, 2005

Philip Baggaley
Managing Director
Standard & Poor's Ratings Services
*A Division of the McGraw-Hill Companies, Inc.*

Good morning, Mr. Chairman, members of the Subcommittee, ladies and gentlemen; thank you for the opportunity to testify today.

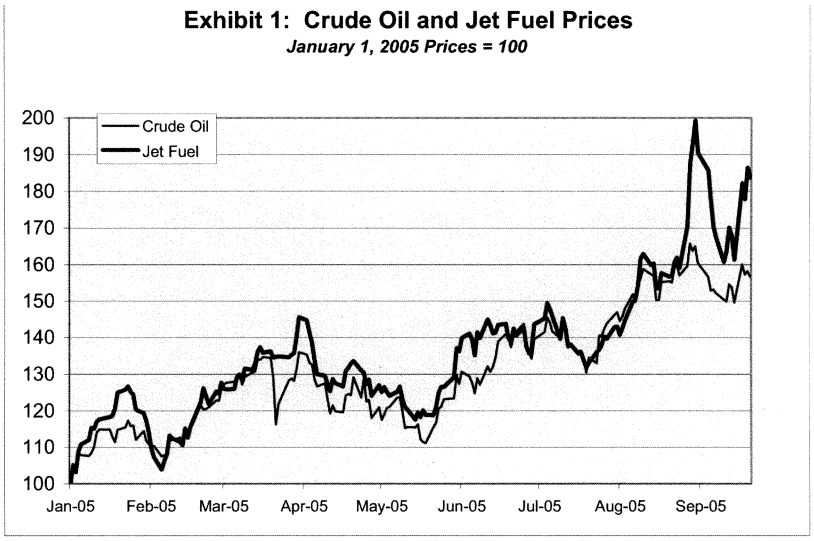
I am a Managing Director in the Corporates and Governments group of Standard & Poor's Ratings Services. I have been the primary credit analyst for the airline industry for the past 20 years. Standard and Poor's rates all major airlines in the U.S. and many major airlines throughout the world. Our ratings are current opinions about the creditworthiness of an entity, i.e. they speak to an entity's future ability to pay its financial obligations as they become due. As such, they should not be viewed as expressing an opinion on public policy matters. My comments should not be interpreted as being recommendations of any kind: they are Standard & Poor's Ratings Services independent and objective opinion of the credit status of the airline industry.

The U.S. airline industry continues to struggle through a prolonged crisis, with three large airlines in bankruptcy and another emerging after two trips into Chapter 11. This grim situation is despite generally robust economic conditions and billions of dollars of federal cash grants and loan guarantees over the past several years. This morning, I hope to provide some perspective on the airline industry's problems by addressing three related topics:

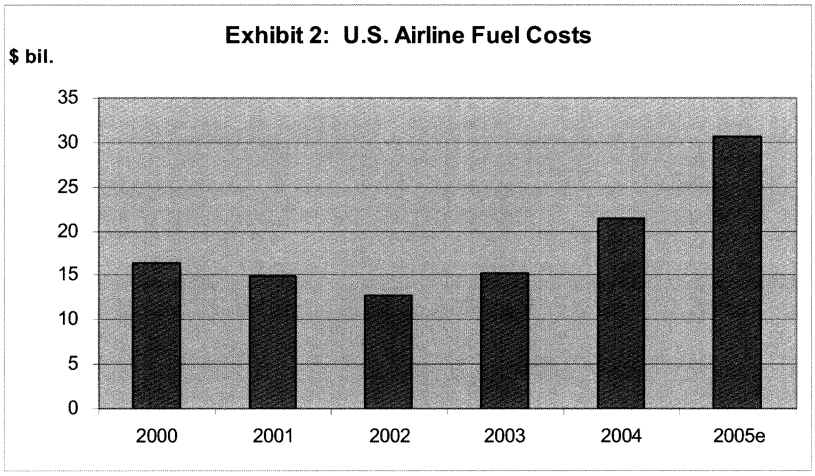
1. What are the principal causes of the U.S. airlines' current financial problems?
2. How are airlines responding to this situation?
3. What broader changes might improve the industry's prospects?

First, why are most airlines reporting losses and bleeding cash in a strong economic environment? Numerous factors have contributed to the problem--some inherent industry characteristics, some that date from the 1990s, and others that were serious concerns following the September 11, 2001 attacks. However, three factors stand out in the current environment: very high jet fuel prices, intense price competition in the domestic market, and heavy debt and pension burdens.

Fuel prices are the most serious concern at the moment. Oil prices have moved up in several large steps starting in the autumn of 2004, and the future outlook is for an extended period of high prices. Added to the high price of oil are the effects of limited refining capacity, which have widened the normal price difference between oil and jet fuel. Exhibit 1 shows the movement of oil prices and jet fuel this year, with the levels of January 1 set to equal 100.

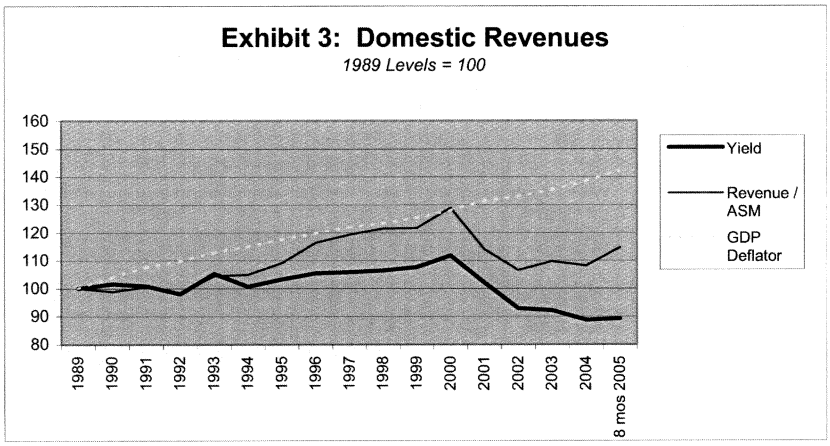



One can see the darker line representing jet fuel prices jump up above the lighter crude oil line over the past month, due to damage to refineries in the wake of hurricane Katrina. The Air Transport Association recently estimated that U.S. airlines will spend $30.6 billion on fuel in 2005, compared to $21.4 billion in 2004 and double 2003's $15.2 billion, as shown in Exhibit 2.



This represents a huge added expense that has offset much of the painful cost cutting that airlines have undertaken in recent years. Even low-cost airlines are under pressure. Southwest Airlines would be operating at breakeven without its fuel hedges, and JetBlue recently warned that it could report losses. Standard & Poor's on September 21 placed its ratings on JetBlue on CreditWatch for a possible downgrade. Most airlines do not have the credit profile that would allow them to enter into hedges without putting up cash collateral, and thereby depleting their cash reserves. In any case, hedges cannot undo the current price levels, only protect against further increases. Airlines are seeking to raise fares to help cover the cost of higher fuel—an effort that has been partly successful in 2005, after years of price cutting—but the enhanced pricing only partly offset the higher fuel prices. Unlike railroads, trucking companies, and shipping lines, airlines do not provide their services under corporate contracts that often allow for fuel surcharges. Rather, they must attempt to raise fares in competitive markets, a move that requires all major players to follow suit or the attempted fare increase will fail.

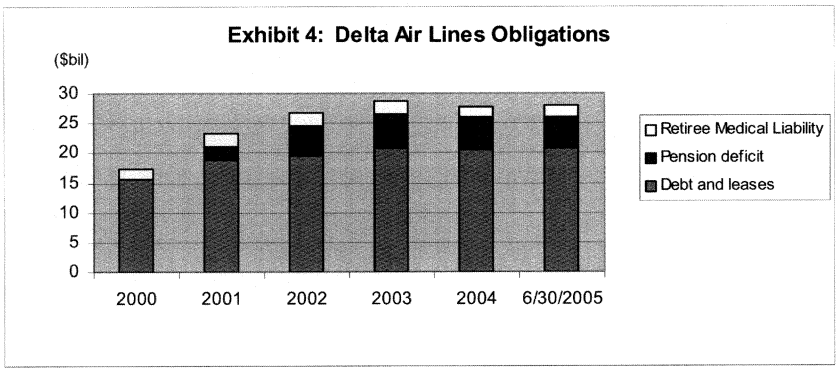
The second major cause of the airlines' financial problems is intense price competition, particularly in the domestic market. Exhibit 3 shows yield, the standard industry measure of pricing, and revenue per available seat mile, the measure of revenue generated per unit of capacity, as reported by the Air Transport Association, for this market.



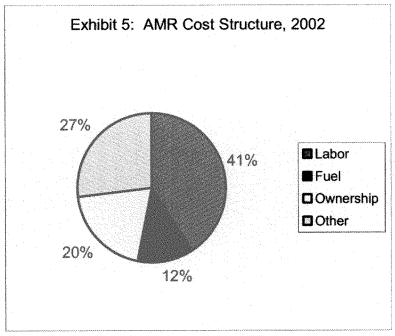

The data is expressed as an index, where the levels of 1989 are set equal to 100. Both measures turned sharply downward starting in 2001, and yield has not improved materially despite several years of economic recovery. Although the recession and September 11, 2001 attacks triggered the initial decline, they have since been superseded by other trends. The rapid spread of low-cost airlines and excess seat capacity has prolonged the pricing weakness, and at least the first of these appears to be a permanent change. Shown also in this Exhibit is an index of inflation, measured by the gross domestic product (GDP) deflator, with 1989 set to equal 100. The gap between this line and the two airline measures shows how much worse the decline of the past few years is

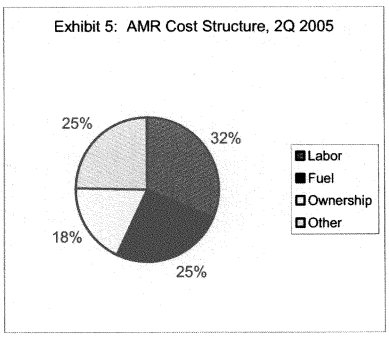
when measured in real, rather than nominal, terms. Over the past year, the pressure of high fuel costs has led to a series of fare increases, reversing the trend of the past several years. While this has been a welcome development, it may not last. If high oil prices cause the U.S. economy to slow, the recent momentum toward higher fares could stall.

