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FUTURE OF THE AIRLINE INDUSTRY

HEARING

BEFORE THE

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

JANUARY 9, 2003

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SENATE COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

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FUTURE OF THE AIRLINE INDUSTRY

THURSDAY, JANUARY 9, 2003

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
Washington, DC.

The Committee met, pursuant to notice, at 9:30 a.m. in room SR–253, Russell Senate Office Building, Hon. Ernest F. Hollings, Chairman of the Committee, presiding.

OPENING STATEMENT OF HON. ERNEST F. HOLLINGS, U.S. SENATOR FROM SOUTH CAROLINA

Chairman HOLLINGS. The Committee will come to order. I wanted to yield to my Chairman, that is a fact, even though it has not gotten into law yet, and welcome him back, and we will continue to work together very closely as we have. This Committee has been outstanding in its cooperation during major parts of the leadership of Chairman McCain.

We are delighted to have our airline executives here to tell us about the status of the airlines. I am going to file my statement, Mr. Chairman, and only comment to the effect that I take it today we will not have to hear how deregulation is working.

[Laughter.]

Chairman HOLLINGS. We used to have over a dozen or so airlines all competing at a reasonable price. It costs now, a round-trip ticket from Charleston, South Carolina, to Washington, or it did last year—I think they are trying to adjust—$1,036 coach class, and we have gotten most of the airlines broke and the rest of them begging. I think they have got three that are left in the black, and it is not all 9/11. We put in $5 billion as a result of 9/11, and we are willing to help in any way we can.

I know there is a burden with respect to the security of the airports. In other words, there is an additional burden. However, you can see they have gotten way out of line when, in trying to save the airlines, you see the pilots now cutting back 30 percent of their salaries, and other cost savings that should have been instituted sometime ago, but let us hear from the airline executives. Let me yield to Chairman McCain.

[The prepared statement of Senator Hollings follows:]

PREPARED STATEMENT OF HON. ERNEST F. HOLLINGS,
U.S. SENATOR FROM SOUTH CAROLINA

Good morning. First, let me express my sympathy to the family and friends of the folks that lost their lives in the crash in Charlotte yesterday. We have spent a great deal of time focusing on security over the last 16 months, recognizing that making people safe and secure in their travel is a critical part of what our governmental responsibilities are. Crashes are a devastating experience for the families and loved ones, and I wanted to express my condolences to those folks.

Turning to the economic plight of the airline industry, above all else we must ensure that the industry is safe. We must also work to make certain that it is strong and viable. Right now, the Federal Aviation Administration (FAA) has targeted the two carriers in bankruptcy for greater surveillance. Does the FAA have the resources to fully do its job? I do not yet know the answer to that question, but I know we will look into this matter.

It is clear to all of us that the airlines face perhaps the most difficult period in their history. Analysts indicate that air carriers have collectively lost at least $15 billion over the past two years with just a few carriers operating in diminished profitability. More than 80,000 good paying jobs have been lost over this same period with up to 30,000 more personnel cuts planned for 2003 as companies restructure their business models in an effort to remain competitive. The aircraft manufacturing sector is faring no better, with more than 600 airplanes having been moved into storage or early retirement, and new orders for Boeing and others continuing to fall off.

After the tragic events of September 11, 2001, Congress acted quickly to provide air carriers access to $5 billion in direct compensation and $10 billion in federally guaranteed loans. While this support was a needed "shot in the arm," the airline industry obviously continues to struggle, and many other businesses across the country are facing increasingly difficult times as well. Unlike the airlines, these industries did not get a "bailout" after the terrorist attacks and many companies have not survived as the nation's economic slump has worsened. Yet, again we are here to contemplate what further steps the Federal Government can take to improve the condition of our airlines.

