PANEL REPORTS

MAJOR DOMESTIC AIRLINES

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MAJOR TRENDS AFFECTING THE FUTURE STRUCTURE OF THE DOMESTIC AIRLINE INDUSTRY

Transformation to Significantly Fewer Carriers

The U.S. airline industry will undergo significant transformation during the next ten years. Panel members agreed there will be a transformation from an industry of about nine major carriers (excluding all-cargo airlines), about fifteen national carriers, and about 150 regional carriers to an industry of four or five very large major carriers, about 50 large-regional/small-national carriers, and a few very small niche carriers. The surviving majors will have enormous financial reserves to fund continued growth and vast marketing resources to attract passengers and cargo. Most of the survivors will have extensive domestic and international route networks. However, one of the surviving major airlines could well be a very large niche carrier providing high-frequency, low-fare, domestic service primarily over a linear network of short-haul routes. All of the surviving large-regional/small-nationals will be closely affiliated with one of the large majors.

Two related forces will drive the transformation process. First, domestic enplanements have been flat for several years, but the carriers who will survive the transformation process have expanded their domestic market shares. The survivors are growing in a stagnant market by enticing passengers to switch from weaker carriers who lack the requisite marketing resources to those that offer appealing services in a competitive environment. The survivors' superior marketing programs are expected to strengthen passenger preferences resulting in a continuing shift of market share to the detriment of the marginal airlines.

Domestic airlines have added hundreds of new aircraft to their fleets in the past few years. While many have been replacements for aging aircraft that have been retired, some have been to enlarge their fleets. Because domestic enplanements have been flat during this period, the result has been excess capacity that has been a major contributor to the industry's dismal financial performance. Traffic is weak, fares cannot be raised because of excess capacity, and mounting losses are a drain on every airline's financial reserves. The carriers who survive the industry's transformation will have the financial resources to withstand the industry's latest downturn. However, weaker carriers, with limited financial reserves, will be forced out of business due to the industry's inability to implement a profitable fare structure in an environment of excess capacity.

The Transformation Process

The first step in the transformation of the industry will be the demise of one or more major carriers currently operating under the protection of Chapter 11 of the Federal Bankruptcy Code. Based on the prevailing forecasts of lackluster recovery in the U.S. economy, most panel members agreed at least one major airline will stop operating or be consolidated with another large carrier within the next twelve months. However, the panel members also agreed that the industry's transformation will be affected by several factors that could prolong the process as much as ten years.

Upturn of Passenger Demand

A rise in passenger demand is one factor which might prolong the transformation process. Some marginal airlines, whose eventual demise appears inevitable, might receive a temporary boost in traffic resulting from the failure of weaker competitors. The resultant increase in traffic might be enough to sustain some marginal carriers for a brief period. Likewise, the inevitable recovery in the business cycle will provide a much-needed traffic stimulant, thereby prolonging the existence of some marginal carriers.

Although the industry's transformation might take as long as ten years to accomplish, the demise of individual carriers probably will occur much faster than the prolonged failures of Eastern and Braniff, and Pan Am's extended liquidation. Specifically, at least one of the majors operating under the protection of Federal bankruptcy law is not expected to survive and probably will cease operating or be acquired in the very near future. In addition, as other majors seek protection from creditors under the bankruptcy code, creditor committees are expected to become more aggressive in seeking quicker settlements of claims.

Availability of Foreign Capital

An inflow of capital from foreign sources is a second factor which could aid ailing carriers and prolong the transformation of the industry. At least one panel member noted there is a great deal of foreign capital which could flow to U.S. airlines if the DOT ownership limits are liberalized. However, other panel members expressed doubts about the amount of foreign capital that might be invested in marginal U.S. carriers. Panel members noted foreign investors might be reluctant to invest due to uncertainties about both economic and operational prospects.

From an economic perspective, poor historical returns on airline equities could discourage many prospective foreign investors. Furthermore, large foreign carriers who have participated in strategic alliances generally have been disappointed by the results of the alliances, and the alliances have not had much impact on the industry. Therefore, foreign carriers might be very reluctant to commit financial resources to partnerships with marginal U.S. airlines.