The third big financial problem for airlines is a heavy burden of debt and pension deficits. Airlines tend to operate at higher leverage than manufacturing companies, even in the best of times. Starting in 2001, the "legacy carriers" had to borrow heavily to fund losses and maintain an adequate cash reserve, even with cash assistance from the federal government. On top of that, traditional defined benefit plans that were fully funded in the stock market boom of the late 1990s rapidly fell into deficits when share prices and interest rates fell. Exhibit 4 shows the effect for Delta Air Lines, with debt and the pension deficit mounting. The chart includes also liabilities for retiree medical obligations to show total debt and debt-like claims. All this was occurring at a time when Delta's ability to service those obligations was drastically reduced, due to heavy losses.



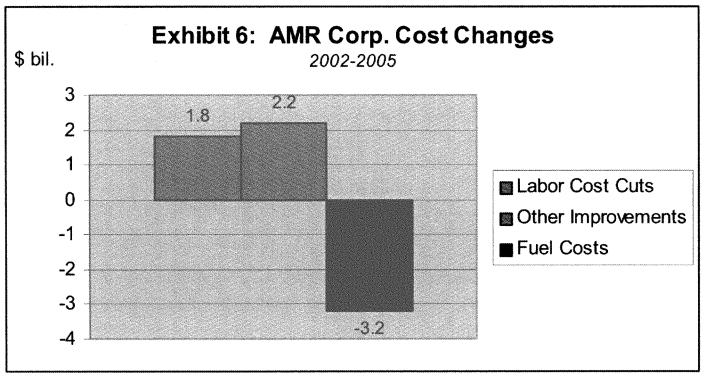

What have airlines been doing in response to these problems? In fact, the legacy carriers have been doing quite a lot, although you cannot fully see that from their financial results. First, airline employees have been asked to take substantial pay cuts, trim their benefits, and, in some cases, lose their jobs. Why has there been so much focus on labor costs? Exhibit 5, the two pie charts below, provides some insight.




It shows broad expense categories for AMR Corp., parent of American Airlines, in 2002 and in the most recent quarter of 2005. In 2002, labor represented 41% of total expenses—the largest category by far. Furthermore, two other categories—fuel and ownership costs (interest, rentals, and depreciation)—are either largely outside the airline's control or inflexible in the short run. The category labeled "other" includes a variety of expense items, some of them, such as distribution costs and purchased services, areas where the airlines have made cost-cutting progress. In short, labor was a target for cost reductions because it was the largest expense and one that is within the control of management and unions. Following large concessions in the spring of 2003 and fuel price increases in late 2004 and early 2005, labor's share of total expenses had declined significantly, to 32%, while fuel had more than doubled to 25%. A second reason why legacy airline's have sought labor cost reductions is that the pay scales, benefits, and work rules of the legacy carriers were simply much more costly than those of the low-cost carriers. In 2002, labor costs consumed 49% of AMR's total revenues; for Southwest Airlines the equivalent proportion was only 36%. In other words, labor was a major area of competitive disadvantage, though not the only one. These labor cost differentials have narrowed, though not disappeared, with changes of the past several years.

All this is not to say that labor costs have been the exclusive focus of cost cutting and profit improvement. American Airlines asked its employees for $1.8 billion of concessions in the spring of 2003, but they also pursued wide-ranging efforts to gain another $2+ billion from other sources. These include fleet simplification, changing hub operations, purchasing efficiencies, and other cost initiatives. Those efforts are harder to measure and are spread across more categories, but they do add up to real dollars. Exhibit 6 shows the relative scale of these various improvements and offsetting fuel cost increases for AMR between 2002 and 2005. The first two columns show financial gains from labor cost reductions and other publicly disclosed cost initiatives, while the third, negative, column is the largely offsetting increase of $3.2 billion of higher fuel costs forecast over that period. The chart shows just how much cost improvement has been cancelled out by the higher fuel prices.




Legacy airlines like American are borrowing some lessons from low-cost carriers, but there are limits as to how far they can or should go in this direction. The story is more complex than the contrast sometimes drawn between costly, hub-and-spoke route networks and low-cost, point-to-point service. First, low-cost airlines have differentiated over the years and are no longer all Southwest Airlines clones. AirTran, Frontier, and America West operate low-cost, hub-and-spoke route networks. JetBlue and AirTran offer cabin service as good or better than that of legacy carriers in the domestic market. Nor are all the low-cost airlines doing well. ATA is in bankruptcy and Independence Air is at the verge of it. Historically, a large majority of low-cost new entrants have failed. Conversely, if we look outside the United States, there are plenty of financially successful airlines that operate hub-and-spoke route networks: Singapore Airlines and Cathay Pacific, for example. The hub-and-spoke system inherently carries higher infrastructure costs, but it also can generate higher revenues, particularly when it is part of an international route network and has connections to regional airlines. The goal is to find a balance of direct and connecting flights that meets current market realities, and to operate the overall system at the lowest possible cost.

The final question that I posed at the outset of my remarks is perhaps the most important one: are there broader trends or changes that could provide the answer to the industry's financial problems? I will consider three such possibilities: bankruptcies, mergers, and reductions in seat capacity. Bankruptcy may have the stigma of financial failure, but it also gives an airline tools to correct that situation. Exhibit 7 shows selected financial data for UAL Corp., parent of United Air Lines, in 2002, when they entered bankruptcy, and from the forecast included in the companies' bankruptcy disclosure statement.

**Exhibit 7:**
UAL Corp. : Before and After

| ($ bil.) | 2002 | Forecast post-bankruptcy | % change |
|---|---|---|---|
| Debt & Leases | 24.1 | 18.4 | -24% |
| Pension Deficit | 6.4 | 0 | -100% |
| Annual Labor Expense | 7.0 | 3.9 | -44% |

Chapter 11 bankruptcy reorganization is intended to provide debt relief, so one might expect that this would be the principal change in the UAL's financial profile. As the exhibit shows, total debt and leases indeed decline between the end of 2002 and the forecast emergence from bankruptcy, but the percentage change is less than one might expect (-24%). Most airline debt takes the form of secured loans and leases, rather than unsecured debt. Whereas unsecured debt can be cancelled, and the creditors given shares in the new company, settlement of secured debt and leases is subject to negotiations with creditors. With aircraft values in a global market stronger now than when United filed for bankruptcy almost three years ago, the airline's bargaining leverage is less. Delta and Northwest will face this same issue—unsecured debt can be wiped out, but the scope for cutting secured debt and leases is more limited, except in those cases where the airline is willing to turn back aircraft to creditors.

The second financial item shown in Exhibit 7, pension shortfalls, is a different story. By persuading the bankruptcy court to terminate its pension plans, United wipes out an obligation on the same scale as its total debt reduction. Delta and Northwest have substantially underfunded pension plans, as well, and it appears likely that they may eventually seek to terminate some or all of those plans to facilitate reorganizing. From a purely credit perspective, eliminating all pension debt helps the bankrupt airline.

The third financial item in Exhibit 7 is annual labor expense. According to the company's forecast, 2006 labor costs are expected to be a substantial 44% lower than in 2002. This represents a combination of layoffs, pay cuts, and benefit reductions. It also includes some transfer of work from inside United to regional partners and maintenance contractors. United still has to pay for that work, but it is classified as a different type of expense (if one nets out the increase in outsourced work, labor costs in 2006 are forecast to be about 25% lower than in 2002). The United that emerges from bankruptcy will be a somewhat smaller airline, with fewer and lower-paid employees, than when it entered Chapter 11. Bankruptcy makes it easier for airlines to secure labor cost reductions, because, ultimately, the court can impose them. Delta and Northwest will seek to negotiate consensual concessions from their unionized employees, but now management's bargaining leverage vis-à-vis the unions is much stronger than outside of Chapter 11. In summary, bankruptcy can help an airline improve its financial prospects through debt reduction, pension terminations, and cost reductions. However, the struggles and continued losses of United, and the fact that US Airways paid a second visit to the bankruptcy court show that this is no panacea.

Mergers are a second broad change that is often suggested as a cure for airline industry problems. Rationalization of excess capacity and reduction in the number of competitors is seen as one way to correct an imbalance of supply and demand, and improve pricing. Yet, the track record of these combinations is poor, with few examples delivering on promised benefits. Airline mergers have historically been driven by a different rationale than those in most other industries. Combinations of manufacturing companies usually provide opportunities for cost cutting and eliminating duplicate facilities, but offer more limited and uncertain revenue gains. In contrast, airline combinations can generate added

revenue, but have historically often resulted in a net increase in operating expenses. Airline mergers generate added revenues through two principal means: diversion of traffic from competitors by creating a larger, more comprehensive route network, and increased pricing power through market control. Diversion of traffic is, by its nature, a zero sum game—what the merged airlines gain, others lose. Market control may result in less competition and higher prices.

While airline mergers can generate revenue benefits, the cost implications have historically been less favorable. The combination of two airlines offers some opportunity for savings through reduced overhead and increased purchasing power. However, that has usually been more than offset by higher labor costs as management "buys" the cooperation of organized labor needed for a smooth integration. United's proposed acquisition of US Airways in 2000 led United to negotiate an expensive pilot contract that later helped push the airline into bankruptcy.

There is some reason to believe that airline mergers in the current industry environment will fare better, particularly if the acquired company is already in bankruptcy. America West's pending acquisition of US Airways demonstrates one potential model. America West is pursuing the merger in part because:

1. US Airways has already secured extensive labor concessions and lowered its operating costs to levels approaching those of America West;
2. As a bankrupt company, US Airways has the flexibility to rid itself of aircraft and facilities that will not be needed in the combined airline; and
3. America West has managed to attract significant outside equity investment and new loans to bolster its cash liquidity.

The merged company will still face a difficult task in integrating its two labor forces over the next several years, and outside forces such as high fuel costs could still cause a renewed financial crisis. Even so, acquiring a bankrupt, but potentially viable, airline appears to avoid some of the pitfalls that have plagued previous mergers. The recent bankruptcy filings of Delta and Northwest have renewed speculation that they may eventually combine, and it does seem likely that some consolidation among the remaining five legacy carriers will occur over the next several years.

