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AIRLINE COMPETITION

Barriers to Entry Continue in Some Domestic Markets

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Mr. Chairman and Members of the Subcommittee:

We appreciate the opportunity to testify on the air service problems that some communities have experienced since the deregulation of the industry in 1978. Airline deregulation has led to lower fares and better service for most air travelers largely because of increased competition spurred by the entry of new airlines into the industry and established airlines into new markets. As we reported in 1996 and 1997, however, some airports have not experienced such entry and thus have experienced higher fares and/or less convenient service since deregulation.[1] Our testimony today summarizes the findings from our prior work on these fare and service trends, factors contributing to the problems, and the initiatives by the Department of Transportation (DOT) and others to address these problems. In summary:

- Not all communities have benefited from airline deregulation. Certain airports—particularly those serving small and medium-sized communities in the East and upper Midwest—have experienced higher fares and/or poorer service since deregulation. There are several reasons for the substantial regional differences in fare and service trends, including the dominance of routes to and from these airports by one or two traditional hub-and-spoke airlines[2] and operating barriers, such as long-term exclusive-use gate leases at hub airports. In contrast, the more widespread entry of new airlines at airports in the West and Southwest since deregulation—and the resulting geographic differences in fare and service trends—has stemmed largely from the greater economic growth in those regions as well as from the absence of dominant market positions of incumbent airlines and barriers to entry.
- Operating barriers—slot controls, restrictive gate leases, and perimeter rules[3]—continue to block entry at key airports and contribute to fare and service problems in the East and upper Midwest. To minimize congestion and reduce flight delays, the Federal Aviation Administration has set limits since 1969 on the number of takeoffs or landings—referred to as "slots"—that can occur during certain periods of the day at four congested

[1]Airline Deregulation: Changes in Airfares, Service, and Safety at Small, Medium-Sized, and Large Communities (GAO/RCED-96-79, Apr. 19, 1996), Airline Deregulation: Barriers to Entry Continue to Limit Competition in Several Key Domestic Markets (GAO/RCED-97-4, Oct. 18, 1996), Airline Deregulation: Addressing the Air Service Problems of Some Communities (GAO/T-RCED-97-187, June 25, 1997), and Domestic Aviation: Barriers to Entry Continue to Limit Benefits of Airline Deregulation (GAO/T-RCED-97-120, May 13, 1997). Related GAO products are listed at the end of this statement.

[2]These airlines include the nation's seven largest: American Airlines, Continental Airlines, Delta Air Lines, Northwest Airlines, TWA, United Airlines, and US Airways.

[3]Rules that prohibit flights to and from airports that exceed a certain distance.

airports—Chicago O'Hare, Ronald Reagan Washington National, and New York's Kennedy and LaGuardia. A few airlines control most of the slots at these airports, which limits new entrants. In 1996 we reported that the vast majority of gates at six airports in the East and upper Midwest were exclusively leased to usually one airline, making it very difficult to gain competitive access to these airports. In addition, perimeter rules at LaGuardia and National airports limit the ability of airlines based in the West to compete at those airports. These operating barriers, combined with certain marketing strategies by established carriers, have deterred new entrant airlines while fortifying established carriers' dominance at key hubs in the East and upper Midwest.

- Increasing competition and improving air service at airports serving communities that have not benefited from deregulation will likely entail a range of federal, regional, local, and private-sector initiatives. DOT is undertaking several efforts to enhance competition, such as granting slots to new entrants at 2 airports and formalizing a policy that will identify anticompetitive behavior and factors DOT will consider if it pursues formal enforcement actions to correct such behavior. In addition, recently proposed legislation would address several barriers to competition: slot controls, the perimeter rule, and predatory behavior by air carriers. Recent national and regional conferences exemplify efforts to pool available resources to focus on improving the airfares and quality of air service to such communities. Other steps—such as improving the availability of gates—may also be needed to further ameliorate current competitive problems.

