DISCUSSION PANEL REPORTS

In advance of the workshop, FAA circulated a questionnaire to all invited participants. The questionnaire listed the preliminary assumed values and growth rates for each sector of civil aviation to be incorporated in the forthcoming FAA aviation forecast scheduled for release in March 1996. The TRB workshop panels were asked to review these figures during their deliberations and to offer alternatives and a statement of reasons for each recommended change. The consensus views of each of the eight TRB panels are presented in Attachment A. More extended discussions of the reasons for suggested changes in FAA forecasts are included in several of the individual workshop reports

DOMESTIC AIRLINES

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"Air travelers are always discovers. There are no signposts in the air to show a man has passed that way before," wrote Anne Morrow Lindbergh in 1935. Indeed, six decades after this passage was written, ambiguity pervades the domestic airlines market and concerns about the industry's future abound.

The primary sources of domestic aviation's turbulent character are easily identified: uncertain government policy, aggressive expansion by new entrants, cyclical price cutting, and the changing preferences of business travelers. At present, the industry is coping effectively, and the short-term outlook for profits is favorable. However, vexing issues suggest a more cautious long-range outlook. This is demonstrated by the unfavorable ratings given by the financial community to many airline bonds.

Rethinking the Future

The panel — consisting of airline representatives, consultants, academics, and government officials —

reconsidered long-standing trends affecting domestic aviation. These deliberations occurred at an opportune moment in the post-deregulation era. After several years of devastating losses, major carriers are reporting robust profits. For the first time in several years, several weaker carriers are operating in the black, and new entrants are announcing far-flung expansion plans. This upbeat mood contrasted sharply with that of the TRB workshop two years ago, which found substantial reason for pessimism about the industry's short-term fiscal viability.

The panel believed that the recent surge in profits reflects the success of the industry's lengthy efforts to the eliminate unprofitable hubs, cut costs, and refrain from aggressive nationwide price wars. In addition, the panel concluded that these efforts will allow major carriers and low-cost startups to coexist profitably in many markets for the first time. The inroads against Southwest Airlines being made by the United Airlines Shuttle on the West Coast exemplifies this point.

The profits of the past two years occurred despite unfavorable government policy. The public sympathy toward aviation problems that followed the Commission to Insure a Safe and Competitive Airline Industry's report two years ago has largely vanished.

The panel expected the following:

- Continued increases in fuel taxes, despite earlier calls for tax abatement;
- Sharply diminished funding for airport infrastructure, especially new airports and runway capacity (A backlash against the costly Denver International Airport set the stage for this policy reevaluation.); and
- Aviation fees rising faster than inflation.

Most major airports already levy a $3 airport facility charge, the maximum permitted under federal law. As a result, these airports will be forced to find other sources of new revenue. The aggressive measures taken by the City of Los Angeles, which dramatically raised landing fees, may pave the way for additional increases nationwide.

Contentious labor issues that are likely to manifest themselves after lying dormant for several years will further squeeze profits. The record profits reported by major carriers are weakening their bargaining positions on major labor issues. Vociferous calls for retroactive salary increases are beginning to be heard. Considering that an unusually large number of labor contracts come up for renewal in the next two years, this issue is likely to dominate the attention of major carriers through 1997.

Labor issues will affect virtually all carriers. Only employee-owned United Airlines is in a position to sidestep them. Start-up carriers will likely be pressured to unionize as their financial position improves. Thus, newcomers are likely to have difficulty maintaining their existing rock-bottom fares.

One likely response of major airlines to labor cost increases will be to pursue (or threaten to pursue) opportunities to spin off additional routes to partner carriers. American Airlines' recent deployment of Midway Airlines' flights to cities from Raleigh-Durham illustrates the far-reaching potential of this strategy. (American has also spun off several jet routes, such as Chicago-Columbus, Ohio, to its commuter partner.) To the extent to labor contracts allow, similar strategies will be pursued zealously by others carriers.

Other simultaneous developments will lower airline costs. The next frontier in cost-cutting will be distribution systems. Ticketless travel, which eliminates paper transactions between the carrier and the customer, holds the promise of reducing costs from as much as $8.50 per customer to a mere 50 cents. This innovation also has the potential to boost the efficiency of airport ground-related operations.