From the perspective of the airline industry's overall financial health, the main potential benefit of airline bankruptcies and mergers is a reduction in overall seat capacity. That would, it is often suggested, improve the balance of supply and demand and allow for increased fares to cover added fuel expense and rebuild balance sheets. One of the most frequent criticisms of the bankruptcy process is that it has (along with federal aid in some cases) permitted struggling airlines to survive, to the detriment of their solvent competitors. There is no doubt that liquidation of a major airline in bankruptcy would have allowed surviving airlines to raise prices. However, whether that revenue gain is sustainable would depend on where the parked aircraft end up, and whether the surviving legacy airlines had lowered their costs enough to remain competitive. If the liquidated airline's planes simply change hands, or if low-cost airlines still have a huge cost

advantage, then the revenue benefits of an airline liquidation would likely erode over time. In other words, consolidation, whether through bankruptcy liquidations or mergers, will help the industry only if it is accompanied by withdrawal of planes from the U.S. market and by competitive cost structures at the survivors.

To conclude, let me summarize my answers to the questions posed at the beginning of my testimony. First, the dire financial condition of most U.S. airlines is due to high fuel costs, intense price competition in the domestic market, and heavy debt and pension burdens. Second, legacy airlines have undertaken significant steps to trim their losses, but these have so far been insufficient to restore profitability. Lastly, bankruptcy restructuring and mergers have the potential to improve the industry's financial health, but only if accompanied by reduced capacity and, most important, by lower operating costs.

Thank you for your attention.

# Appendix

## Standard & Poor's U.S. Airline Debt Ratings

*As of September 28, 2005*

Airlines are arranged from strongest to weakest, by rating category and outlook, except for bankrupt airlines, which are arranged alphabetically. The ratings are shown as follows: Long-term corporate credit rating/Outlook/Short-term corporate credit rating.

| | | |
|---|---|---|
| *Investment Grade:* | | |
| | Southwest Airlines Co. | A/Stable/-- |
| *Speculative Grade:* | | |
| | Alaska Air Group Inc. | BB-/Negative/-- |
| | JetBlue Airways Corp. | BB-/CreditWatch Negative/B-2 |
| | Continental Airlines Inc. | B/Negative/B-3 |
| | AMR Corp. | B-/Stable/B-3 |
| | AirTran Holdings Inc. | B-/Stable/-- |
| | America West Holdings Inc. | B-/CreditWatch Negative/-- |
| | FLYi Inc. | CC/CreditWatch Negative/-- |
| *In Default:* | | |
| | Delta Air Lines Inc. | D/--/-- |
| | Northwest Airlines Corp. | D/--/D |
| | UAL Corp. | D/--/-- |
| | US Airways Group Inc. | D/--/-- |

**Congressman Russ Carnahan**
**House Transportation Committee**
**Aviation Subcommittee**
**Hearing on Current Situation and Future Outlook of U.S. Commercial Airline Industry**
**Opening Statement**
**September 28, 2005**

- Thank you, Mr. Chairman.

- Over the past 5 years, the U.S. commercial airline industry has faced a succession of formidable challenges that have caused severe widespread economic problems in the industry. Since 2001, the U.S. airline industry has lost over $32 billion, furloughed or laid-off over 100,000 workers, and lost over $24 billion in stock value. These trends are expected to persist through 2005. The effects of these problems reverberate through our nation's economy.

- In my home state of Missouri, our communities have been directly affected by the problems plaguing the commercial airline industry. We have seen thousands of workers laid off or relocated and a significant reduction of routes at Lambert International Airport in St. Louis.

- A host of factors including high fuel prices, escalating pension obligations, a decline in business travel and depressed fares caused by fierce competition have contributed to the financial woes of the industry. With so many monumental challenges facing the commercial airline industry, I am glad that we are taking this opportunity to assess its future.

- I look forward to hearing the testimony from the witnesses today and working with my colleagues on this important issue.

- Chairman Mica, Ranking Member Costello, thank you for holding this hearing today.

**OPENING STATEMENT OF**
**THE HONORABLE JERRY F. COSTELLO**
**AVIATION SUBCOMMITTEE**
**CURRENT SITUATION AND FUTURE OUTLOOK**
**OF THE U.S. COMMERCIAL AVIATION INDUSTRY**
**SEPTEMBER 28, 2005**

- I want to thank you, Chairman Mica, for calling today's hearing to examine the *Current Situation and Future Outlook of the U.S. Commercial Aviation Industry*. Since the terrorist attacks in 2001, we have seen airline industry losses of $32 billion, staggering fuel prices, thousands of lost pensions and, in the last two weeks, Northwest and Delta have filed for bankruptcy. I have no doubt thousands more will lose their pensions and health care in this round of bankruptcies. With close to 50% of our domestic aviation capacity in bankruptcy, now is a good time to assess the short and long-term condition of the industry.

- It is difficult to gauge how much of the industry's current condition is attributable to September 11th. Legacy carriers were in trouble before September 11th. The legacy carriers' failed to adjust their business plans to economic trends that began long before September 11th, including business models that depended on extracting a premium fare from business travelers. In fact, the premium fare for business travelers amounted to a significant portion of the revenues to legacy carriers. When the economy started to tighten in 2000, business travelers shifted to low cost carriers. Indeed, low cost carriers are a significant force in the aviation industry, with a combined domestic Origin and Destination (O&D) market share of 30 percent, up from approximately 23 percent in 2000.

- In addition, the aviation industry – and the nation as a whole – is faced with record high fuel costs, which have stymied growth. According to the Air Transport Association (ATA), the industry's jet fuel expenses could increase by $9.2 billion for 2005 alone. The ATA projects industry-wide net losses this year of approximately $9 to 10 billion.

- Some have suggested ways to save the airline industry. ATA has called for repeal of certain taxes and fees – a move that, in my opinion, would wreak havoc on our Aviation Trust Fund and does not take into account the fact that other modes of transportation and consumers are also suffering from high fuel prices. In fact, the amount paid in fuel taxes for 2005 is expected to be $600

million, well short of the $10 billion projected net industry losses. We should not make such policy decisions in a vacuum.

- Some current and former airline CEOs and others have suggested alternative ways to save the industry. Robert Crandall, the former Chairman of American Airlines, wrote an op-ed in the *Wall Street Journal* suggesting that the bankruptcy laws need to be changed. He suggests, "you say, look, if you fail, you liquidate."

- In addition, Crandall and others have suggested that we have too much capacity in the system. Crandall states that "the capacity never comes out. It takes all the guys that haven't gone bankrupt and drives them into bankruptcy." He and others have suggested that in addition to changing the bankruptcy laws, we should remove perceived barriers to consolidation. In fact, ATA agrees that consolidation and capacity reductions are needed.

- Yet, it is still unclear to me that any of these proposals -together or separately - will provide the much-needed "fix" for the ailing airline industry. So, I hope you will address these proposals just mentioned above.

- In addition, I hope you will tell this Subcommittee what the short and long term affects would be if the Congress does not make any significant changes- what happens to the industry short and long term.

- Lastly, in addition to addressing the issues of the suspension of current fees and taxes, current bankruptcy laws and the capacity issue, I hope you will address any other action that in your opinion, the Congress or the industry can take to provide a solution.

- Mr. Chairman, this hearing presents a good opportunity to assess the short and long term condition of the aviation industry and I look forward to the witness' testimony.

Statement of Mark Kiefer
Associate Principal
CRA International
Before the House Aviation Subcommittee of the
Committee on Transportation and Infrastructure

September 28, 2005

## Introduction

Mr. Chairman, members of the Subcommittee, thank you for the opportunity to appear before you today to discuss this very important subject. My name is Mark Kiefer, and I am an aviation industry analyst for CRA International, a global economics and management consulting firm. In my remarks I will speak directly to each of the issues that have brought us all here today. Specifically, I will provide an assessment of the current situation now facing the US commercial airline industry, provide comments on the likely impacts of the recent bankruptcies of Delta Air Lines and Northwest Airlines and the current high fuel prices, and offer my views on the outlook for the future of the industry.

## The Current Situation

It is not an exaggeration to say that the US commercial airline industry is now facing the greatest crisis in its nearly 100 year history. The statistics that describe this crisis are staggering. Since 2000, US airlines have collectively sustained net losses of over $32 billion, a figure that will likely rise to $40 billion by the end of this year. These companies are all publicly traded corporations. The steep declines in their stock prices have wiped out over $24 billion in market value, an impact felt directly by the millions of Americans who are their shareholders. These losses have clearly taken their toll, as five of the ten largest US airlines have filed for bankruptcy protection in the last four years.

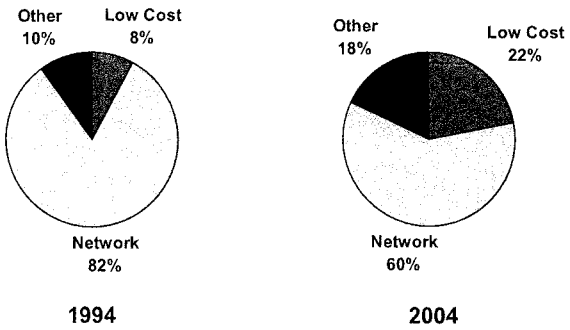
These airlines are also significant employers, both in the cities in which they are headquartered and in the many cities throughout the country that they serve. Well over 100,000 Americans employed in the industry have either been furloughed indefinitely or lost their jobs entirely, and both Delta and Northwest have recently announced that additional job losses are likely. Wages and benefits have been cut substantially, and this trend is likely to continue. Two of the largest US airlines have terminated their pension plans, resulting in the largest pension default in US history. Those airlines that continue to provide these benefits face unfunded pension liabilities of nearly $14 billion.

The effect of this crisis is also being felt in many other sectors of the economy. Aircraft financiers are having to renegotiate less favorable terms as the airlines struggle to make interest and lease payments. Aircraft manufacturers and their suppliers likewise face the prospect of delayed, cancelled, or foregone orders as airlines are unable to afford new equipment. And the Federal Aviation Administration faces a potential funding shortfall due to significantly reduced ticket tax revenues.

This crisis has resulted from a number of factors. Even before the events of September 11, 2001, a softening economy had begun to significantly weaken the demand for air travel. At that same time, business travelers had begun to balk at the high prices being charged for unrestricted tickets, and had begun to seek lower cost alternatives, if not forgo their travel altogether. After September 11, air travel declined markedly, and this decline was disproportionately made up of business travelers. The industry has since been buffeted by the additional challenges of SARS and the war in Iraq, and oil prices have risen dramatically, reaching an all time high in nominal terms in the last month. While air travel has returned to pre-9/11 levels, the number of business travelers willing or able to pay high fares has not.

The increasing availability of online travel services has created unprecedented price transparency, such that business travelers now have far easier access to the lowest fares available. And today low fares are not the exception but the rule. Low Cost Carriers (or LCCs) having grown significantly in recent years, now constituting nearly one fourth of the US market, up from only 8% ten years ago.

