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Speech

Remarks of
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"Winds of Change: The Airline Industry in 2004"

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Let me begin this morning by congratulating you on the subject of this conference—"Winds of Change." My only recommendation might be to add some further specificity to the title: "*Gale Force* Winds of Change" – or maybe "*Tsunamis* of Change" – might be more accurate portrayals of what the airline industry is experiencing right now.

A lot of us are trying hard to understand where those winds – or tidal waves – are likely to take us. While I am sure that many of you have your own pet predictions of where the industry is heading, I wouldn't bet good money on any of them. This industry has consistently confounded the best guesses of economists and other experts from the day we deregulated it in 1978. The architects of deregulation got it wrong, and we will get it wrong.

Aviation Policy Accomplishments

I want to offer some thoughts this morning about the profound changes sweeping through the airline business. But first I want to share with you a few observations regarding some important developments in aviation that may have escaped your notice.

First, the Herculean effort to ramp up the security of air travel—while still a work in progress—can be counted as a major success. It is fair to say that our creation of TSA and the suite of new requirements and procedures introduced by the new agency represented nothing less than a fundamental transformation of the framework within which commercial air services are conducted. While not every aspect of that transformation went as smoothly as we might have liked, the net result has been the restoration of a system in which travelers have confidence. Whatever problems continue to compromise the industry's economic performance, fear of flying is not among them. That is no small accomplishment.

Second, despite a host of security-driven obligations, the Department of Transportation and its FAA have remained focused on our core aviation responsibilities. In addition to continuing to finance new airport projects under our previous enabling legislation, the Administration worked closely with Congress as it enacted a new four-year aviation reauthorization statute—Vision 100 – The Century of Aviation Act. That $60 billion act of Congress includes $14 billion in new money for airport projects, $140 million to assist small communities in attracting and retaining air service, and $308 million to ensure air service to isolated communities. We estimate that the bill will support over 665,000 new jobs thanks to airport improvement projects that will be undertaken throughout the country.

In February of this year, Secretary Mineta announced an historic new initiative that will take our aviation system to an entirely new level. No matter what the shape and characteristics of the future market for air transportation look like, we know we will have to handle a great many more aircraft operations than we do today. Government's job is not to try to push the market one way or the other; our job is simply to be sure that we have the wherewithal to accommodate whatever it is that the market delivers. Accordingly, Secretary Mineta has called for nothing less than a tripling of system capacity over the next two decades. As part of his "Next Generation Air Transportation System Initiative," we have established a new Joint Planning and Development Office within the FAA that is staffed by representatives of a number of participating agencies. In addition to FAA staff, they include NASA and the Departments of Defense, Homeland Security, and Commerce. The program is being guided by a Senior Policy Committee chaired by Secretary Mineta personally, with high-level participation from each of the participating agencies. It is a major departure in the way government prepares for the future, and we are very excited about it.

Third, some exciting things are happening on the international front. Many of you are aware, I'm sure, that the U.S. has been campaigning since the late 1970s to liberalize international aviation markets—that is, to persuade governments to stop regulating price, frequency, entry, marketing, and other features of the international air transport business. We forged our first Open Skies Agreement with the Netherlands in 1992—and in so doing reinvented the framework for regulating international air services. Today the U.S. enjoys 60 Open Skies relationships with trading partners around the world. The idea has caught on: More and more countries are negotiating Open Skies agreements with each other. The benefits of the Open Skies revolution to travelers and shippers have been enormous.

I am sure you have read that the U.S. and the EU are now engaged in a process of establishing an even more open and competitive market for air services across the North Atlantic. It will be good not only for consumers, but also for airlines on both sides of the Atlantic. Once we have finished it, that new US-EU agreement will enable airlines to operate far more flexibly than at present, offering far more competition in a broader array of markets than ever before. The industry can look forward at last to managing itself in keeping with commercial exigencies, not political ones.