A number of carriers have expressed the need to have their tax, fee, and security burdens lessened. Some airline CEOs have explained that when the airlines were profitable, these costs could be passed on to customers, but now that the demand is down these costs are absorbed by the airlines. We know the carriers were weakened by 9/11, but some were weak prior to 9/11. Now, the market has radically shifted and the major carriers can not change quickly enough to make a profit. Herb Kelleher and Southwest, and Dave Neeleman and JetBlue, continue to make money as passengers look for lower fares. The major carriers, like American and United, have announced fare reductions in an effort to lower business fares and attract more people to fly. The planes are full—Northwest had a 77 or 78 percent load factor last month, but revenues are down per passenger. I like the lower fares, and the one way walk up even for my Charleston flight has dropped by about $400. This is good news for the consumer, but the carriers need to reduce costs if they are to survive.

The airlines are calling for Congress to alter the current tax system, but we need the carriers to show us what changes *they* are going to make to improve their business structure, service and economic viability. The Air Transportation Board was tough on applicants, asking for detailed business plans. They did not give loans to all comers, and in fact turned down United, and gave US Airways conditional approval for $900 million in loans.

The airlines are also asking Congress to revamp the Railway Labor Act by inserting a mandatory arbitration clause. As I see it, yesterday, United's pilots—and Mr. Woerth from ALPA can provide us details—agreed to cut salaries by 29 percent. The other carriers and their unions will need to follow. The labor-management negotiations seem to be working, so we should not inject ourselves into the process. Management, for its part, has also been making concessions and I am hopeful that future efforts among the airlines will continue to incorporate a similar balance. I should add that I appreciate Mr. Woerth's appearance and want to recognize his efforts following 9/11 to help us pass the Aviation and Transportation Security Act. He helped us push that bill through, and I want to thank him for his efforts.

If the airline market failure leads to an industry collapse the ramifications for our entire economic system are dire. I find it interesting that Congress is being asked to tinker with fees and repeal taxes—the majority of which pay for programs that directly benefit the air carriers—while the Administration is pushing for a major economic stimulus package that provides nothing for our airline industry. Clearly, the industry is too important to our nation's economy not to take action—but what steps will best provide the most dependable and equitable aviation transportation system for the traveling public? These issues must be very carefully considered in light of the airline industry's current market failure. We need to see real fixes with real results, not a system of continual boom and bust that overcharges customers in good times and asks for handouts from them in bad.

This hearing will provide the industry an opportunity to make it's case for further support in the form of changes to the current tax and fee structures, but know that you are facing a skeptical audience. I am hopeful that our time here will lay the groundwork for finding workable solutions to lingering troubles in the airline industry which will help to benefit aviation, the entire U.S. economy and the American people for a long time to come.

STATEMENT OF HON. JOHN McCAIN, U.S. SENATOR FROM ARIZONA

Senator McCAIN. Thank you, Senator Hollings, and I would like to note for the record that the Committees have not been organized, which means that Senator Hollings remains the Chairman of this Committee until such time as that parliamentary procedure is completed. And I would like to take this opportunity again, as I have over the last 18 years of service with Senator Hollings, to thank him for the bipartisan fashion in which we have treated these issues. We have not always agreed from time to time, but I have always been treated with the utmost courtesy and consideration and deference, whether—by Senator Hollings—whether I was the Chairman or the Ranking Member. I believe this is the third time we have rotated that position.

Chairman HOLLINGS. People cannot make up their minds, can they?

[Laughter.]

Senator McCAIN. I do not think that we are a perfect Committee. I do believe, however, that the relationship that has existed between the two of us, whether it was Chairman or Ranking Member positions, has led to beneficial results for the American people. The sheer volume of legislation that has been reported out and passed by this Committee exceeds by far any other Committee of the United States Senate, and many very important pieces of legislation such as the establishment of the Transportation Security Authority and many other major pieces of legislation that have emerged from this Committee and passed by the entire Senate signed by the President could not have been achieved without a relationship of mutual trust that exists between the two of us, so I want to thank you again, Mr. Chairman, and I do not look forward to a fourth shift, but if it does happen, I will regain and retain my confidence in our ability to work together for the benefit of the American people, and I say that with all sincerity and goodwill.