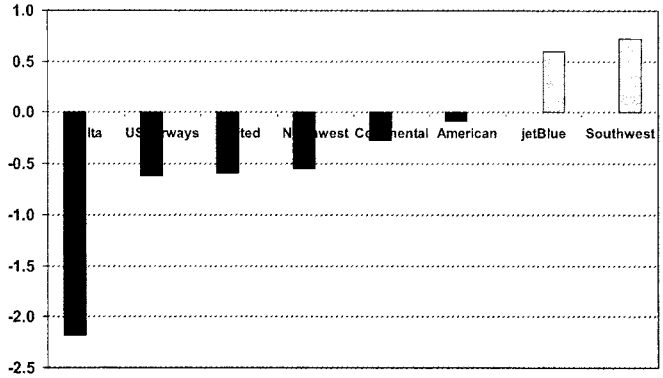
**Airline Market Share by Category**




Source: US DOT Form 41, Schedule T-3.

jetBlue and AirTran have both surpassed $1 billion in annual revenue, such that they are now classified as major carriers by the US Department of Transportation. Southwest Airlines is now the largest domestic airline in the US. Most cities served by the legacy carriers are now served by at least one LCC, and legacy carriers face LCC competition in most city pair markets. This high level of market penetration has allowed the LCCs to dictate price. Because the legacy carriers still have higher operating costs, they can't make money at these low prices.

**Operating Margin for Selected US Airlines (cents/available seat mile)**
**Year Ending 12/31/04**




Source: Airline annual reports.

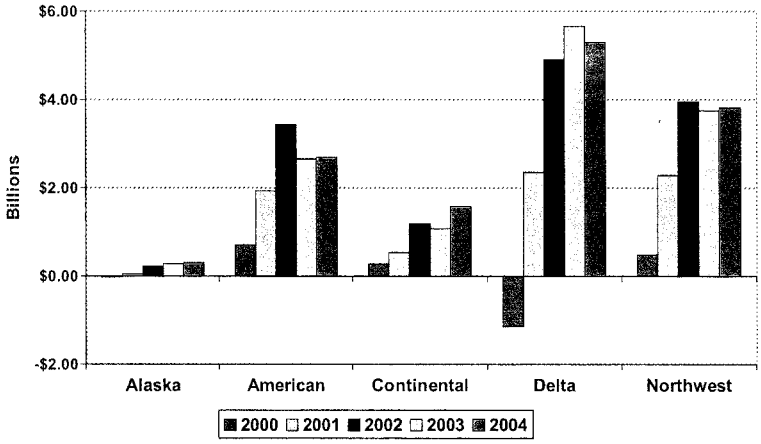
Now, having said all this, the current situation facing the US airline industry is not all bad. Indeed, in stark contrast to the legacy carriers, the financial performance of the LCCs has been remarkable. They are, as a group, consistently profitable and growing. In fact, neither Southwest nor jetBlue has had an unprofitable quarter since September 11, 2001, certainly a significant achievement for the most challenging four years in the history of the industry. And importantly, the success of the LCCs has helped create a low fare environment that has produced tremendous benefits to consumers. The question, then, is why has the financial performance of the legacy carriers differed so greatly from the LCCs?

I would submit to you that the deregulation of the industry that occurred in 1978 has finally "caught up" to the legacy carriers. We call them legacy carriers because they were each founded in the pre-1978 period, when both fares and routes were regulated by the Federal Government through the Civil Aeronautics Board (CAB). The cost structure of these airlines, even today, is to a significant extent a legacy of that regulated era. Under the regulatory system, the airlines were allowed to charge fares that generally reflected their costs, plus a modest profit. Thus they were able to offer lucrative pay and benefits packages, including pension plans and post retirement health insurance, because these costs could ultimately be built into the prices that were charged to consumers. Indeed, this system created an *disincentive* to cut costs, because profits were essentially calculated as a percentage of costs. The combination of this mechanism, and the regulatory limitation on the number of airlines allowed to serve a given route ensured the profitability of the industry.

Since deregulation, fares have on the whole declined, making it more difficult for the legacy carriers to operate profitably while maintaining these expensive benefits. And the events of the last four years have produced an environment in which prices are so low as to make these costs unsustainable for the legacy carriers.

The remaining legacy carrier pension plans are now underfunded by over $14 billion, and as a result of the aging workforce and rapidly increasing healthcare costs, post retirement insurance plans were underfunded by nearly $10 billion by the end of 2004.

**Unfunded Status of Selected Major Airline Pension Funds**
**Year End FY2004**




Source: Airline annual reports.

The LCCs by contrast, can be thought of as essentially "post deregulation carriers." They have, by and large, been founded after the deregulation of the industry in 1978.[1] As such, they have been designed from the ground up to be profitable in an environment of intense route and fare competition. Importantly, the business model of the LCCs is predicated on the primary objective of providing the lowest fares possible. The low cost structure in turn simply reflects that imperative. LCC wages generally remain below those of the legacy carriers, even despite the significant reductions made in the last few years. While all legacy carriers have historically offered pension and post retirement insurance benefits, no LCC has ever offered these benefits. LCCs have instead provided defined contribution and profit sharing plans that have a much lower overall cost to the airline.

LCC costs are also lower for a variety of other reasons. Though LCCs do provide connecting services, their operating model is based primarily on point-to-point services rather than a hub and spoke network. This allows higher asset utilization. Fewer flight crews are required per airplane, and fewer airplanes are required per scheduled departure. LCCs typically operate a single aircraft type, or very few aircraft types, which reduces training and maintenance costs, and allows crews to be more easily and cheaply interchanged. Southwest Airlines

[1] Southwest Airlines was founded in 1971, but provided only service within Texas before deregulation.

does not assign seats, allowing aircraft to be boarded more quickly, which in turn facilitates rapid aircraft turnaround times. The deregulation of route competition has also made it possible for LCCs to serve major metropolitan areas through secondary airports, which often have lower fees and charges than the primary airports most often used by the legacy carriers.

It is these structurally lower operating costs, combined with a greater ability to hedge against the dramatic increase in fuel prices, that have allowed the LCCs to remain profitable despite the otherwise difficult market environment. While the legacy carriers have traditionally made their money by charging very high fares to business travelers, the events of the last four years have fundamentally and perhaps permanently changed the market for air travel in the US. Travel has now exceeded pre 9/11 levels, but it is because fares are now so much lower. In this environment of lower fares, the average traveler is now much more price sensitive. The much flatter pricing structure of the LCCs is ideally suited to this environment, while the traditional pricing model of the legacy carriers has proven very difficult to sustain.

## Impact of the recent bankruptcies

Perhaps the most obvious proof of this has been the recent bankruptcies of Delta Air Lines and Northwest Airlines. I'd like to now turn to the question of what these developments are likely to mean for the industry. First, some context. It is important to note that, notwithstanding the unprecedented financial challenges of the last four years, airline bankruptcies are not unusual in the post-deregulation era. In fact the US airline industry has seen nearly 150 bankruptcy filings in the last 25 years, an average of almost six per year. Though most of these companies were small regional carriers, there have also been a number of major airline bankruptcies, with most occurring during or just after significant downtowns in the industry or the economy, as in the early 1980s, the early 1990s, and of course more recently since 9/11.

The most recent bankruptcies of Delta and Northwest, when taken together with the earlier bankruptcies of United, US Airways, and ATA however, represent an unprecedented level of financial failure in the industry. These carriers together represent nearly half the capacity in the industry.

Delta and Northwest will need to achieve something similar to a low cost carrier cost structure in order to survive. Labor costs will need to be reduced and work rules relaxed in order to increase labor and aircraft productivity. I believe the pension plans of both airlines are likely to be eliminated and replaced with much less costly defined contribution plans, in order to achieve a competitive cost structure for the long term. Consideration of proposed pension reform legislation should therefore have as its objective the preservation of some level of benefits for existing plan participants, rather than the provision of pension benefits for future workers.

Though the financial condition of both Delta and Northwest had been quite serious even before the most recent increases in fuel prices, it was the increased fuel prices that finally pushed them into bankruptcy. The proposed fuel tax holiday would save the industry about $600 million. Though fuel tax relief probably would not have prevented the financial collapse

of these airlines, one lesson that can be learned from these bankruptcies is that the legacy carriers must seek to reduce costs wherever possible in order to survive. Taxes and fees now make up a much larger share of ticket prices than they did just four years ago. In the current low fare environment of very cost conscious travelers, the airlines are unable to pass these taxes and fees on to their customers, leaving less revenue available to contribute to profitability.

Consideration of the proposed fuel tax holiday should be viewed in this context, but at the same time, it's also important that it be viewed within the broader context of FAA funding requirements. Every dollar saved by the airlines from elimination of fuel taxes will be one less dollar available to fund nation's critical Air Traffic Control infrastructure needs. The FAA is already facing a potential funding shortfall, and Congress may eventually be asked to consider alternatives to the current funding mechanism. Reducing the amount of FAA funding derived from general revenues, or increases in the fees or taxes charged to the airlines to make up for any funding shortfall will only worsen the tenuous financial condition of the legacy carriers.

## Outlook for the future

The recent bankruptcies also raise the question of what will happen to those legacy airlines that have managed to avoid bankruptcy so far. American Airlines achieved significant wage and benefit concessions from its unions early on in the crisis. Continental's losses were less severe than other legacy majors in 2004, and a modest profit the prior year helped it avoid a significant cash drain. Continental also does not provide post retirement insurance benefits. If Delta and Northwest's pension plans are terminated during bankruptcy, I think it's likely that American and Continental will eventually have no choice but to do the same. Given American's prior success at achieving labor concessions, and Continental's reputation for good labor relations generally, I'm optimistic that these airlines will be able to achieve the cost reductions necessary to continue to avoid bankruptcy in the near term. They, along with all the other legacy carriers will remain vulnerable to continued high fuel prices, however, as they will have no hedges remaining by the end of the year.

While the cost model of the legacy carriers will need to be transformed to more closely resemble that of the LCCs, the legacy carrier *operating* model is likely to remain. Though the hub and spoke system does not allow the high rates of asset utilization possible with point to point service, it provides many important benefits. Hubs create an economy of density that is in itself inherently efficient, providing the ability to connect far more cities using a given number of flights or aircraft. The number of international gateways is of necessity limited, and those hubs that form such gateways also represent an essential means by which to connect the domestic network with international destinations. Hubs are also essential for connecting smaller communities to the national air transportation network, as many of these communities could not otherwise support air service to many destinations.