We expect to conduct aviation consultations with China during the next several weeks, and we are optimistic that it will be possible to craft some important improvements in the framework for air services between our two countries – with a particular focus on delivering a quality of air service more in keeping with one of our largest trade relationships.

Last September, with the Senate's advice and consent, the United States ratified the Montreal Convention of 1999, thereby bringing into force a long overdue modernization of the 1929 Warsaw Convention system of airline liability. Gone are the artificial caps on damages that characterized the Warsaw System; gone is the need to prove "willful misconduct" by the airline in order for an accident victim to receive more than token compensation. To be sure, international airline accidents are few and far between. They do happen, however, and when they do, the international law framework now will serve the interests of passengers and their loved ones in a far more just and humane way than ever before.

The U.S. also signed the Cape Town Convention last year. When it takes effect, this new treaty will make it much easier for aerospace manufacturers and lessors to finance the placement of new aircraft and engines throughout the world. This is particularly important in less developed countries whose legal systems have been less than clear about whether the seller of an airplane can repossess it if the buyer stops paying for it. By setting up a new international registry, the new treaty overcomes that uncertainty. Because the cost of financing in a country varies directly with the seller's perceived risk in that country, the advent of Cape Town will reduce the cost of financing significantly. As a result, newer, state-of-the-art aircraft will be available on more favorable terms in a great many developing economies, the real market for new aircraft sales will increase, and air safety will improve throughout the world. Not bad for a treaty that the press has hardly noticed.

An Industry in Transformation

Indeed, it has been difficult to observe any of these important developments through the economic fog in which so much of the industry is flying today. The truth is, however, that there has never been a time when aviation was characterized by as much change as the time we are living in right now.

Most of that change should be seen as welcome – even those winds of economic change that you have gathered here to talk about today.

A fundamental restructuring of the airline industry is taking place. That restructuring is attributable to two simultaneous phenomena: first, the disappearance of high-end demand for air travel toward the latter part of 2000; and second, the emergence of a new breed of low-cost carriers, or LCCs.

Even casual observers of the industry understand that our so-called legacy carriers have suffered jaw-dropping losses during each of the past three years while significantly shrinking. Perhaps that shouldn't be surprising in an environment characterized by 9/11 and its aftermath, SARS, the war in Iraq, and a general economic turndown. What is surprising is that at the same time, during the most challenging operating environment the industry has faced during the past 25 years, LCCs managed to earn profits and expand market share. Something important is happening.

At DOT, we believe that the meltdown in high-end demand toward the end of 2000 was not merely another cyclical change; it was an important *organic* change. It was attributable to factors like the Internet's rapidly growing role in the distribution of airline services and the LCCs' growing networks and improved service quality. These developments have seriously compromised the ability of legacy carriers to charge premium prices to their high-end customers.

We note too that high-end legacy carrier fares have declined not merely on routes served by LCCs; they have declined even on routes where there is no current LCC competition. Very clearly, the fare transparency delivered by the Internet and the expansion of LCC services has increased the price-sensitivity even of business passengers. The airline seat is rapidly becoming a commodity. The pressure on legacy carriers to reduce their cost structures in this environment has been immense.

While the conventional wisdom is that demand for air travel remains soft, and that is why our traditional networking carriers are suffering at the moment, the truth is that the only demand that's soft is demand at the high end. The demand for more affordable air travel appears to be robust. That the carriers earning profits in this market are the ones with the lowest prices speaks volumes about the kind of structural transformation that is taking place.

We have hit the tipping point. For years, our large network carriers were able to avoid cost-side pressures by focusing on revenue-side strategies – largely centered on the high-yield business traveler. That focus led to innovations like sophisticated global distribution systems, revenue management, and frequent flyer programs that helped the airlines segment demand. The strategy generally worked because the business traveler grew accustomed to paying high fares, didn't have any really attractive alternatives, and because the airlines enjoyed a greater ability to control the number of seats available to discretionary travelers. In a market characterized by declining high-end demand, a widespread availability to business travelers of attractive low-fare options, and a loss of capacity control attributable to LCC expansion, the oxygen has gone out of that strategy.