PC-based ticketing systems, such as the Internet, will forge a new partnership between airlines and customers. Frequent flyers are becoming highly skilled travel decision makers and want the flexibility to arrange their own schedules. As a result, the panel expected spectacular growth in electronic home-based ticketing. However, several participants urged caution in projecting uninterrupted growth of this new medium, citing the practical limits of the technology. For example, many consumers are unwilling to make costly travel decisions without outside assistance. At a time when fare structures are extremely complex, many could remain unwilling to expose themselves to the travails of this technology.

As this new technology develops, however, airlines will enter new types of marketing agreements with large groups of ticket buyers, such as corporations. Electronic ticketing systems will be especially attractive for major airlines seeking to use their distribution systems as a means of differentiating their product. It will allow them to develop new tools for rebating commissions, offering special fares, and using first-class seating as a reward for brand loyalty.

Amid so much change, the role of the traditional travel agents will sharply diminish. To allow them to achieve the efficiencies necessary to earn a fair profit, small agents will need to exploit economies of scale. Thus, they will face increased pressure to close, sell, or consolidate. Already, many are already focusing their

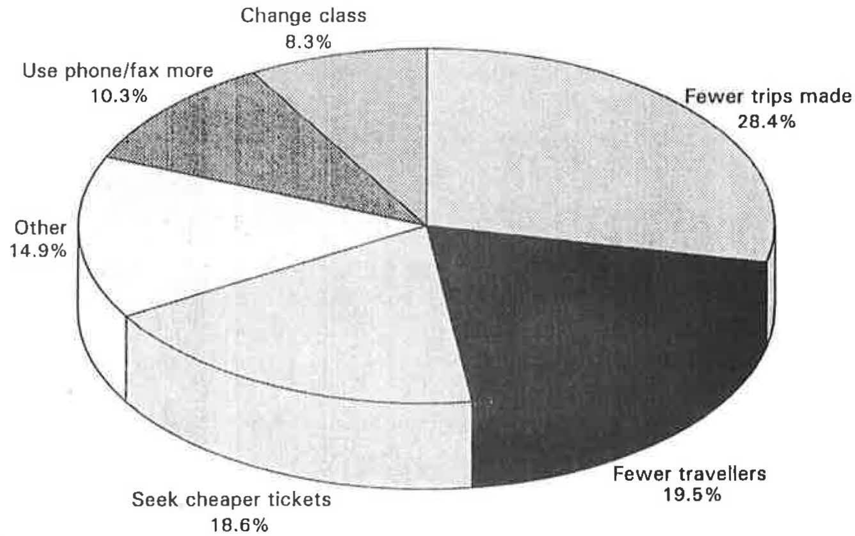

FIGURE 1 Impact of lower budgets on business air travel.

marketing efforts on nonairline products. Within five years, many panelists also expected small agencies to levy a service charge (akin to the fees imposed by entertainment ticket vendors such as Ticketron) on low-cost airline tickets.

Business Travel

Although airlines deserve much credit for cutting costs, they remain extremely vulnerable to changes in the business-travel market. Business travel has grown substantially slower than pleasure travel in most recent years, and the performance of this market segment will remain disappointing in the years ahead.

Three factors have disconcerting implications for business travel:

- Rapidly growing industries, including telecommunications and the high-tech sector, tend to be less travel-intensive than the sectors they are replacing, such as manufacturing and defense contracting.
- Corporations are putting into place innovative policies to minimize business travel costs. This is exerting downward pressure on airline yields (Figure 1).
- Much of the growth of the business market in recent years has been artificially stimulated by a drop in prices rather than by real increase in demand.

Although these issues cast doubt on the growth of business revenues, not all business-related developments are unfavorable. There is mounting evidence that video conference technology, as it exists today, poses little threat to the business-travel market. Similarly, little pervasive evidence suggests that the growth of electronic mail, the Internet, and other computer-based systems will chip away at the volume of business travel. Rather, they may create new business relationships that could generate new business trips.

All of these developments, however, render the business traveler more flexible, time-sensitive, and discretionary in making travel plans. Little evidence was found to suggest that airlines will be able to reverse the long-standing decline in the percentage of passengers paying full coach fares.

Industry Structure

As carriers struggle to maintain a profitable niche, they are offering consumers a continuum of price and quality choices. Regardless of the type of service they provide, however, profitability in today's marketplace requires a "critical mass" at a major airport. This sharply contrasts many earlier start-ups, such as Jet America, which emphasized point-to-point route systems. The panel divided carriers into four basic sectors.