If the legacy carriers can achieve sufficient cost reductions, they have several strategic advantages that will help them compete with the LCCs. They provide national networks connecting far more cities with higher frequency service than is possible with a point to point

operation, and they provide international services not presently offered by any LCC. Through alliances and marketing partnerships they offer coordinated connections to a global network with interchangeable frequent flyer benefits.

The US Airways/America West merger will provide an important test case. The two carriers seem to be a good strategic fit. US Airways is an East Coast focused airline while America West is a West coast focused airline. The combination will allow the creation of a larger national network facilitating more transcontinental service, and providing connections from the West Coast to US Airways Caribbean transatlantic and international services. America West essentially reinvented itself as a low cost carrier some time ago, and the challenge will be in producing this same type of transformation within US Airways. The lack of overlap between the two networks, however, will limit the ability of the merged entity to make capacity reductions that will improve systemwide yields.

Notwithstanding their current success, the Low Cost Carriers are themselves quite vulnerable. Were it not for the extensive fuel hedging undertaken by Southwest Airlines this year, they would be losing money at today's oil prices. The high cost of the portion of their fuel not presently hedged is reducing the profits the airline is now enjoying, and the extent of their hedging will decrease significantly over the next few years. And the other LCCs have much less hedging in place, leaving them even more vulnerable to continued high fuel costs. LCC labor costs are likely to increase over time, further putting pressure on their profitability.

But despite all of the challenges now facing this industry, the long term outlook remains very positive. None of the primary forecasters of air travel (Boeing, Airbus, FAA), revised their forecasts downward after 9/11. Air travel demand, both in the US and internationally is projected to grow rapidly. It is forecast to grow most rapidly in the Asia/Pacific region, where both United and Northwest have a significant market presence. New aircraft now in development, specifically the Boeing 787 and the Airbus A350, promise dramatic increases in fuel efficiency. The industry has already made great strides toward restructuring, and the LCC business model has proved robust in a most difficult market environment. While many challenges lie ahead, the industry that is likely to emerge from the current crisis will be more efficient, more productive, and more competitive in the global aviation market, and will remain a vital part of the nation's economy for years to come

Mr. Chairman and members of the subcommittee, I thank you again for allowing me to appear before you today.

**Moody's Investors Service**

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**Good afternoon. I'm Maria Matesanz and I manage the team at Moody's that rates debt issued by US airports. Thank you for inviting me to speak today. It's a pleasure to be here with you, Chairman Mica, and the House Aviation Subcommittee members.**

**Moody's Investors Service is the oldest bond rating agency in the world. We have been rating bonds since 1909. Today, we have more than 1,000 analysts in 19 countries around the world. Our products include our credit rating opinions, which are publicly disseminated via press release and made freely available on our website, as well as research and special reports about debt issuers and their industries that reach more than 2,600 institutions and 16,500 users around the globe. Our ratings and analysis cover approximately 10,000 corporations and financial institutions, more than 20,000 municipal debt issuers, over 12,000 structured finance transactions, and 100 sovereign issuers. Additional information on the company is available on our website: www.moodys.com.**

**In Moody's view, the main and proper role of credit ratings is to help enhance transparency and efficiency in debt capital markets by reducing information asymmetry between borrowers and lenders. We believe that this benefits the market by enhancing investor confidence and allowing borrowers to have broader access to funds.**

**Moody's does this by publishing forward-looking rating opinions publicly, freely and broadly, and by publishing credit research about debt securities and their issuers. Our credit ratings are opinions about the future probability of full and timely repayment of debt obligations, such as bonds, notes and commercial paper. Our opinions are communicated to the market through a symbol system originated almost 100 years ago, which rank-orders relative credit risk on a scale with 9 broad categories ranging from Aaa to C. Most of the broad rating categories are further refined with numerical indicators, from 1 to 3.**

**My comments today will focus on the impact of airline bankruptcies on US airports. Moody's has ratings on 166 debt issues at 114 publicly-owned US airports. The median rating is A2, with ratings ranging from a high of Aa2 to a low of Caa1. Most airport debt is secured by a pledge of general airport revenues, which includes airline charges as well as diverse concession revenues, such as parking, rental car fees and food and beverage concessions. The only two ratings below investment grade (Baa3) are for standalone project financings. This contrasts sharply with the median rating of B3 for airlines. Airlines have had a very unprofitable number of years as a result of extremely low air fares, high labor costs and increasing fuel costs.**

**The combination of low fares and the growth in capacity by both the legacy airlines and the low-cost carriers has resulted in very strong passenger and revenue growth at airports, and a stable outlook for airport sector issuers. In most markets, passenger volume has now exceeded pre-9//11 peak levels and many airports are experiencing flight delays due to capacity constraints.**

**In Moody's opinion, credit quality in the airport sector has stabilized due to the maintenance of solid liquidity levels, growth in non-airline concession revenues, management's control over operating and capital budgets, and the strength of the underlying origin and destination (O&D) service area economies. Moody's analysis focuses on these factors as key explanatory variables for the increasing gap between the median airport and the median airline rating.**

**Air transportation remains an essential service in our economy and Moody's believes that because of the difficulty in building new airports and the long lead time needed for environmental approvals, existing airports will generally be able to pass justifiable operating and capital costs onto airlines and passengers despite financial turmoil in the airline industry.**

**Recent experience indicates that hub airports may remain financially and operationally stable despite the bankruptcy of the dominant airline tenant. Examples include Chicago O'Hare and Denver (United) and Charlotte and Philadelphia (US Airways) and now of course Atlanta (Delta), and Detroit (Northwest).**

**Given the strategic importance of hub facilities for legacy carriers and their large investments in local facilities, certain hubs may even benefit from route restructurings by their dominant carrier. For example, when Delta chose to 'de-emphasize' its Dallas/Fort Worth (rated A1) hub last year, Atlanta Hartsfield-Jackson (rated A1) saw a significant increase in its connecting traffic. Likewise, when American scaled back its hub at Lambert-St. Louis (rated Baa1), Chicago O'Hare (rated A1) saw an increase in connecting traffic. We define a hub as having more than 30% connecting passengers.**

**With four of the six legacy airlines in the US now operating in bankruptcy, our focus is on identifying those airports that may suffer financial stress as a result of cuts in service, reductions in passengers and revenues, as well as those airports that may suffer a rejection of key airline leases.**

**Airlines operating in bankruptcy generally continue to pay airports' rates and charges and in most cases do not radically downsize their operations. These are two important offsetting factors that help buffer the impact of an airline bankruptcy on the ability to generate revenue at an airport. Our analysis will continue to weigh the credit impact of the bankruptcy filing of an airline on the ratings of its hub airports. We will also consider such credit fundamentals as the size and economic health of the origin and destination (O&D) base, the financial strength of the airport and the operating agreements for airlines at each facility.**

**Hub airports served by airlines in bankruptcy often have agreements that allow the airports to charge the airlines fees to recover all operating and debt expenses. These so called 'residual' agreements often include a credit for all non-airline revenues, such as parking and rental car fees and food and beverage concessions, as an offset to airline charges. While some airlines may not wish to pay increased fees, Moody's believes that the opportunity to serve many of the larger local markets and the higher fares in some of these markets would be an incentive for remaining or new carriers to increase service and/or continue to pay the agreed upon rates and charges.**

**While the recent bankruptcy filings of Delta and Northwest are partly the result of certain pressures common to all airlines such as high fuel costs, rising labor costs, low yields, and the aftermath of Hurricane Katrina, the circumstances surrounding each filing differ significantly and the resulting impact on airports may be different as a result. Both airlines will look to regain their long term business viability by seeking to lower their costs in a variety of areas.**

**Some of these, for example labor costs, are neutral to airports. Strategic decisions about route structure and capacity reductions, on the other hand, can have a significant operational and financial impact on airport credit. Airports may also be affected by the legal strategy the airlines adopt regarding their airport leases - airlines may choose to reject comparatively expensive and/or older leases, especially at airports that they are also considering for service cuts. On the other hand, and as we have seen time and again, airlines are likely to affirm other leases at airports that they deem strategically vital to their network.**

**We continue to focus on those airports that in our view lack one or more of the credit strengths that support the divergence in credit quality of airports and airlines. In Moody's opinion the increased risk that the airline restructuring process implies will be borne by those airports with less profitable routes, a high reliance on airline-derived revenues, a service area that is below the median in terms of generating demand for air travel, below-average liquidity levels, and limited ability to cut airport operating costs and/or scale back capital programs.**

**Looking at the risks and challenges ahead for airports, Moody's credit analysis will focus on answering the following questions:**

- **Will increased passenger traffic stimulated by low cost carriers spur airports to expand facilities and increase costs to the airlines?**
- **How will these capacity improvements be funded?**
- **How will the FAA address capacity constraints at congested airports and what will be the impact on airport finances?**

**This concludes my remarks. Thank you again for the invitation to testify today. I would be happy to respond to any questions you might have.**

# What's Wrong with the Airline Industry? Diagnosis and Possible Cures

**Statement of**

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**Hearing before the**
**Subcommittee on Aviation**
**Committee on Transportation and Infrastructure**

**The Problem**

From 2001 to 2004 the U.S. airline industry flew nearly 3 billion passengers. Unfortunately, it lost an average of $13 on each one generating more than $32 billion in losses. With losses continuing this year, it is no understatement to say that the industry has a serious financial problem.

To be sure, the airline industry has always exhibited cyclicality because travelers' demand is sensitive to the performance of the macroeconomy yet airlines must predict this demand accurately because of the lead time required to acquire aircraft. When airlines over predict demand, which can happen for any number of reasons, they suffer losses.

Figure 1 shows the cyclical nature of the U.S. airline industry's operating profit margin for the last 67 years. The huge losses since 2000 have resulted, in our view, because the long-standing challenge of aligning capacity with demand over the business cycle has been exacerbated by the confluence of several events that have significantly reduced the industry's revenues and raised its costs.

**Evidence on the Sources of the Industry's Losses**

An airline's profits depend on its revenue and its costs. Revenue depends on what a carrier is able to charge for its flights and the number of passengers it carries. Costs depend on, among other factors, the price of fuel and the wages and salaries of employees. What has happened to these components of profit during the past several years?