From an operational perspective, marginal carriers lack sufficient resources to appeal to a large foreign flag carriers considering a U.S. investment. A large foreign-flag carrier with sufficient financial resources to prop up an ailing U.S. carrier probably could not find a single U.S. carrier with a route network that would provide the desired level of feed traffic at all of the foreign flag carrier's U.S. gateways. For example, a foreign flag carrier with bilateral rights to serve many U.S. gateways (e.g., Atlanta, Chicago, Detroit, New York, Orlando, and Washington) would have to purchase several U.S. airlines to realize the desired level of feeder operations at each. It appears unlikely a foreign carrier would be willing to commit the financial resources needed to keep a marginal carrier afloat.

Airline fares

A third factor prolonging the demise of weaker carriers will be the return of price rationality. Most panel members agreed airline fares will, in the long run, become more rational. Future fares will more closely reflect the cost of providing service, including a reasonable return on investment. Panel members also noted price rationality will return because of the declining presence and influence of irrational cash-flow discounters.

Although panel members expect to see more rational pricing of airline services, they do not expect airline fares to become excessively high. Panel members noted six constraints on future price increases. First, air travel demand is relatively elastic and excessively high fares would result in declining revenues. Indeed, panel members agreed fare rationality will be a significant contributor to the continuation of stagnant growth in domestic passenger enplanements. Second, the increasing economic clout of large corporate travel departments will prevent business air fares from becoming too high. Third, the increasing presence of low-fare survivors will exert significant competition in several key markets. Fourth, near-term overcapacity will encourage airlines to engage in discount pricing to fill surplus airline seats. Fifth, the surviving major carriers will have extensive domestic route networks linking nearly every major city pair either with direct or connecting service. Consequently, the surviving carriers will compete with each other in nearly every city pair, and the battle for market share will preclude unreasonably high fares. Sixth, surviving carriers might be reluctant to raise prices for fear of raising the ire of Congress.

Prospects for New Entrants

With the anticipated transformation of the industry, niche markets will exist for new entrants. However, the majority of market niches probably will be too small and fragmented to support a carrier of any size. The panel members agreed that one large niche market does exist, but it is unlikely any carrier will be able to exploit it.

There appears to be substantial demand for low-fare service in the high-density, short-haul markets of the northeastern United States. The experience of People

Express demonstrated that additional travel in many northeastern air service markets could be stimulated with the introduction of high-frequency, low-fare service. However, it will be difficult for any carrier to provide such service because the region's high infrastructure costs and congestion are not conducive to the development of low-cost, high-frequency service.

Higher operating costs, including the cost of acquiring slots and gates, in the major northeastern metropolitan areas create higher costs per enplanement, and higher costs per enplanement are especially onerous for low-cost, low-fare carriers. Moreover, airport and airway congestion and the resultant delays prevent quick turnarounds and decrease aircraft utilization. Based on the higher cost of operation and the prospect of significantly higher ground times, it seems unlikely there will be a carrier that can exploit fully the low-fare, high-frequency niche in the northeastern region. Similarly, a low-fare carrier might not be able to establish a significant market presence at the new Denver airport, or any new airport, because of the relatively high facility charges and resultant higher cost per enplanement.

Congestion and Delay
The transformation of the industry probably will not reduce congestion and delays at many of the nation's largest airports. Panel members agreed that economies of scale and marketing leverage will entice the surviving carriers to expand their hub-and-spoke networks by funnelling more flights through existing hub airports. Competing airlines will attempt to increase market share and to stimulate demand by increasing frequency between their hubs and the outlying spokes. Consequently, congestion and delays at the existing hub airports of the surviving carriers will not decrease.

Aircraft size
The surviving carriers probably will not increase substantially the size of the average aircraft in their fleets. The panel members put forth four arguments why the size of the average airplane in the surviving carriers' fleets will not increase significantly. First, the fleets of the surviving carriers are relatively new, and there will be no economic incentive for the carriers to modernize their fleets. Second, the surviving carriers will be competing with each other by offering increased frequency through their hubs, and to attract profitable loads with higher frequency the airlines will continue to operate moderate-sized airplanes. Third, passenger demand to fill very large aircraft exists in relatively few city-pair markets and then only at certain times of the day (e.g., Chicago to San Francisco at 5:00 p.m.). Airplanes with the capacity to accommodate peak demand tend to be underutilized at other times. Therefore, airlines add flight sections rather than substitute larger aircraft.