Megacarriers

American, Delta, and United have multiple hubs and expansive international route systems, giving them a highly favorable prognosis. Although employing vastly

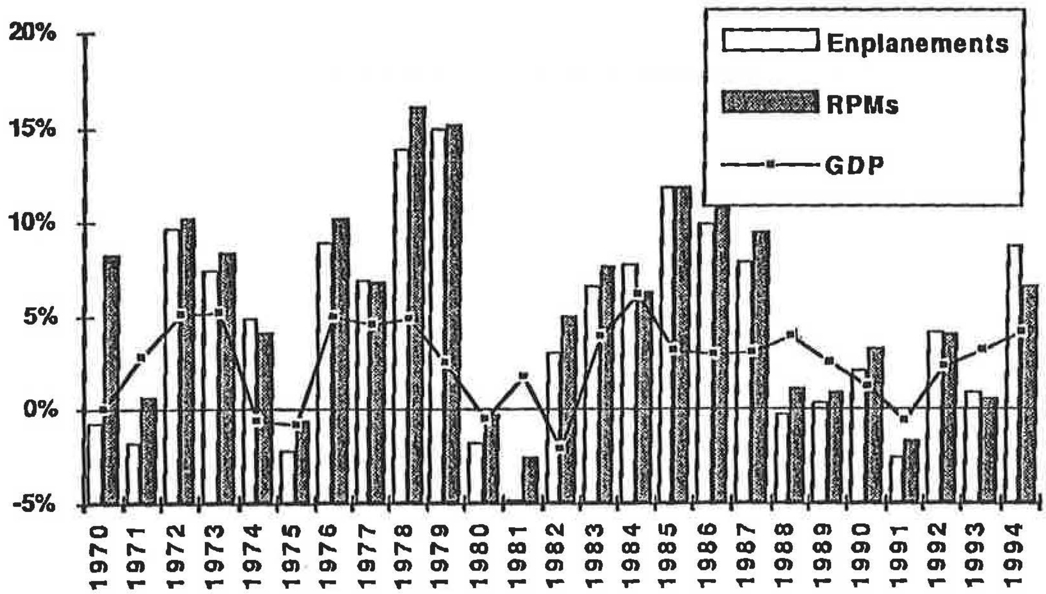

FIGURE 2 Domestic air travel and the macroeconomy.

different strategies, all three will continue to exhibit restraint in the domestic market — a fundamental change in approach they have taken since the mid-1980s.

Second-Tier Carriers

Although carriers such as America West, Continental, Northwest, TWA, and USAir occupy more tenuous niches, each is favorably positioned to survive the onslaught of low-cost competition. Their disadvantages, such as their more narrowly-focused route systems, will be only partially offset by their cost advantage versus megacarriers. The market share of this sector is likely to erode slightly. Consolidation between these carriers (such as the once-discussed merger of USAir and TWA) is unlikely.

High-Frequency Low-Cost Operators

The proven marketing formula of airlines such as Reno and Southwest — low fares and attractive schedule frequencies — will render this the fastest-growing sector. As their traffic expands, other carriers will likely mimic this strategy.

Low-Frequency Low-Cost Startups

Carriers such as Kiwi, ValueJet, and American Trans Air occupy the most tenuous niche. Their survival requires the maintenance of a successful macroeconomy. Unlike earlier startups, these carriers will continue to concentrate their operations at a central hub. Although they will be likely to exit markets upon the entry of Southwest Airlines, they will redeploy their fleet elsewhere. (Southwest's expansion in Florida will accelerate this process.) Also exerting upward pressure on costs is the diminishing market for inexpensive, used aircraft.

The panel anticipated that, with the possible exception of the second-tier group, each will maintain their approximate share of the market over the next three years.

Summary

Overall, the panel expected air travel to continue to grow two to three percentage points faster than the Gross Domestic Product in upcoming years (Figure 2). Indeed, air travel will become more attractive relative to over-the-road travel. Since 1991, for example, airline yields have remained constant at 13.3 cents per mile, while the average cost of operating an automobile has risen by approximately 20 percent. This bodes well for mid-distance airline trips of between 300 and 500 miles, where a large share of the market has historically traveled by car.

As deregulation approaches its third decade, there is ample room for optimism about the short-term outlook for domestic aviation. Although the long-term outlook remains uncertain, the prognosis is improving. After a tumultuous decade of transition, major airlines are exhibiting an unprecedented ability to cut costs and respond swiftly to the changing times.