Benefits of Deregulation Have Been Uneven

Our April 1996 report found that since deregulation, as expected, fares had fallen and service had improved for most large-community airports. However, without the cross-subsidy that was present when the industry was regulated, experts also expected fares to increase somewhat at airports serving small and medium-sized communities and expected service to decline. We found, in fact, that since deregulation, substantial regional differences have existed in fare and service trends, particularly among small and medium-sized community airports. A primary reason for these differences has been the greater degree of economic growth that has occurred over the past two decades in the West and Southwest and in larger communities nationwide. In particular, we noted that most low-fare airlines that began interstate air service after deregulation, such as Southwest Airlines[4] and Reno Air, had decided to enter airports serving communities of all sizes in the West and Southwest because of these

[4]Before deregulation, Southwest provided intrastate air service within Texas.

communities' robust economic growth. By contrast, low-fare airlines had generally avoided serving small- and medium-sized-community airports in the East and upper Midwest, in part because of the slower growth, harsher weather, and greater airport congestion in these regions.

Our review of the trends in fares between 1979 and 1994 for a sample of 112 small-, medium-sized, and large-community airports identified 15 airports where fares, adjusted for inflation, had declined by over 20 percent and 8 airports where fares had increased by over 20 percent.[5] Each of the 15 airports where fares declined was located in the West or Southwest, and low-fare airlines accounted for at least 10 percent of the passenger boardings at all but one of those airports in 1994.[6] On the other hand, each of the eight airports where fares had increased by over 20 percent since deregulation was located in the Southeast and the Appalachian region.

Our April 1996 report also discussed similar trends in service quantity and quality since deregulation. Large communities, in general, and communities of all sizes in the West and Southwest had experienced a substantial increase in the number of departures and available seats as well as improvements in such service quality indicators as the number of available nonstop destinations and the amount of jet service. Over time, however, smaller- and medium-sized communities in the East and upper Midwest had generally experienced a decline in the quantity and quality of air service. In particular, these communities had experienced a sharp decrease in the number of available nonstop destinations and in the amount of jet service relative to turboprop service. This decrease occurred largely because established airlines had reduced jet service from these airports and deployed turboprops to link the communities to those airlines' major hubs.

[5]Our sample of 112 airports included 49 airports serving small communities, 38 serving medium-sized communities, and 25 serving large communities. In 1994, these airports accounted for about two-thirds of all domestic airline departures and passenger enplanements in the United States. We defined small communities as those with a metropolitan statistical area population of 300,000 or less, medium-sized communities as those with a metropolitan statistical area population of 300,001 to 600,000, and large communities as those with a metropolitan statistical area population of 1.5 million or more.

[6]Of the 15 airports, 5 serve small communities, 5 serve medium-sized communities, and 5 serve large communities.

Airline Barriers to Entry Persist and Predominantly Affect Competition in the East and Upper Midwest

We reported in October 1996 that operating barriers at key hub airports in the upper Midwest and the East, combined with certain marketing strategies of the established carriers, had two effects on competition. The operating barriers and marketing strategies deterred new entrant airlines and fortified established carriers' dominance of those hub airports and routes linking those hubs with nearby small- and medium-sized-community airports. In the upper Midwest, there is limited competition in part because two airlines control nearly 90 percent of the takeoff and landing slots at O'Hare, and one airline controls the vast majority of gates at the airports in Minneapolis and Detroit under long-term, exclusive-use leases. Similarly, in the East, one airline controls the vast majority of gates under exclusive-use leases at Cincinnati, Charlotte, and Pittsburgh and a few established airlines control most of the slots at National, LaGuardia, and Kennedy. Perimeter rules at LaGuardia and National further limit the ability of airlines based in the West to compete in those markets.

Particularly for these key markets in the upper Midwest and East, the relative significance of these barriers in limiting competition and contributing to higher airfares has grown over time. As a result, our October 1996 report recommended that DOT take action to lower the operating barriers and highlighted areas for potential congressional action. Our 1996 report also discussed the effects of some marketing strategies of incumbent airlines on competition.