By all accounts, the airline industry has hit one of its toughest times ever. The terrorist attacks of 2001 compounded the impact of an economic slowdown that was already underway. As a result of the attacks, the airlines faced a serious crisis that required government intervention, and Congress responded with legislation designed to stabilize the industry in the short term.

Our efforts appear to have been somewhat successful, because all the major carriers are still operating. However, two of them are currently attempting to restructure themselves through bankruptcy, others are in serious difficulty. The current condition of the industry and its future prospects are of paramount concern.

The airlines are seeking additional assistance from the government. Although there may be ways that we can be helpful, we must be cautious about any effort that we might undertake. There is no dispute about the importance of aviation to our Nation, but as a general matter, government involvement in the financial health of an industry should proceed cautiously.

We must ask whether our actions would improperly distort the marketplace. The ability of some airlines to remain profitable in the current climate raises a question of whether there is something wrong with the rest of the industry. We should be reluctant to do anything that might keep inefficient businesses afloat. Many people believe that the basic business model of the traditional hub-and-spoke air carriers was broken long before these current difficulties.

We face no easy choices. I want to repeat: We face no easy choices. While I instinctively favor market solutions, one potential drawback to allowing the market to sort out winners and losers is that the failure of one or more airlines could substantially increase market concentration, which necessarily means that the consumers will suffer.

I, for one, do not relish the thought of having the airline industry restored to financial health through consolidation or other industry action that erodes competition and significantly increases air fares in captive or semi-captive markets. Furthermore, there could be significant losses of service in some markets and regions if one major carrier were to be liquidated. We need to look carefully at the potential effects of any actions we may take.

Whether or not Congress provides additional assistance, the industry must act to help itself. The economy is struggling, and many industries would like governmental aid. Very few have received the assistance that has been given to the airlines. That assistance has certainly been warranted, but it does not mean the government will or should step in every time. The aviation industry may simply need to adjust to the new realities of air travel before we can take any further significant action. There are signs that such efforts are underway at some airlines. These efforts may lead to difficulties that might be painful in the short term, but also might be better for the industry as a whole in the long term. It also may mean, for those of us who travel frequently on the Nation's airlines, a much less comfortable and enjoyable experience, I might add.

I want to thank our witnesses for being here this morning. I look forward to hearing again from Mr. Shane, who has been a very frequent witness before this Committee over many years, and I believe that this issue is one of paramount importance to the future of this Nation, and one that may require us thinking and acting outside of the norms of the behavior we have exhibited in the past with regard to the airlines of the United States. I do not believe that anyone can argue that airlines have ever been in a deeper crisis since airline deregulation than they are today.

Thank you, Mr. Chairman.

[The prepared statement of Senator McCain follows:]

PREPARED STATEMENT OF HON. JOHN MCCAIN,
U.S. SENATOR FROM ARIZONA

By all accounts, the airline industry has hit one of its roughest times ever. The terrorist attacks of 2001 compounded the impact of an economic slowdown that was already underway. As a result of the attacks, the airlines faced a serious crisis that required government intervention, and Congress responded with legislation designed to stabilize the industry in the short term. Our efforts appear to have been somewhat successful because all of the major carriers are still operating; however, two of them are currently attempting to restructure themselves through bankruptcy.

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We face no easy choices. While I instinctively favor market solutions, one potential drawback to allowing the market to sort out winners and losers is that the failure of one or more airlines could substantially increase market concentration, which necessarily means the consumers will suffer. I, for one, do not relish the thought of having the airline industry restored to financial health through consolidation or other industry action erodes competition and significantly increases airfares in captive or semi-captive markets. Furthermore, there could be significant losses of service in some markets and regions if one major carrier were to be liquidated. We need to look carefully at the potential effects of any actions we may take.

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I thank our witnesses for being here and hope they will be able to shed light on what the future holds for the industry.

Chairman HOLLINGS. Thank you. I have listed Senator Hutchison, Brownback, Lott, Dorgan, Inouye, Nelson, Burns, Rockefeller. Senator Hutchison.

