TESTIMONY OF
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Chairman Rockefeller, Ranking Member Hutchinson and Members of the Subcommittee, thank you for the privilege of appearing before you today. My name is Patrick Murphy and I am an aviation consultant with over 36 years of aviation economic experience both inside and outside of government.

I would like to present the results of a study on domestic airline competition that was completed last year by myself and two colleagues, Randy Bennett and Jack Schmidt. We are now updating that analysis. We believe our study entitled, "A Competitive Analysis of An Industry in Transition" is the most comprehensive review of the state of airline competition that has been performed since the tragic events of September 11, 2001.

We have presented the results of our findings in a series of separate meetings with numerous organizations. Among the groups we have briefed are: DOT (twice), DOJ Antitrust Division, DOS, FAA, GAO, ATA, NACA, AAAE, ACI, House Aviation staff and Senate Aviation staff.

All three of us who prepared the study are former long-term government aviation officials. We therefore prepared our study using data and analytical techniques that we used while in the federal government. We believe our results are objective, and the various government agencies we have briefed seemed to agree.

Our fundamental finding is that the U.S. domestic airline industry is today more competitive than at any time since 1995, the start of our study period, and almost certainly more competitive than at any time in history. The key to this increased competition is the emergence and evolution since airline deregulation 30 years ago of two distinct business models – network carriers (also known as the six legacy airlines) and low-cost carriers (LCC's such as AirTran, Frontier, Jetblue, Southwest and Spirit). Each of these two business models plays a vital role in serving the public. Both business models are key to providing a comprehensive and affordable air transport system, and neither business model alone could serve the nation's needs.

Today's unprecedented level of competitiveness is the consequence of a sharp change in industry economics that can be traced to 2000. Between 1993 and early 2000 the airlines earned record profits. However in late 2000, almost a full year before 9/11, industry fortunes changed radically the airlines suffered the largest drop in profits ever recorded. This loss was largely attributable to the network airlines, whose costs were escalating rapidly while at the same moment their unit revenues were plummeting. This dramatic swing coincided with the dot.com collapse, new fare transparency for consumers because of the internet, accelerating growth of the LCC's, a new-found customer resistance to high fares, and new more costly labor agreements.

This unprecedented change in the industry's fortunes started a six year string of record losses for the network carriers that stretched from the beginning of 2001 to 2006, and totaled over $30 billion in red ink. At the same time, the newer and faster growing LCC's were profitable every single year. This was in stark contrast to the six year period ended in 2000, when most LCCs struggled for survival while the network airlines recorded record profits.

The LCC's have grown in size, in market share, and in numbers. They have entered into both longer distance and lower density markets. Since 2000 the LCC's grew 73%. At the same time the network carriers and their regional partners cut domestic capacity 13%. This is a remarkable development. The legacy airlines shrunk, not only in relative terms, but in absolute terms. They have continued to reduce domestic capacity and are expected to further reduce capacity in 2008. By 2006 LCC's accounted for 30% of all passengers. Perhaps most importantly, LCC's compete in markets that account for ¾ of all U.S. passengers. This is an absolutely key development. This means U.S. travelers benefit by head-to-head LCC price competition on ¾ of their journeys, whether they fly on an LCC or not.

When looked at by city-pairs, which is the matrix most frequently used as the "relevant market" in antitrust reviews, the number of competitors in city-pair markets has grown since 1995, and this healthy trend accelerated in 2000.

Meanwhile the network carriers that ten years ago dictated the terms of domestic competition have faced a sharp decline in revenues due mainly to greatly diminished demand for higher fares. Until 2000 the network carriers were able to "segment" traffic into higher end "fare buckets" that resulted in much of their revenue coming from higher paying passengers. That market segmentation strategy has collapsed. Competition from low cost carriers that stress low fares and consumer resistance to paying high fares means that the network airlines have permanently lost a $12 billion annual revenue stream. Market segmentation has even been substantially reduced in markets where LCC's do not compete. The loss of market segmentation alone could account for the legacy carriers' enormous losses through 2006.

Inflation adjusted fares in 2006 were 20% lower than in either 1995 or 2000. Even without adjusting for inflation, fares dropped from 1995 and from 2000. For example, non-adjusted fares in 2006 were just about 10% lower than 2000. Also, the practice of charging higher fares for local passengers at hub city airports has largely been eliminated. The dominant carriers at most large connecting hub cities no longer can charge "fare premiums". There are still a very small number of hubs with significantly higher fares for local passengers, but that practice has almost been eliminated by ever expanding competition.

On the cost side, we were surprised to learn that even after the massive cost cuts made by labor and management, including a series of painful bankruptcies, network carriers still have significantly higher costs than LCC's. The cost gap between network and low cost carriers remains about where it was in 1999 at between 40% and 50%. We have found no evidence of the "cost convergence" theory that many had anticipated whereby network and LCC carriers would evolve toward each other's cost levels.

In response to this unrelenting lower cost competition, network carriers have devised new strategies. They have focused on their core strength – their large connecting networks. They bundle traffic from all sizes of markets, both domestic and international, onto connecting flights at their hubs. LCC's, on the other hand, continue to expand but they stress large and medium sized domestic markets over smaller markets.

The legacy carriers have pressed their network advantage largely in the international market. They have shifted away from intense head-to-head domestic battles for market share with LCC's. They have found the international sector to be more profitable. New foreign services not only build profitable international traffic but they also build domestic traffic that connects through hubs onto international flights. Since 2000, the domestic portion of international flights has grown 20% for the network carriers, or $2.4 billion per year in added domestic revenues.

Just as the network carriers face little LCC competition on international routes, they also face little or no LCC competition on flights to small, non-hub cities. This explains the network carriers' continued focus on serving smaller markets with their regional partners. Network airlines serve more than 300 of the nation's 334 non-hub airports. LCC's are almost non-existent at these communities as they serve only 38. Consequently, smaller cities rely almost exclusively on the network carriers. Network carriers now derive over 11% of their revenues from their small markets, and this share is growing. It is fair to state that the network airlines and small communities have become codependent on each other.

CONCLUSION:

The network carriers returned to very modest profitability in 2007. However, they are again losing money and their long-term prospects remain uncertain as they continue to lose domestic market share; and as foreign competitors grow in size and strength. To some extent the network carriers are stuck in a competitive vise between intense domestic pressure and emerging international pressure. For now the network carriers are finding the international sector friendly, but that could change.

Meanwhile the LCC's that have enjoyed significant growth and profit opportunities at home are scaling back their aggressive growth, but are still gaining market share. The LCC's are now the dominant force in the domestic industry, and they are the drivers of both growth and price. For them the key to success is to prudently manage their growth and not expand beyond their managerial capability.

As for the American public, fares and service levels are at very competitive levels, although fuel costs are now reversing the long-term decline in fare levels.

Mr. Chairman, this concludes my statement. I would be honored to answer any questions that you or Members of the Subcommittee may have.