*Number of passengers*

The good news is that, as shown in figure 2, traffic (revenue passenger miles) in 2004 exceeded its previous peak in 2000. Negative traffic growth is a relatively rare occurrence in the airline industry—the last downturn is only the fifth occurrence of a negative year over year traffic growth since record keeping began in 1930. However, what is unprecedented about this drop in traffic is that it took four years for traffic to rebound.

The recent downturn in traffic began in February 2001, one month before the recession that began in March 2001 (and ended in November 2001). The downturn was exacerbated by the aftermath of the September 11, 2001 terrorist attacks. Traffic growth has subsequently returned, but why? One reason is that GDP is growing. Since its trough in 2001:3, real GDP has been growing by more than 3 percent per year. Another reason is more travelers are feeling that flying is safe enough for them to travel by air. Still another important reason is that the airlines responded to the initial drop in traffic by reducing fares to induce people to fly.

*Fares*

As shown in figure 3, fares fell by 25 percent from 2000 to 2004 after adjusting for inflation. This substantial decline in fares has occurred only one other time in the United States, namely after capacity restrictions were eased following the end of World War II.

Because of the dramatic decline in air fares, the rebound in traffic masks underlying changes in passengers' demand for air travel. Our "back-of-the-envelope" calculations indicate that, under reasonable assumptions about the sensitivity of air travel to fare changes, in 2004 prevailing fares generated 17 percent less traffic than those fares would have generated in 2000 (with a plausible range between 6 and 25 percent).

What has caused the change in passengers' underlying willingness to pay for air travel? Plausible reasons are that the airline "product" has changed. Increased security leads to earlier arrival at airports and longer trip times; fuller planes—over 75 percent full on average, the highest since right after World War II—make traveling more unpleasant. And alternatives to air travel, teleconferencing and rail travel—at least in the Northeast Corridor—have become more attractive options.

Consider as an illustration the effect on air travel of required earlier arrival at airports. If passengers must now arrive at their origin airport one-half hour earlier than previously, then, under plausible assumptions of relevant parameters, travel could decline 7 percent (a plausible range is 3 percent to 11 percent).

In addition to these considerations, the traveling public, especially the (formerly) lucrative business travelers, are less willing to pay fares many times higher than their fellow leisure travelers.

*Fuel*

In addition to unanticipated reductions in travel demand, the industry is vulnerable to unanticipated increases in costs. Jet fuel, a necessary input into the production of air transportation, accounts for between 10 and 30 percent of airlines' costs, and its price can fluctuate widely from year to year as shown in figure 4.

Fuel price increases can be a significant drain on airline profits. Relative to the (nominal) price of jet fuel that prevailed in 2000—the last "good" financial year for the airline industry (and one in which the price of fuel was relatively high by previous historical standards)—in 2003 and 2004 the industry lost an estimated $8+ billion dollars due to the higher price of jet fuel. Given higher prices in 2005, especially the post-hurricane Katrina price spike, the industry is estimated to lose an additional $16 billion this year from the increased cost of fuel alone.

*Labor*

Labor represents the biggest single category of airline costs, currently about 28%. "Legacy" airlines, by definition, are those that existed during the period when airlines were regulated (through 1978). In that environment, there was so-called "rent sharing," as unionized workers sought, and received, a share of the "rents" (profits) that the regulated firms earned. Low-cost carriers emerged with the advent of deregulation in 1978 and adopted a more entrepreneurial/cooperative style of labor relations that resulted in lower pay and/or higher worker productivity than legacy carriers were able to achieve with their work force. The expansion of low-cost carriers has put increasing pressure on legacy carriers to lower their labor and other costs. Since 2000 food and beverage costs per revenue passenger mile have fallen by 35 percent and travel agent commissions (per available seat mile) have fallen by 69 percent. But since labor is the largest category of airline costs, it too has been the target of cost cutting (and enhanced productivity) by legacy carriers, through negotiation as well as in bankruptcy, as they seek to reduce their costs to compete with low-cost carriers.

Given the demand and cost shocks, the U.S. airline industry finds itself with more capacity than can be profitably supported at the fares that passengers are willing to pay. And in this environment it is difficult, if not impossible, to sustain fare increases to cover increased costs, such as for fuel, causing several legacy carriers to seek bankruptcy protection.

*Competitive Environment*

As noted, low-cost carriers have put increased pressure on "legacy" airlines to reduce their fares and their costs. This pressure has become intense as low-cost carriers have increased their share of the nation's airline traffic. As shown in figure 5, in 2004 low-cost carriers competed on routes between metropolitan areas that accounted for over 50 percent of the nation's domestic air travel. And one study (Morrison, 2001) found that one low-cost airline—Southwest—lowered fares on routes accounting for more than 90 percent of domestic air travel.

**What Can Be Done to Improve the Industry's Financial Performance?**

It may be surprising to some that the financial problem that the industry is currently encountering is broadly associated with the industry's long-term adjustment to airline deregulation. Airline deregulation was based on the correct belief that enhanced and unfettered market competition and enlightened public policy would benefit the traveling public. But it is now clear that the airline industry has needed and still needs time to adjust to its deregulatory freedoms by ridding itself of remaining cost inefficiencies, doing a better job of matching capacity with demand, and anticipating and responding to changes in traveler preferences.

Both the market and enlightened public policy can enhance industry financial viability. But we believe that policymakers should rely on the market to do the bulk of the work.

The fundamental problem is that there is excess high-cost capacity in the industry. Competition among air carriers will reduce such capacity and no doubt may lead at least one if not more carriers to contract, undergo liquidation, or be absorbed by another carrier. But successful carriers—that is, those that are cost efficient and responsive to passenger preferences—will be poised to pick up any slack. Indeed, travelers will gain if legacy carriers make the required changes to be effective competitors in the new environment or are replaced by lower cost carriers.

We have found in a recent working paper (Morrison and Winston, 2005) that by 2000, low-cost carriers tended to enhance traveler welfare much more than legacy carriers enhanced traveler welfare. Thus, airline competition is working in the sense that those carriers that enhance traveler welfare are rewarded with higher profits. This is an important finding because it indicates that policymakers should not intervene in the competitive process.

However, Congress can help carriers to lower costs and improve traveler welfare, thereby stimulating demand, by reducing wait times at security checkpoints. Current bankruptcy policy gives carriers a chance to remain as competitors—which they can only do in the current environment by lowering costs. Although carriers in bankruptcy do gain a cost advantage from lower capital costs, they also suffer a diminished reputation among travelers and potential investors. Moreover, whatever cost advantage they gain is certainly not enough by itself to close the gap between their costs and the costs of low-cost carriers. Thus, we see little urgency to change current bankruptcy laws. In previous work (Morrison and Winston, 1995), we found that the effect of healthy carriers competing against bankrupt carriers was mixed—for some bankruptcies, competing carriers were helped by competing against a weakened competitor; in other cases healthy carriers were hurt by such competition. On net, the effects did not merit a reevaluation of current policy.

We would like to hope that the airline industry's eventual adjustment to recent revenue and cost shocks would signal the end of its adjustment to airline deregulation. Of course, we cannot be certain. But we can be certain that the industry will only become stronger as it strives to become more efficient while benefiting the flying public.

