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Financial Condition of the Chinese and U.S. Airline Industries

Presentation by
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It is an honor to be here in Beijing today to talk about China's developing aviation system and to address the financial condition of the U.S. airline industry. I want to thank Minister Yang for hosting this conference. Also, I would like to thank Bonnie Allin, the AAAE Chairperson, and Jim Bennett, IAAE Chairman, and President/CEO of the Metropolitan Washington Airport Authority for their efforts to organize this conference. And finally, thank you to Thelma Askey and the U.S. Trade and Development Agency for its role in sponsoring this symposium.

A primary responsibility of the Inspector General's Office is to exercise oversight of the Department of Transportation, including the FAA, and to report to the U.S. Congress and Transportation Secretary Mineta on how effectively and efficiently programs are working and other emerging issues. As part of our oversight, we periodically issue a report on trends on demand and capacity, aviation system performance, airline finances, and service to small communities. The last report we issued was in January of this year and we expect to issue our next update in early June. The report is available on our website at www.oig.dot.gov or you may contact my office to get a paper copy mailed to you.

***Please note that Mr. Mead's speech will summarize this presentation.**

Many changes have occurred in the U.S. airline industry since it deregulated 25 years ago. Deregulation gave the airlines almost unlimited freedom to choose where they wanted to operate and what fares to charge. Deregulation allowed new carriers to enter the market and encouraged competition in domestic markets. This competition lowered airfares and made flying affordable to the general public. In 1978, the year of deregulation, total passenger enplanements totaled 257 million; in 2003, that figure was 618.4 million. The number of markets with air service grew significantly, as did the level of service in those markets. This produced huge benefits to the U.S. economy.

Safety, however, is still the subject of intense Government oversight and the Department of Transportation does not allow carriers to begin or continue operations unless it determines that the carrier meets the highest safety standards.

Following deregulation, the airline industry expanded rapidly, which resulted in new demands on the national aviation system. These challenges were not entirely unanticipated -- and many proved temporary in nature. In hindsight, they proved to be a small price to pay for the tremendous benefits to consumers and the U.S. economy.

In meeting the challenges associated with airline deregulation, I would like to make three basic points: First, some U.S. carriers are still struggling to adjust their business plans to compete in a deregulated marketplace. Second, new low-fare carriers are growing, and in some cases providing better service at lower cost to the public. Third and finally, growth in air travel in the post-deregulation environment resulted in significant demand on airports, air traffic control, and passengers – China has many options available for addressing congestion – but one of the lessons we learned is that it is too late to wait until congestion and delays occur to start implementing those solutions.

I. Pre-deregulation carriers still adjusting business models

For the six largest U.S. legacy airlines – those that inherited the "legacy" of pre-deregulation high cost structures -- the financial crisis is not over. The carriers have made some progress in lowering labor costs and increasing worker productivity, but probably not enough. Ticket revenues are still below those of 2000, although ticket sales are increasing. Operating margins are improving but most carriers are still not reporting profits.

Net losses in 2003 totaled $4.8 billion US – about $2.5 billion better than the $7.4 billion loss in 2002, but none of the legacy carriers are expected to report profits this year. These carriers face a number of financial challenges. Labor costs are still too high, fuel prices are soaring, worker retirement funds need large cash infusions, and high levels of debt will require significant cash.

When the economy declined in late 2000, the airlines were hurt most by the loss of high-fare business passengers. In 2000 when the economy was at its peak, the airlines could count on between 40 and 50% of their revenues coming from 20% of its passengers. Those were the business travelers paying premium fares for unrestricted airline tickets.

In late 2000, business travelers either stopped traveling, switched to low-fare carriers, or started traveling on much cheaper restricted tickets. Very few airlines believe that the high-fare business market will return to what it was, even when the economy improves. The legacy carriers are restructuring their costs to survive without these high business fares.

The legacy carriers are also restructuring their pricing schemes to draw back the business passengers. While business passengers may not be willing to pay the high fares they once paid, they are likely to be willing to pay *some* level of premium in exchange for greater schedule flexibility and special amenities.

The carriers have taken steps to restructure their costs and remain competitive, including eliminating excess system capacity. Compared to May 2000, scheduled seat availability in May 2004 is down nearly 10%, although it has improved over May 2003 when scheduled seat availability was down 15%.

Many large airplanes are now parked in the Arizona desert while the carriers move to smaller aircraft in their own fleet or regional aircraft operated by their lower cost regional airline partners. Since March 2000, regional jet departures have increased by 159%.

The Internet has also helped carriers reduce their distribution costs by eliminating travel agency fees and internal reservation agent positions. In 2003 about 31% of all domestic airline tickets were sold over the Internet in the United States, with some carriers posting online sales as high as 75%.

While the airlines have saved money because of the Internet, consumers have become more efficient at finding lower-cost flights. Increased price awareness by both business and leisure travelers will continue to compel the airlines to price competitively.

II. Growth in Low-fare Carriers has Made Flying Even More Affordable.

Since deregulation, new low-fare carriers have entered the market and existing low-fare carriers have expanded. In some cases, the low-fare carriers offer newer aircraft, better in-flight services – like satellite radio and leather seats – and better on-time performance than the legacy carriers.