STATEMENT OF HON. KAY BAILEY HUTCHISON, U.S. SENATOR FROM TEXAS

Senator HUTCHISON. Thank you, Mr. Chairman. I am pleased to be able to have this hearing early to talk about the state of the airline industry. Anyone who has been reading the newspapers knows that our airline industry is in dire straits. In my home state, we have three of the major air carriers, including the world's largest, American. Before 9/11 there were more than 79,000 airline employees in Texas. 8,000 of those employees have lost their jobs. The airlines themselves have lost $7 billion in 2002.

We cannot deny the tremendous impact of the attacks on air travel. However, the roots of the current crisis go much deeper than that single day of terror. 2001 was already shaping up to be a terrible year for the airlines on that fateful morning. After the travel boom of the 1990's, the airlines entered into a series of disastrous contracts with their unions. While I fully endorse strong partnerships between management and labor, these agreements compromised the financial stability of most of the airlines.

Anyone who has watched the rail industry in our country knows that if this happens in the airline industry it will annihilate this very important part of commerce in our country. That is why I will support the concept behind Senator McCain's legislation that would amend the RLA to bring labor negotiations to a definite conclusion either by agreement of the parties or by binding arbitration. We must make sure that this industry stays viable, and I think Senator McCain's bill will do that.

I think it is also critical to maintain the safety requirements that we have imposed since 9/11. Certainly, we are going to need to add some things like air cargo, which Senator Rockefeller and I have been working on in the last year. That will be a help, but some of the airlines have indicated that the security measures have been part of their economic woes.

I have to say I reject that. I think the security measures have actually helped the airlines from going into a deeper hole. So while I think we do need to make some changes to make sure that the security system is as efficient and noninterfering as possible, I think that the traveling public will only stay on the airlines if they believe that security is strong. I also believe that the changes we have made in airline security have made it extremely strong.

I am very proud of the Transportation Security Administration and the work that they have done in making our screeners more professional. I look forward to working with them to make it even more efficient and traveler-friendly, and I am going to be there to support the airlines.

I supported both of the proposals designed to help the airlines and the loan guarantees that made it into the system. I think we need to make sure that we prop up our industry, but we also need to ask the industry to monitor itself and do what it needs to do to maintain its viability. The government will be there when necessary, but not at every turn, because we also have other priorities for our country that will be running us into deficit. So we need a partnership, and that is what I will be working for.

Thank you, Mr. Chairman.

Chairman HOLLINGS. Very good. Senator Brownback.

STATEMENT OF HON. SAM BROWNBACK, U.S. SENATOR FROM KANSAS

Senator BROWNBACK. Thank you, Mr. Chairman, and thank you again for holding the hearing on the airline industry. As I have pointed out and talked about in the past, I wanted to speak, if I could, briefly on the aircraft manufacturing industry.

Over the break, I had a chance to sit down with the major aircraft manufacturers, all of which have plants in Wichita, Kansas. Wichita is home to Boeing, Raytheon, Cessna, and Bombardier's major factories or headquarters. Over the break, I sat down with leaders of these four major aviation manufacturers in Wichita and discussed their situation, and as you might suspect, as I pointed out to the Committee previously, they are in a very, very difficult situation.

While the state of the commercial industry is dismal, the general aviation community is suffering even more so. Over the past 18 months, there have been 10,400 layoffs in Wichita alone, 10,400. And this is just the direct layoffs in the aviation community. The number does not include the multiplier effects that are felt throughout the city. For every one job in the aviation industry in Wichita, there are—1.9 jobs created. This is devastating, when you consider that even since the last hearing that we had in October, Wichita has suffered another 1,000 additional layoffs.

The situation is not getting better, and we must commit to improve it immediately, and while we're focused so much on the airline industries, the manufacturers are really taking a huge hit. And much of the business is being moved overseas or taken over by Airbus, which I am going to ask the Commerce Department, Mr. Shane about later on as well, about what Airbus is doing in this period, when we are seeing a downturn in aircraft manufacturing and they are upscaling their manufacturing during the same period of time. That has to be due to heavy government subsidization, for them to be able to do that at this time.