Slots

To reduce congestion, the Federal Aviation Administration (FAA) has limited since 1969 the number of takeoffs and landings that can occur at O'Hare, National, LaGuardia, and Kennedy. By allowing new airlines to form and established airlines to enter new markets, deregulation increased the demand for access to these airports. Such increased demand complicated FAA's efforts to allocate takeoff and landing slots equitably among the airlines. To minimize the government's role in the allocation of slots, in 1985 DOT began to allow airlines to buy and sell them to one another. Under this "Buy/Sell Rule," DOT "grandfathered" slots to the holders of record as of December 16, 1985. Emphasizing that it still owned the slots, however, DOT reserved the right to withdraw slots from the incumbents at any time. In addition, to mitigate the anticompetitive effects of grandfathering, DOT retained about 5 percent of the slots at O'Hare, National, and LaGuardia and in 1986 distributed them in a random lottery to airlines having few or no slots at those airports.

Even with the lottery, we found that the level of control over slots by a few established airlines had increased over time. By contrast, the share held by the airlines that started after deregulation has remained low. (See app. I.) To address this problem, in October 1996, we recommended that DOT redistribute some of the grandfathered slots to increase competition, taking into account the investments made by those airlines at each of the slot-controlled airports. We were envisioning that a small percentage of slots would be redistributed. In response to our report, DOT has begun to use the authority that the Congress gave it in 1994 to allow additional slots for entry at O'Hare, LaGuardia, and Kennedy.[7] In October 1997, DOT awarded Reno Air and Trans States Airlines exemptions from slot limitations at O'Hare, while Frontier Airlines, ValuJet Airlines,[8] and AirTran Airways were granted exemptions at LaGuardia. These exemptions should help to enhance service in the East and upper Midwest. For example, Trans States Airlines received 8 exemptions to provide service between O'Hare and its choice of Asheville, North Carolina; Chattanooga, Tennessee; Roanoke, Virginia; and Tri-Cities, Tennessee/Virginia.[9]

Long-Term, Exclusive-Use Gate Leases

Our reports have also identified restrictive gate leases as a barrier to establishing new or expanded service at some airports. These leases permit an airline to hold exclusive rights to use most of an airport's gates over a long period of time, commonly 20 years. Such leases prevent nonincumbents from securing necessary airport facilities on equal terms with incumbent airlines. To gain access to an airport where most gates are exclusively leased, a nonincumbent must sublet gates from the incumbent airlines—often at nonpreferred times and at a higher cost than the incumbent pays.

While some airports, such as Los Angeles International, have attempted to regain more control of their facilities by signing less restrictive, shorter-term leases once the exclusive-use leases expired, our October 1996 report identified several airports where entry was still limited because of long-term, exclusive-use gate leases with one airline.

[7]The FAA Authorization Act of 1994 (P.L. 103-305, section 206) created an exemption provision to allow additional slots at O'Hare, LaGuardia, and Kennedy when DOT "finds it to be in the public interest and the circumstances to be exceptional." The number of flights at National Airport is further limited by federal law to address local concerns about noise. As a result of these additional limits, the Congress chose not to extend DOT's exemption authority to include National.

[8]ValuJet is now AirTran Airlines.

[9]Each exemption is one arrival or departure.

We identified six airports in particular where this occurred: Charlotte; Cincinnati; Detroit; Minneapolis; Newark, New Jersey; and Pittsburgh. The vast majority of gates at each airport are exclusively leased, usually to one established airline. (See app. II.) As a result, it is extremely difficult to gain competitive access to these airports, according to executives at many airlines that started after deregulation.

Although the development, maintenance, and expansion of airport facilities is essentially a local responsibility, most airports are operated under federal restrictions that are tied to the receipt of federal grant money from FAA. To address the gate lease problem, we recommended that when disbursing airport improvement grant moneys, FAA give priority to those airports that do not lease the vast majority of their gates to one airline under long-term, exclusive-use terms. DOT did not concur with this recommendation. According to DOT, because the number of airports that we identified as presenting gate access problems is sufficiently small, the agency would prefer to address those problems on a case-by-case basis. DOT emphasized that in cases where incumbent airlines are alleged to have used their contractual arrangements with local airport authorities to block new entry, the agency will investigate to determine whether the behavior constitutes an unfair or deceptive practice or an unfair method of competition. If so, the agency noted that it will take appropriate action.