Low-fare carriers have significantly lower cost structures and can afford to charge low fares and still carry passengers profitably.

Since 2000, low-fare carriers have taken advantage of the legacy carriers' financial distress to move into markets traditionally dominated by the legacy carriers. Low-fare airlines together now control about 25% of domestic air capacity – up from 15% four years ago – and all fly in the highest-demand markets. About 70% of domestic fliers have access to at least one low-fare carrier.

As low-fare carriers grow and enter new markets, the fares offered by all airlines in those markets will drop, benefiting the communities that receive service. The legacy carriers, facing competition from low-fare carriers, are attempting to restructure their operations to better survive now that they have lost the ability to charge higher fares.

United Airlines and Delta Airlines have created "Ted" and "Song" as lower cost divisions to operate in many of the markets where they compete with low-fare carriers. The legacy carriers are also hoping that their large networks, their frequent flyer programs, and access to International destinations will provide them some competitive advantages over the low-fare carriers.

That remains to be seen. The low-fare carriers continue to expand their networks, develop frequent flier programs of their own, and consider the possibility of serving foreign markets.

III. Significant industry growth followed deregulation, placing new demands on the Aviation System.

In the summer of 2000, as the US economy was soaring, air traffic reached an all-time high. Airspace, runways, and airport terminals reached their saturation point and congestion and delays surged -- nearly 1 in 3 flights delayed, delays averaged 57 minutes.

When the economy faltered in 2000, demand and traffic were down, taking some of the pressure off the system. But we are now seeing demand beginning to return and with it, delays at some of our nation's busiest airports. Systemwide, in January and February of this year, nearly one in five flights was delayed -- a 33% increase over last year – and the average delay was more than 45 minutes.

By increasing service frequency with smaller regional aircraft, the airlines are carrying fewer passengers but, over time, this can result in more operations. And, as demand increases, the number of operations will further multiply and this, in turn, will increase demand for airport gates and runways.

In the area of Air Traffic Control, airports, and Infrastructure, there are several lessons we can learn from the congestion crisis in the U.S. in 2000. Most important is the need to take steps now to prevent a recurrence of those conditions. Transportation Secretary Mineta and FAA Administrator are taking both short and long term actions.

In the short term, we are using new technology, Air Traffic Control procedures, daily communication with the airlines and air traffic control, and encouraging the airlines to schedule flights responsibly. New runways have been constructed at some airports and others are under consideration at key airports like Chicago O'Hare.

Also, Secretary Mineta recently announced the Next Generation Aviation Initiative that will examine ways to potentially triple the capacity of the US aviation system by 2025. While new runway construction will ultimately play a major role in improving capacity, the Initiative could result in technologies that form the platform for a new and more efficient global system.

Although not all of the challenges we have in the U.S. apply to the same degree or in the same manner in China – like labor and land acquisition – there *are* similarities. And discussions of these areas – like those occurring at this aviation symposium and the Air Service Agreement negotiations -- will benefit both China and the U.S.

So, looking forward to China's future, I'd like to offer a few thoughts. As China moves forward to modernize its own air traffic control system, it could take advantage of the billions of dollars that have already been invested in aviation technology research and development over the past few decades. By doing so, China can save time and money it might otherwise spend on research and development.

Delays are not yet a big problem in China, but traffic into Beijing is expected to almost double in time for the Olympics in 2008 and the present system must be prepared to accommodate this increased demand for air service. I commend the

Civil Aviation Administration of China (CAAC) for working with the FAA to identify ways of coping with anticipated future demand. Some of these options include introduction of air traffic control procedures, the use of existing air traffic control technology, runway configuration planning, and construction.

Also, I understand that China is planning to produce a new regional jet – the ARJ-21, which it hopes to have in service in just a few years. The foundation of the airplane certification process is to ensure a high level of safety, and the process for meeting the basic safety standards is demanding. All efforts should be made in the near term to recruit and fully staff qualified personnel to oversee the process.

And finally, on the economic and marketplace level, it's been a difficult few years for the airline industry worldwide – but the U.S. and Asia have been hit harder than others. In the third quarter of 2003, mainly due to SARS, Transpacific traffic by U.S. carriers was down 8% over 2002 levels. But it looks like we're back in a positive growth cycle. Scheduled departures this June are up 11% from last June, and scheduled seats are up nearly 17%.

As China's trade and tourism industries grow, a great demand for air-passenger and air-cargo is likely to develop both domestically and abroad. I understand that we are currently in the process of negotiating expanded opportunities for air services under the U.S.-China Air Services Agreement to accommodate the demand that is expected to develop on both sides of the Pacific for access to each other's markets. A liberalized approach to opening markets for international air services would result in large benefits to China's economy and its citizens.

These benefits will be achieved as we work together cooperatively and energetically to build upon a mutually beneficial partnership. Federal Aviation Administrator Blakey was here in February to attest to this relationship and to assure our country's commitment to this partnership and to assisting China in its program of aviation and economic growth. It's been an honor and a privilege to be present with you here today.

Thank you.