Figure 1

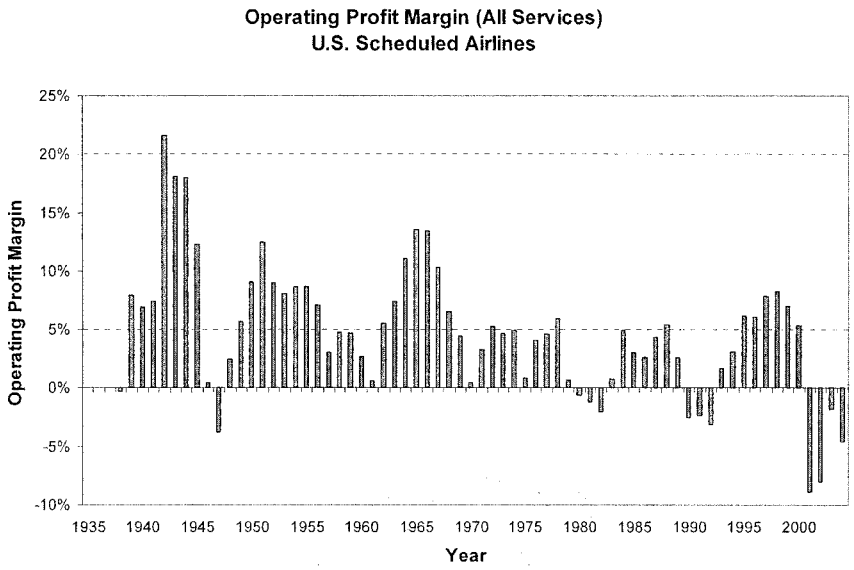



Figure 2

Figure 3

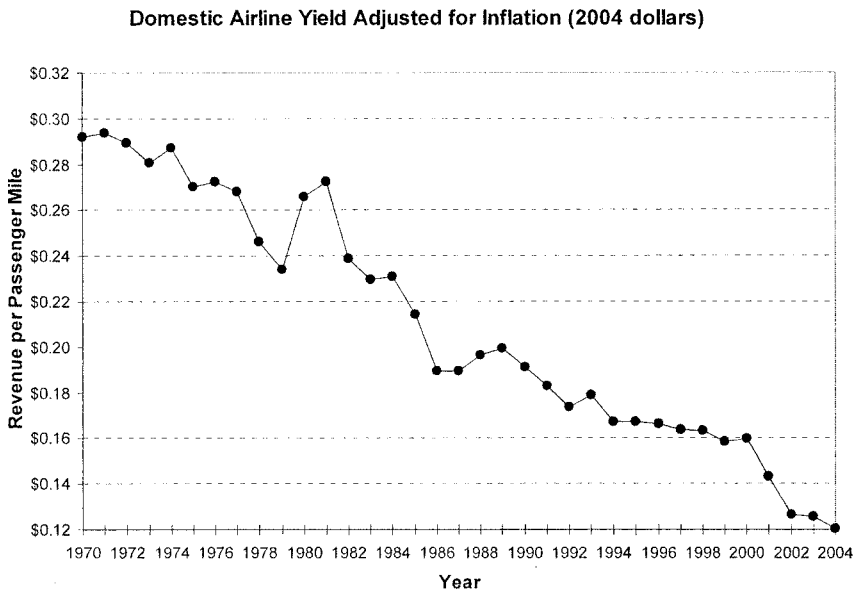



Figure 4

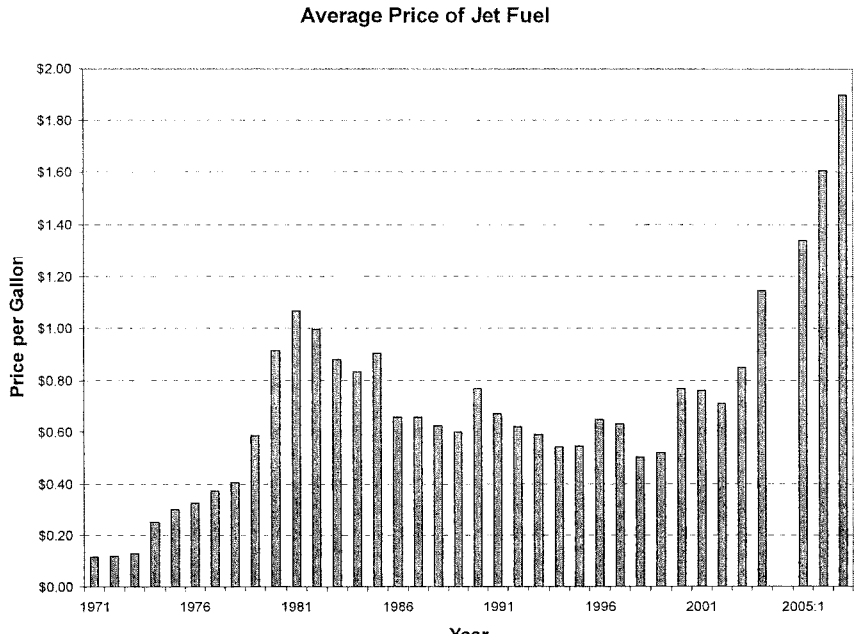
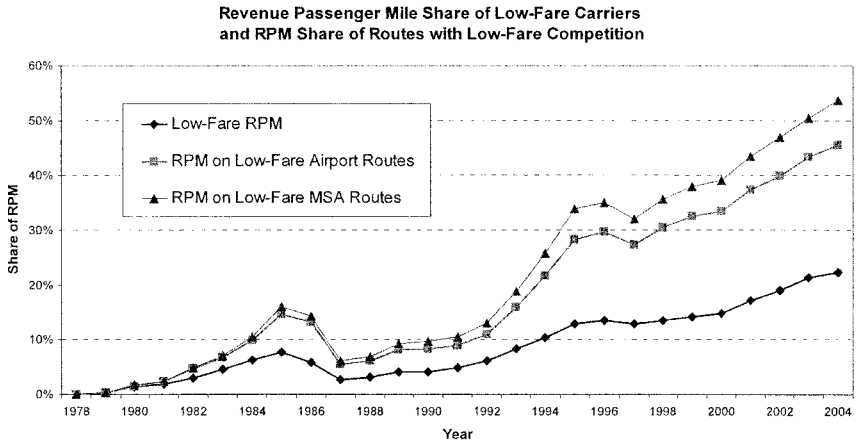


**Figure 5**

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**OPENING STATEMENT OF**
**THE HONORABLE JAMES L. OBERSTAR**
**AVIATION SUBCOMMITTEE**
**HEARING ON THE CURRENT SITUATION AND FUTURE OUTLOOK**
**OF THE U.S. COMMERCIAL AIRLINE INDUSTRY**
**SEPTEMBER 28, 2005**

- I want to thank Chairman Mica and Ranking Member Costello for calling today's hearing on the *Current Situation and Future Outlook of the U.S. Commercial Airline Industry*. It has been a little more than four years since the tragic September 11th terrorist attack – years marked by massive financial losses for most airlines triggered by September 11th, the SARS epidemic, the Iraq war, the unwillingness of many business travelers to pay premium fares, and rising fuel costs. These losses have forced several of our major carriers, including Northwest and Delta, into bankruptcy, costing over 135,000 workers their jobs and thousands more their pensions.

- Although travel is rebounding, the industry has changed dramatically since September 11th. While domestic load factors are running just below 79 percent through the first eight months of 2005, domestic passenger yields are down nearly 1 percent from 2004, to 11.61 cents per passenger mile flown. More telling, yields are down 19 percent from the first eight months of 2000. Combined, the drop in yields and the spike in jet fuel prices have driven the industry's breakeven load factor requirements into the mid-80s. In the aggregate, the major airlines have posted net losses of $32 billion between 2001 and 2004. For 2005, the Air Transport Association (ATA) projects industry-wide net losses of $9 to 10 billion.

- Moreover, since 2000, we have seen the emergence of low cost carriers as a much more significant force in the aviation industry, with a combined domestic Origin and Destination (O&D) market share of 30%, up from approximately 23 percent in 2000. Soaring fuel costs have also stymied growth in the aviation industry – the ATA estimates that every dollar increase in the price of crude oil represents $450 million in additional fuel expenses for the carriers each year. Crude oil prices have increased from $33 a barrel in November 2003 to $63 a barrel today.

- Some of the industry's current condition is also attributable to the failure of the legacy carriers to adjust their business plans to economic trends that began

before September 11th. Since deregulation, the legacy airlines' revenue model has depended on extracting premium fares from a small percentage of passengers. That revenue model began to unravel in the year 2000 when the general tightening of the economy led businesses to discipline their travel policies, and to use low cost carriers more frequently. So, as the legacy airlines have continued to struggle with their cost and fare structures, low cost, low fare carriers such as Southwest and Jet Blue have remained largely profitable and are competing head on with the majors.

- This all leads to the question of what should be done, if anything, to ensure that the U.S. has a robust aviation industry well into the future. I am therefore pleased that we have some of the foremost aviation industry analysts and academics here today to give their views on the current state of the aviation industry and to discuss possible solutions to restore the aviation industry back to financial health. I am particularly interested in hearing any recommendations that the panel may have for legislative action, if any, including the impacts of any such recommendations on competition, fares, and service to small and medium communities.

- Mr. Chairman, I look forward to hearing from our distinguished witnesses.

Statement of Rep. Jon Porter (R-NV)
House Transportation and Infrastructure Committee
Subcommittee on Aviation
September 28, 2005

Mr. Chairman, thank you for holding today's hearing on the issues facing the United States commercial airline industry and how this important sector of our economy will cope with these challenges in the future. I am confident that this hearing will provide us with a more thorough understanding of the industry's current situation, and look forward to the testimony of our guests.

Over the past four years, the U.S. airline industry has lost in excess of $32 billion, with an additional $9 to $10 billion loss projected for 2005. These staggering numbers are the result of many factors. Most pressing among these issues, however, may be the price of fuel.

Oil prices have reached record levels after Hurricane Katrina. The average price of oil has climbed from under $20 dollars from 1992-2001 to about $54 so far this year. This $34 increase represents a massive structural change in airline costs over that period of time.

We must remember that a barrel of crude oil is not the same as a barrel of refined jet fuel. On average so far this year a barrel of jet fuel is over $13 more then a barrel of crude oil.

The increased cost of crude oil and refined jet fuel in conjunction with greater usage are driving fuel costs for airlines to all time highs. The Air Transport Association estimates the airline industry's jet fuel expense could increase by $9.2 billion this year, raising costs of $21.4 billion in 2004 to $30.6 billion in 2005.

While the high cost of fuel directly increases the bottom line costs of the airlines, it also negatively affects travel demand. As consumers must pay more for gasoline, heating oil, and other energy needs, their discretionary income shrinks, limiting their ability to enjoy the leisure activities, like travel.

This is an extremely distressing reality for the district that I represent which serves as a vacation destination for upwards of 40 million people per year. This, however, is a problem not endemic to Southern Nevada alone

As you know, Mr. Chairman, the airline industry drives industry throughout out nation. Ensuring that this community is able to provide these valuable services to all Americans should remain on of the highest priorities of this Congress.

Mr. Chairman, again I thank you for holding this important hearing today. I appreciate our witnesses appearing today and look forward to their testimony. I yield back.

Good Afternoon Members of the Congress & Distinguished Guests,

My name is Stuart Sokel and I am a Director at Deutsche Bank in New York City. Having spent the last 14 years in the oil trading industry, my testimony today will attempt to provide insight into the logistical and economic forces that are currently in place today.

Without a doubt, high energy prices are having a major impact on the nation's economy and it is imperative to understand the core issues which are significantly affecting the US Commercial Airline Industry. I invite questions & comments at any point should further clarity be required.

In brief, the oil market today reflects a composite view of global macroeconomic strength, environmental concerns and demographic changes all of which have contributed to dramatically higher energy prices over the past year. Most Americans are keenly aware of how limited refinery capacity in the United States, a point that has been pronounced due to the damage wrought by the hurricanes in the gulf coast region, has meant higher refined product prices.

This point, however, only gives a partial explanation and needs greater scrutiny. To start, let's remember what has taken place in the world since 1998. At precisely the same time that a number of emerging market countries, including India & Thailand, were rapidly expanding domestic refinery capacity, a financial crisis in Asia coupled with overcapacity from OPEC pushed oil prices to levels that seem like a mere memory today. 10$ oil was just another session away and many respected journals and pundits predicted the end of reliance on oil, middle eastern or otherwise.

In retrospect, this period was a mere blip on the trendline of growth that has taken place in the world today. Today, the major US Airlines are competing for the same barrel of jet fuel that Singapore Airlines, Qantas and British Airways need for their own fleet. Seven years ago, domestic passenger demand in India and China alone was a mere pittance compared to today. In addition, the environmental regulations of a lower sulphur gasoline and diesel fuel in Europe and the United States have only served to take the jet fuel market into further deficit given the continuing difficulty of refiners to adapt to changes in product specification. In short, the situation would appear to be dire and it becomes critical to develop a strategy that serves the industry in the coming years whilst addressing the immediate need to remain solvent.

To start, we have to acknowledge that the lack of investment in refinery and terminal capacity over the past 30 years will not likely suffice for the next 30 years. To be critical of the oil industry, however, neglects a very important point. The logistical hurdles of building a new refinery coupled with the questionable return on investment given historically poor margins did not exactly provide the integrated companies with any major incentives.

This point may be small consolation for the Aviation Industry but it does provide a bit of historical context to the current dilemma. In order to remedy the supply

bottlenecks, the coastal areas of the United States will need investment in the downstream sector and will also need support from the Congress in order to educate an electorate which seems comfortable with the notion of affordable oil as long as the infrastructure is not in their back yard. Storage facilities need to be in close proximity to high volume airports and major markets. Such projects will need to be environmentally and economically sound but without a reasonable commitment from all interested parties, the burden of supplying jet fuel will fall exclusively into the hands of market forces which will lead to a continuation of high prices in years ahead.