Perimeter Rules

At LaGuardia and National airports, perimeter rules prohibit incoming and outgoing flights that exceed 1,500 and 1,250 miles, respectively. The perimeter rules were designed to promote Kennedy and Dulles airports as the long-haul airports for the New York and Washington metropolitan areas. However, the rules limit the ability of airlines based in the West to compete because those airlines are not allowed to serve LaGuardia and National airports from the markets where they are strongest. By contrast, because of their proximity to LaGuardia and National, each of the seven largest established carriers is able to serve those airports from its principal hub.

While the limit at LaGuardia was established by the Port Authority of New York & New Jersey, National's perimeter rule is federal law.[10] Thus, in our October 1996 report, we suggested that the Congress consider granting DOT the authority to allow exemptions to the perimeter rule at National when proposed service will substantially increase competition. We did not recommend that the rule be abolished because removing it could have

[10]The Metropolitan Washington Airports Act of 1986 (49 U.S.C. Sec. 49109).

unintended negative consequences, such as reducing the amount of service to smaller communities in the Northeast and Southeast. This could happen if major slot holders at National were to shift their service from smaller communities to take advantage of more profitable, longer-haul routes. As a result, we concluded that a more prudent course to increasing competition at National would be to examine proposed new services on a case-by-case basis.

Marketing Strategies

Our October 1996 report also emphasized that certain marketing strategies of incumbent airlines, taken together, had created strong loyalty among passengers and travel agents, making it difficult for nonincumbents to enter markets dominated by an established airline. Two strategies in particular—booking incentives to travel agents and frequent flier plans—have encouraged business flyers, who represent the most profitable segment of the industry, to use the dominant carrier in each market. Because about 90 percent of business travel is booked through travel agencies, airlines strive to influence the agencies' booking patterns by offering special bonus commissions as a reward for booking a targeted proportion of passengers on their airline. Similarly, frequent flier programs have become an increasingly effective tool to encourage customers' loyalty to a particular airline. As such, entry by new and established airlines alike into a market dominated by one carrier is very difficult. This is particularly true given that to attract new customers a potential entrant must announce its schedule and fares well in advance of beginning service, thus giving the incumbent an opportunity to adjust its marketing strategies. Such adjustments by the incumbent may include matching low fares offered by new entrant airlines and selling far more seats at these low fares than are being offered by the new entrants. In many cases, we found that airlines chose not to enter or to quickly exit markets where they did not believe they could overcome the combined effect of these marketing strategies.

In October 1996, we reported that the effect of these and other marketing strategies tends to be the greatest—and fares the highest—in markets where the dominant carrier's position is protected by operating barriers. However, we also noted that the marketing strategies produced consumer benefits, such as free frequent flier trips, and concluded that short of an outright ban, few policy options existed that would mitigate the marketing strategies' negative impact on new entry.

Range of Initiatives Will Likely Be Needed to Address Air Service Problems

Because a variety of factors has contributed to higher fares and poorer service that some small and medium-sized communities in the East and upper Midwest have experienced since deregulation, a coordinated effort involving federal, regional, local, and private-sector initiatives may be needed. Recent efforts by DOT and proposed legislation are aimed at enhancing competition. Additional public and private activities are currently under way to address regional and local air service problems. If successful, these initiatives would complement, and potentially encourage, the increasing use of small jets by the commuter affiliates of established airlines—a trend that has the potential for increasing competition and improving the quality of service for some communities.

DOT Has Begun Efforts to Increase Competition

In response to our October 1996 report, DOT stated in January 1997 that it shared our concerns that barriers to entry limit competition in the airline industry. As we mentioned earlier in this testimony, in October 1997, DOT granted slots to two new entrants at O'Hare and three new entrants at LaGuardia. At the same time, DOT set forth its new policy on slot exemptions, which has been expanded to take into account the need for increased competition at the slot-controlled airports. DOT is currently considering other slot exemptions but acknowledged that there are only a limited number of exemption opportunities. Because some in government and academia believe that slots at some airports may be underutilized, DOT is also evaluating how effectively slots are being used at these airports.