I have got a chart that I just wanted to show briefly if we could of Boeing commercial aircraft delivery. That is right here if we could put that up, Mr. Chairman. You can see, in 2001, Boeing Commercial delivered 527 aircraft, 2002, 381, projected this year, somewhere between 275 and 285. Now, if that last number holds, and you see we are roughly half of what we were in 2001, Airbus will take over for the first time since its creation's the number 1 position of delivery of aircraft of the main airliners throughout the world. They have done that through heavy subsidization against agreements.

So we have got a two-fold problem here. We have got a difficult situation financially for the airline industries, which—being shown by the manufacturers, and you have a heavy subsidization coming in by other countries to take over the manufacturing, and that is something I am going to be working aggressively on. We need to focus, and I think take into clear concern and embrace the recommendations of the Commission on the Future of the U.S. Aerospace Industry, that final report to Congress. They emphasized the needs and the ways that we can bolster basic research for the aviation industry.

What the manufacturers were telling me is, look, we were hurting. We do not have the income, and so we are going, or other countries are coming to us and saying, we will pay for the research and development of this wing or this engine on this aircraft, but if we do that, we want it manufactured here. We want it manufactured in China or in Japan, or Thailand, or Europe, wherever they are coming to buy the—if they are going to pay for the research, they want the manufacturing, the jobs to go there, and the companies, strapped for cash, are saying, well, I guess we are probably going to have to do that. So you are seeing the dismantling of the aircraft manufacturing industry in this country now.

The industry is used to cyclical ups and downs. It's had those for a number of years, but what is different about this structural change, is that a number of those jobs are being then sucked away to other countries that are unlikely to come back, so they'll be importing the wing from China, the engine from somewhere else, assembling it here, but you have lost those jobs and you have lost them on a long-term basis. I really hope we look at what this commission reported and we take a serious focus on that, and Mr. Shane, I also want your Department to be looking, and I am going to be asking questions about, what Airbus is presently doing to take this industry away via government subsidization.

Thank you, Mr. Chairman.

Chairman HOLLINGS. Thank you so much, Senator, for free trade. We are all in trouble. We have lost 55,200 textile jobs with free trade, and now the airline industry is hit, and before long, you farmers are going to get hit.

Senator BROWNBACK. Free trade, I do not have a problem. It is heavy government subsidization that takes it away that I have a real problem with.

Chairman HOLLINGS. That is the kind of free trade we are into. Senator LOTT.

STATEMENT OF HON. TRENT LOTT, U.S. SENATOR FROM MISSISSIPPI

Senator LOTT. Thank you, Mr. Chairmen, plural, Senator McCain, incoming Chairman, and Senator Hollings, outgoing Chairman, for having this early hearing. I think it is certainly justified, and from what we have already heard, this is an area clearly that we are going to have to pay a lot of attention to this year. I believe one of the most important components of our economy is transportation as a whole, and aviation is certainly a critical part of that.

I want to thank Senator Hollings and Senator Rockefeller, and certainly my friend and colleague, Senator Hutchison for the work they did last year and in the aftermath of 9/11 passing emergency legislation that was critical to the industry, dealing with such things as the cargo issue. They have done great work, and I think that this year this will be one of the most active areas in this Committee.

I am looking forward, when we do get an organization resolution, to Chairing the Subcommittee. I have had some good discussions already with Senator Hutchison and Senator McCain about what we need to do to be helpful. I pledge to meet with all sectors of this industry to make sure I understand where the problems are and what the Federal Government's role is, and how we can improve the situation with modernization. We are going to look at security costs, with the impact it is having on manufacturing and the whole sector.

I think that this is a critical area where we need to act, probably with two or three bills this year to help deal with the problems. To the industry, I have already said, and I have always said, you know, Federal Government is certainly not the total answer. The industry has problems of its own they are going to have to face up to. We need to help make it possible for those problems to be dealt with in terms of costs that we have helped cause you to deal with in terms of additional cost. For instance, the airports. Airports all over this country are having additional costs from security that they certainly would not have done before 9/11, and also we have to look at the best way to deal with labor disputes and we will be looking for some answers to that, too.