Management of energy risk is an area that many carriers have neglected in recent years and unfortunately, the blame may be spread around in no short order. Most of the airlines which did hedge for the current fiscal year have not hedged their exposure for 2006 and beyond. In addition, a large percentage of the hedges were placed in crude oil as opposed to their actual exposure which is jet fuel. In trading jargon, this differential is commonly referred to as basis risk given the potential for jet fuel to outpace the rise in crude oil prices. In effect, that is precisely what has happened this year and the market expectation is that this will continue.

For airlines that did not hedge, or for those which liquidated hedges due to court ordered instruction, the outlook remains very severe given the current forward price of approximately 2.00/gallon for 2006. It is fair to say that Wall Street can be critical of hedging activity which is unprofitable, as exemplified by certain refiner activity. However, the incremental cost of fuel and labor will continue to play the largest role in the future outcome of the industry. Whilst, labor costs cannot be hedged, oil prices certainly can be managed in the same manner in which companies monitor their foreign exchange, interest rate and credit exposure.

There is an adage in financial markets which states that the only thing that can cure high prices is high prices. The airline industry, however, suffers from the burden of having to pay high prices without the flexibility of receiving higher fares. Historically, carriers have been loathe to pass on higher fuel costs in the form of any additional tariff for fear of being undercut by the competition. This has lead to a vicious cycle within the industry, an important matter left for an airline industry expert to discuss as opposed to an oil trader. From my perspective, however, the potential solutions aforementioned are sound and will allow the forces of supply and demand to act to the advantage of the consumer and industry alike.

Thank you.

**House Transportation and Infrastructure Committee**

**Aviation Subcommittee**

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**"Current Situation and Future Outlook of U.S. Commercial Airline Industry"**

**September 28, 2005**

## Statement of Edward P. Faberman, Executive Director

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**Statement of Edward P. Faberman**
**Executive Director**
**Air Carrier Association of America**

**Before the Committee on Transportation and Infrastructure**
**Subcommittee on Aviation**
**United States House of Representatives**

**"Current Situation and Future Outlook of U.S. Commercial Airline Industry"**
**September 28, 2005**

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Mr. Chairman and Members of the Subcommittee, on behalf of the members of the Air Carrier Association of America ("ACAA") and the communities we serve, I submit this statement in support of communities across the country, including those impacted by Hurricanes Katrina and Rita,[1] regarding the future of air service.

The ACAA is dedicated to working with the leadership and members of this Committee to identify actions that can be taken to help carriers maintain and expand service to communities across the country. The Committee's decision to review current and future issues impacting the industry is an important step in that effort.

If the Nation's economy is going to be stimulated and if we are going to see expanded employment opportunities, it is essential that low-fare carriers expand service and travel options. Government studies clearly indicate that as low-fare carriers re-enter markets and start service to new cities, those cities and states receive significant economic benefits. According to the FAA 2005-2006 forecast for the aviation industry, "[t]he

[1] Members of the ACAA have demonstrated their dedication to supporting communities impacted by Katrina and Rita. Spirit Airlines was one of the first carriers to provide airlift to aid victims when, on Friday, September 2, 2005, it brought the first flight to Louis Armstrong International Airport (MSY) in New Orleans. Working closely with government agencies, Spirit has flown thousands of residents to various Texas cities. AirTran Airways initiated humanitarian aid flights on Friday, September 2, 2005, from Hartsfield-Jackson Atlanta International Airport to Gulfport/Biloxi Regional Airport. AirTran delivered more than 40,000 pounds of water, food, clothing, medical supplies and other goods to support the Red Cross and the Salvation Army. AirTran also has operated other support flights including partnering with Peyton and Eli Manning to bring more than 15 tons of relief items into Mississippi. In addition, AirTran operated Air Mobility Command flights from various military bases to MSY. Frontier Airlines operated aircraft to evacuate residents from the impacted region. Frontier also coordinated with Volunteers of America in Denver to seek out individuals and families at the Houston Astrodome who would relocate and bring them back to Denver. Additionally, the carrier donated frequent flyer miles to the American Red Cross. Last week, Frontier Airlines supported TSA's efforts to move screening personnel and other people around the state of Texas to address staffing screening problems created by Hurricane Rita. Frontier was able to position several flights to support TSA's efforts to keep all impacted airports fully operational, secure and passenger friendly by moving screeners to those airports.

benefits to the American consumer brought about by low-cost, low-fare airlines have been substantial and are well documented. ... The expansion of these low-cost, low-fare carriers will help to ensure that competitive forces remain strong in the industry."[2] As Secretary Mineta stated at the FAA Commercial Aviation Forecast Conference in Washington, DC, on March 17, 2004, "[while] demand is still off, demand for low-fare service is strong and growing stronger. ... Consumers are driving these changes – and that, ultimately, is a very healthy development. ... We are forecasting that more passengers will fly [in 2004] than did the previous peak year of 2000."

Unfortunately, the continuing rise in carrier costs, particularly due to jet fuel costs, are making it more difficult for low-fare carriers to bring important full-size jet service to many communities, and in particular to small communities. Fuel costs were already devastatingly high for U.S. carriers before Hurricanes Katrina and Rita impacted oil and gas operations in the Gulf Coast. As oil prices stay at current levels or continue to increase, carriers will have to adjust schedules and will find it difficult to open new markets. Several larger carriers have already announced that they are cutting back service because of rising fuel costs. This phenomenon is a particular problem for small markets that are often most in need of low-fare service to stimulate economic growth. To open new markets, smaller carriers face significant facility, personnel, operational and marketing costs. When fuel and flight costs are added, opening a new market can be an impossible challenge. Therefore, many carriers are foregoing the opportunity to open new markets and are only looking at existing markets.

In addition to rising fuel costs, other industry costs continue to increase:

> Security – In addition to the security fees charged on each ticket, carriers are routinely asked to pay for construction to add new security lanes and equipment at airports, (charges that TSA was supposed to address), additional security staffing, and costs for delayed or canceled flights because of security problems.
>
> Airports – At many airports, carriers have been hit with increased landing fees and facility costs to reimburse airports for their additional expenses, lower passenger numbers, and for security construction costs. These fees will also be utilized to rebuild facilities impacted by Hurricanes Katrina and Rita.
>
> Air Traffic Control System – Due to significant increases in smaller aircraft and general aviation aircraft operating in the system, ATC delays have increased in several parts of the country including southern Florida, Chicago, and New York. Newer carriers, with fewer total flights in these areas, have been hit particularly hard by delays and congestion, which also adds to their costs.
>
> Customs Service – At various airports, the U.S. Customs and Border Protection Agency, DHS, have advised that because of the hurricanes and other events, they

[2] FAA Forecasts for Fiscal Year 2005-2006 (p. III-15 & 16).

will only be able to provide Customs Service if the airport or carrier pays the overtime costs, another new expense item for airlines.

Cancelled Flights – A number of carriers had to cancel and reroute flights because of the recent storms.

To partially address these costs, we hope the Committee will support a limited fuel tax relief proposal. The ACAA supports the recommendations of Jim May of the Air Transport Association and Debby McElroy of the Regional Airline Association that Congress grant a one-year holiday from the 4.3 cents-per-gallon jet fuel tax and that additional efforts be undertaken to expand oil production. While this will help limit new costs, the airlines will still be responsible for the other costs noted above.

While it is important to limit costs, the Committee can also take important steps to help the entire industry expand service options. We believe that this temporary jet fuel relief would provide some benefit to the industry, communities, the traveling public, and the nation's economy. Therefore, we ask that Congress provide relief to the industry as a whole, rather than focusing exclusively on initiatives having only a limited impact on the economic health of the industry, such as pension relief that would only potentially help one or two carriers.

The money conserved during a fuel tax reprieve would help small and low-cost airlines enter and expand service in markets throughout the country. The resulting increase in travelers taking advantage of the lower fares and expanded service will generate increased ticket fees and further promote economic growth.

As costs have increased and as legacy carriers have failed to reduce costs, a number of these carriers have filed for bankruptcy in order to cut costs. Nevertheless, those carriers have not taken steps to reduce operations or operational costs. While these air carriers have taken some steps to reduce personnel, pension and health costs, they continue to hold on to airport gates and facilities regardless of need and operate unlimited numbers of flights in limited markets. They continue to take steps to attack competition without regard to overall costs. Whenever legacy carriers have obtained economic support from Congress, they ignore their expanding operational costs. As a result, their economic condition worsens.

As to the airline bankruptcy process, I note recent comments of Rod Eddington, CEO of British Airways, in a Speech to the Aviation Club of the UK, September 22, 2005:

> But America - land of the free - is turning itself into the land of the free ride. In the last four years, the airlines have soaked up $15 to $20 billion of public subsidy and loan guarantees. They're operating in protected markets, they're hoovering up public funds and still they can't make a profit. They are dumping capacity on the North Atlantic, distorting competition and pricing for cash. They struggle to compete and, at some, the workforce has been demoralized. The more the government has tried to help, the worse things have become.

* * *

> If fifty years of post-war economics has taught us anything, it's this: state subsidies preserve bad habits. We all know the answer: Let the market clear. America would do itself a favor by going back to long lost principles of real and honest competition.

* * *

> Profitable airlines invest in quieter, better, more fuel efficient, more environmentally-friendly planes. Profitable airlines invest in better products, better service, and respond to what the customer wants. Profitable airlines deliver the infrastructure that governments want.

* * *

> Competition keeps companies honest. Competition increases the market size. We big carriers had to sweat to keep up with the low cost carriers. We adapted. We learnt from them. They had lessons to teach those who'd listen. The market has cleared. Things have come to a pretty pass when we have to tell America this.

We also ask that this Committee take steps to open all markets to small low-fare carriers. If we are going to bring two low-fare options to small communities, we must also be able to expand into business markets including in the New York, Chicago and Washington areas.

For smaller carriers to expand and provide alternative travel and service options not available to travelers and businesses in many markets throughout this country, they must be able to have reasonable access to closed markets. As those closed and dominated markets open, low-fare carriers will reach those who have few travel options.

We congratulate the members of this Committee for their leadership on these issues. On behalf of the ACAA, thank you for the opportunity to present our statement on these important issues and we look forward to work with you to expand fare and service options for all Americans.



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