In addition, DOT has expressed concern about potentially overaggressive attempts by some established carriers to thwart new entry. According to DOT, over the past 2 years, there has been an increasing number of alleged anticompetitive practices—such as predatory conduct—aimed at new competition, particularly at major network hubs. DOT is formulating a new policy to clearly delineate what is acceptable and unacceptable behavior in the area of competition between major carriers at their hubs and smaller, low-cost competitors. The policy will indicate those factors that DOT will consider if it pursues formal enforcement actions to correct unacceptable behavior.

Proposed Legislation Would Address Competition Issues

Over the past several months, a number of bills have been proposed to promote aviation competition and address some of the problems we identified.[11] The proposals include creating a mechanism by which DOT

[11] For example, see H.R. 2748 (sponsored by Representative J. Duncan), H.R. 3160 (sponsored by Representative C. Schumer), H.R. 3179 (sponsored by Representative T. Manton), S. 1331 (sponsored by Senator J. McCain), and S. 1353 (sponsored by Senator B. Frist).

would increase access to the slot-controlled airports by periodically withdrawing a small portion of the slots that were grandfathered to incumbent airlines and reallocating them among new entrant and limited incumbent air carriers. The proposals also include requiring DOT to grant exemptions to the perimeter rule at National under certain circumstances, limiting the time that DOT has to respond to complaints of predatory behavior, and providing loan guarantees for commuter air carriers to purchase regional jet aircraft for use in underserved markets.

Regional, State, and Local Initiatives Undertaken to Improve Service

Recognizing that federal actions alone would not remedy their regions' air service problems, several airport directors and community chamber of commerce officials in the Southeast and Appalachian regions have begun a coordinated effort to improve air service in their region. As a result of this effort, several Members of Congress from these regions in turn organized a bipartisan caucus named "Special Places of Kindred Economic Situation" (SPOKES). Among other things, SPOKES is designed to ensure sustained consumer education and coordinate federal, state, local, and private efforts to address the air service problems of communities adversely affected since deregulation. Two SPOKES-led initiatives include establishing a Website on the Internet and convening periodic "national air service roundtables" to bring together federal, state, and local officials and airline, airport, and business representatives to explore potential solutions to air service problems.

The first roundtable was held in Chattanooga in February 1997. The roundtable concluded that greater regional, state, and local efforts were needed to promote economic growth and attract established and new airlines alike to serve small and medium-sized markets in the East and upper Midwest. Suggested initiatives included (1) creating regional trade associations composed of state and local officials, airport directors, and business executives; (2) offering local financial incentives to nonincumbent airlines, such as guaranteeing a specified amount of revenue or providing promotional support; and (3) targeting aggressive marketing efforts by communities toward airlines to spur economic growth. A second roundtable was held in Jackson, Mississippi, in January 1998.

A regional conference, held in West Virginia in December 1997, brought together federal and state officials, airport representatives, and local businesses to discuss ways to restore quality air service to small communities in the state. In West Virginia, for example, Wheeling, Elkins, and Martinsburg have lost all scheduled air service since deregulation. Throughout the state, communities have experienced declines in the number of nonstop flights, the number of seats available, and the number of jet flights. Regional concerns about air service have extended to other states and conferences were recently held in Iowa and Arizona.

Private-Sector Initiatives Are Addressing Air Service

To grow and prosper, businesses need convenient, affordable air service. As a result, businesses located in the affected communities have increasingly attempted to address their communities' air service problems. Perhaps the most visible of these efforts was the formation of the Business Travel Contractors Corporation (BTCC) by 45 corporations, including Chrysler Motors, Procter & Gamble, and Black & Decker. These corporations formed BTCC because they were concerned about the high fares they were paying in markets dominated by one established airline. BTCC held national conferences in Washington, D.C., in April and October 1997 to examine this problem and explore potential market-based initiatives. At the October conference, attendees endorsed the concepts of (1) holding periodic slot lotteries to provide new entrant airlines with access to slot-controlled airports, (2) allowing new entrants and other small airlines to serve points beyond National's perimeter rule, and (3) requiring DOT to issue a policy addressing anticompetitive practices and specifying the time frames within which all complaints will be acted upon. While BTCC suspended operations in January 1998, its lobbying arm—the Business Travel Coalition—plans to continue efforts to increase competition.