It can all be summed up as follows: Throughout the first quarter-century of deregulation, demand for scheduled passenger air transportation was driven by the constraints and confines of its providers. That supply-driven characteristic of demand is coming to an end. Demand now is beginning to drive supply. I said earlier that the architects of deregulation got their predictions all wrong. That's not quite right. They predicted the results pretty accurately; they just didn't guess that it would take 25 years for those results to be realized.

Whether the legacy carriers are going to remain an industry force will depend in large part on how successful they are in achieving lower costs. They are leaving no stone unturned in their efforts to get their costs down – both by reducing unit costs and by bringing unit costs and revenues into better balance by reducing supply. Most legacy carriers have achieved cost reductions that border on the heroic. What we don't know is whether they are heroic enough.

One strategy for addressing cost issues is through far greater use of regional jets. Our statistics indicate that around 40 percent of legacy carrier departures in the lower 48 States are RJ operations. By using RJs for a larger portion of their operations, some legacy carriers undoubtedly seek to persuade passengers to pay a premium for frequency and other network advantages while, at the same time, avoiding the need to carry traffic at the lower end of the demand curve – traffic that would be unprofitable at their cost structures. In effect, some legacy carriers may be working to breathe new life into the revenue-side strategy of the past 25 years. Some skeptics wonder whether using a high-unit-cost aircraft is the right answer for a segment of the industry that is struggling to get costs under control, and at a time when a lower-cost segment of the industry continues to expand. Personally, I have learned to temper my skepticism. I am bullish on this industry, and I believe there is a robust future ahead even for our large, network airlines. However they do it, it is important that the legacy carriers work their way through the problems that now confront them. Their broad-based global networks still offer the only service to many cities in our country and around the world.

At the same time, there is little doubt that the low-cost carriers will continue to expand. First, the new generation of low-fare carriers – JetBlue, AirTran, and Frontier – are very good at what they do. They have new aircraft, a better in-flight product, and better on-time performance and completion factors than the first-wave of post-deregulation start-ups. They are also reducing other advantages traditionally held by the legacy carriers, such as frequency and service scope. And they have hundreds of aircraft on order.

They are also departing from some of the time-honored assumptions about the kind of services LCCs provide. They no longer limit themselves to dense, short-haul markets. Several low-fare carriers serve a growing number of smaller communities and city-pair markets of all distances. Conventional wisdom is that they do not serve international markets. But most of them already do – or at least they will by this summer. They are serving transborder Canadian and Mexican markets and the foreign Caribbean, but there is no reason why they should stop there. Transcontinental U.S. distances are not that different from transatlantic distances. In other parts of the world, low-cost carriers are going where some industry experts said they would never go. Think of Ryanair, EasyJet, Air Asia, Pacific Blue.

Second, if the airline seat is indeed becoming a commodity, there will be even more pressure to reduce costs, and those still lower costs will enable the LCCs to reach further down the demand curve. In that connection, differences between the legacy carriers and the LCCs in cost per available seat mile remain very high. That should tell us that average industry costs are still a long way from hitting bottom, and thus will decline further over time.

Third, it would be a serious mistake to assume that LCCs will all adhere to a single, monolithic business model. True, they all seek to emulate Southwest's focus on low costs and high equipment utilization. But each has a different approach to the business, and most have revised their models over time. Two already have used regional affiliates. JetBlue has ordered 100-seat aircraft. Independence Air is about to start a low-fare business model focused on regional jets. There is ample reason to think that entirely new business models will materialize.

I said at the outset that, while the structural changes I have been talking about represent a huge challenge to a major segment of the airline industry, they are nevertheless welcome changes. That, of course, is because the public has been the major beneficiary. Affordable air travel is a key driver of economic activity, and these developments can be expected, therefore, to have a huge and salutary impact on the American economy as a whole.

I know you are about to enjoy a very interesting day looking more closely at these and other issues. Thank you for inviting me to share these thoughts with you this morning.

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