The industry's transformation also will affect aircraft manufacturers. The demise of marginal carriers will result in a glut of used aircraft, some of which, the surviving carriers could add to their fleets. Consequently, with these alternative used aircraft available and the likely oligopolistic tendencies of the remaining carriers, manufacturers could experience a decline in their order books.

Government Actions
Panel members expected governments to become involved in a number of new issues. For example, local governments will become more involved in air transportation issues, such as hearings on the award of international route authority. At the State and Federal levels, governments will become more involved in the mediation of disputes between airport users and neighbors. The Federal Government will be asked to assume a greater role in landside development to reduce airport congestion.

RESULTS OF THE TRANSFORMATION OF THE DOMESTIC AIRLINE INDUSTRY

Impact on Airports

Airport operations will be disrupted at the airport hubs of marginal carriers, who will not survive. At some airports that are now airline hubs, the failure of the hubbing carrier will result in a drastic reduction in service as the airport reverts from a hub role to that of a spoke on the survivors' route networks. It appears that the airports most vulnerable to the severe service curtailments are those that are now hubs of marginal carriers with hub status based on their geographic location (e.g., a good location for connecting traffic flowing from the northeastern states to Florida).

Hub airports of marginal carriers with relatively large origin and destination traffic bases might not lose their hub status after the marginal carrier fails. A surviving carrier could open a replacement hub operation at a large O&D airport after the demise of the marginal carrier. In addition, a few entirely new hub operations (e.g. Orlando) might be opened by one or more of the surviving carriers. Nevertheless, it appears that the transformation of the industry will result in a net reduction in the number of airline hubs.

The number of new-entrant niche carriers and their long-term prospects in the transformed industry will depend largely on the new entrants' ability to gain high-volume, low-cost access to secondary airports near large metropolitan areas. In addition, the introduction of high-frequency, low-fare service in the northeastern United States will also depend on prospective carriers' abilities to obtain sufficient landing slots at underutilized secondary airports. Physical expansion of existing hub airports will probably have little impact on increasing competition because the surviving carriers will be adding frequency as rapidly as the existing hub airports can be expanded.

Although the panel foresaw no change in the recent pattern of flat growth in domestic enplanements, they agreed that enormous pressure will be placed on government to continue to expand the domestic infrastructure. Congestion and delay will decrease at the hub airports of failed carriers but will worsen at the hub airports of the surviving carriers. Moreover, there is likely to be pressure to improve and expand the facilities at secondary airports to provide opportunities for new-entrant niche carriers. Therefore, there will becontinuing need to obtain funding for major capacity enhancements. However, the proposed passenger facility charges, which are expected to provide a significant new source of funding for airport development, could be a problem for carriers who provide short-haul, low-fare service. The PFC represents a much larger percentage of the ticket price for low-fare carriers, and in some markets the PFC can be enough to make the price of air service uncompetitive with other transportation modes.

Impact on Labor

The transformation of the airline industry will result in significantly greater economic and political clout for organized labor. For example, the Strike Replacement Bill could enhance the economic leverage of labor. With little threat of nonunion, new-entrant competition, the surviving carriers are less likely to adopt hard-line bargaining positions with their unions. Moreover, with fewer carriers providing the Nation's airlift capabilities, a work stoppage at any one of the survivors would cripple a very significant share of the nation's air transportation network. This could lead the Federal Government to invoke the provisions of the Railway Labor Act or possibly to enact new legislation specifically tailored to the airline industry.

REGIONAL AIRLINES

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REGIONAL AVIATION PANEL

INTRODUCTION

The regional aviation panel was comprised of a wide range of industry experts that included domestic regional airlines, representatives from aircraft and equipment manufacturers, and consultants specializing in regional aviation. The panel spent time primarily on issues that will affect the regional aviation segment of air transportation over the coming decade and beyond. Issues of concern in the short term were only addressed with regard to their long-term effect on the industry.