Airlines' Use of Regional Jets Is Improving Service

In addition to public and private-sector initiatives, the increasing use of 50- to 70-seat regional jets is improving the quality of air service for a growing number of communities. Responding to consumers' preference to fly jets rather than turboprops for greater comfort, convenience, and a perceived higher level of safety, commuter affiliates of established airlines are increasingly using regional jets to (1) replace turboprops on routes between established airlines' hubs and small and medium-sized communities and (2) initiate nonstop service on routes that are either uneconomical or too great a distance for commuter carriers to serve with slower, higher-cost, and shorter-range turboprops.

Because regional jets can generally fly several hundred miles farther than turboprops, commuter carriers will be able to link more cities to established airlines' hubs. To the extent that this occurs, it could increase competition in many small and medium-sized communities by providing consumers with more service options.

Mr. Chairman, this concludes our prepared statement. We would be glad to respond to any questions that you or any Members of the Subcommittee may have.

Percentage of Domestic Air Carrier Slots Held by Selected Groups

Airport	Holding entity	1986	1991	1996
O'Hare	American and United	66	83	87
	Other established airlines	28	13	9
	Financial institutions	0	3	2
	Post-deregulation airlines	6	1	1
Kennedy	Shawmut Bank, American, and Delta	43	60	75
	Other established airlines	49	18	13
	Other financial institutions	0	19	6
	Post-deregulation airlines	9	3	7
LaGuardia	American, Delta, and US Airways	27	43	64
	Other established airlines	58	39	14
	Financial institutions	0	7	20
	Post-deregulation airlines	15	12	2
National	American, Delta, and US Airways	25	43	59
	Other established airlines	58	42	20
	Financial institutions	0	7	19
	Post-deregulation airlines	17	8	3

Notes: Numbers may not add to 100 percent because of rounding. Some airlines that held slots have gone bankrupt, and as a result, financial institutions have acquired slots.

Source: GAO's analysis of data from the Federal Aviation Administration.

Airports Where Post-Deregulation Airlines Reported Difficulty Gaining Competitive Access to Gates, and the Leasing Arrangements at Those Airports, 1996

Airport	Total number of jet gates	Gates under exclusive-use leases	Major lease holders and dates of lease expiration
Charlotte	48	43 (90%)	34 gates leased to USAir until 2007
Cincinnati	67	67 (100%)	50 gates leased to Delta with 9 leases expiring in 2015 and 41 expiring in 2023
Detroit	86	76 (88%)	64 gates leased to Northwest until the end of 2008, with all but 10 under exclusive-use terms
Minneapolis	65	65 (100%)	49 gates leased to Northwest with 16 leases having expired as of 1996 and on month-to-month basis, and remainder expiring at various times ranging from the end of 1997 to 2015
Newark	94	79 (84%)	43 gates leased to Continental until 2013, 36 gates leased to the other established airlines until 2018, and 15 gates reserved primarily for international use
Pittsburgh	75	66 (88%)	50 gates leased to USAir until 2018

Source: GAO's presentation of the airports' data, from Airline Deregulation: Barriers to Entry Continue to Limit Competition in Several Key Domestic Markets (GAO/RCED-97-4, Oct. 18, 1996).

Related GAO Products

Domestic Aviation: Barriers Continue to Limit Competition (GAO/T-RCED-98-32, Oct. 28, 1997).

Airline Deregulation: Addressing the Air Service Problems of Some Communities (GAO/T-RCED-97-187, June 25, 1997).

Domestic Aviation: Barriers to Entry Continue to Limit Benefits of Airline Deregulation (GAO/T-RCED-97-120, May 13, 1997).

Airline Deregulation: Barriers to Entry Continue to Limit Competition in Several Key Domestic Markets (GAO/RCED-97-4, Oct. 18, 1996).

Changes in Airfares, Service, and Safety Since Airline Deregulation (GAO/T-RCED-96-126, Apr. 25, 1996).

Airline Deregulation: Changes in Airfares, Service, and Safety at Small, Medium-Sized, and Large Communities (GAO/RCED-96-79, Apr. 19, 1996).

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Computer Reservation Systems: Action Needed to Better Monitor the CRS Industry and Eliminate CRS Biases (GAO/RCED-92-130, Mar. 20, 1992).

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