I want to hear the witnesses, so Mr. Chairman, I know it is not done often enough, but I would like to submit my entire statement for the record.

[The prepared statement of Senator Lott follows:]

PREPARED STATEMENT OF HON. TRENT LOTT,
U.S. SENATOR FROM MISSISSIPPI

I would like to congratulate the Chairman for holding this hearing and his commitment to evaluating the status of the aviation industry.

I look forward to serving as Chairman of the Aviation Subcommittee this Congress. Chairman McCain plans to start off the year with an aggressive agenda. The Committee is planning to hold hearings on the Federal Aviation Administration (FAA) reauthorization, computer reservations systems, aviation capacity, and competition issues.

The Committee also will consider the financial condition of the airline industry, air traffic control modernization, the continued organization of the FAA into a performance-based organization, and the resolution of airline labor disputes. I am anxious to begin working with Chairman McCain, Senator Hollings, Senator Rockefeller, and the other Committee Members to accomplish these goals and address other issues that might arise during the Congress.

I agree with Senator McCain on the importance of a quick start to evaluating the current situation and the future of the aviation industry. We have seen the industry hit bad cycles before, especially in times of war and economic stress. High fuel costs during Desert Storm strained the industry. However, the combination of the slow economy and the tremendous drop in air travel since 9/11, have had an unprecedented impact on the industry.

In the immediate aftermath of 9/11, the Congress acted to improve aviation security and assist the industry. Now we need to look at what should this Congress do to stabilize the industry and ensure that all of America, especially smaller communities in states like mine, are well served? If the industry does not begin to swing upward, the nation is likely to see additional bankruptcies and massive consolidations. This often times means higher prices and less service.

I continue to hear from the aviation industry that there needs to be a reduction in the regulatory and security cost burdens on the industry. The airlines have taken on the cost of additional air marshal tickets, airport security costs not borne by TSA, and security fees attached to tickets in order to remain competitive.

In my home state of Mississippi, the Jackson International Airport reports that the TSA's security regulations are costing the airport $60,000 monthly. In order to reconfigure the terminal to meet new security requirements, the airport is having to dip into AIP (Airport Improvement Program) funds. If this continues, airport improvement will be deferred and economic development will be hampered.

Already, two major airlines have filed for bankruptcy under Chapter 11. While this has allowed them to lower their costs and continue operating, the resulting intense price competition may drive the remaining carriers to follow that same path as an industry sized for the rapid growth of the late 1990's attempts to rapidly reshape itself for the current economic reality.

One of my first priorities will be to meet with representatives from all segments of the aviation industry in an effort to explore ways that Congress can help.

Another area where I plan to focus is labor reform. Last year Chairman McCain introduced, and I along with several other Members co-sponsored the Airline Labor Dispute Resolution Act. This legislation would move the industry to baseball-style arbitration. I believe with the financial crisis the industry is now facing, it is more important now than ever to resolve airline labor disputes fairly and in the least disruptive manner.

I look forward to hearing from today's witnesses and working with each of you this Congress.

Chairman HOLLINGS. It will be included. Senator Dorgan.

STATEMENT OF HON. BYRON L. DORGAN, U.S. SENATOR FROM NORTH DAKOTA

Senator DORGAN. Mr. Chairman, thank you very much. I agree with much of what has been said this morning, and I would like to make the point, it is in our selfish interest to care about what happens to the airline industry. This country will not have a strong economy, in my judgment, unless it has a strong airline industry. So for the traveling public, for the hundreds of thousands of people who work for the airlines, for aircraft manufacturers, suppliers, all of which make up a nearly $1 billion industry, we have a very big stake in making sure that we have an airline industry that is viable in the future. It is the case that a soft economy, a recession, and terrorism represent things that the industry could not and would not be able to control themselves, so this is an important hearing, and I appreciate your calling the hearing.

The airline industry itself is trying to restructure, trying to be creative, trying to cut costs. I must say that when I saw a report on television the other day, that one airline is now beginning to charge for food, it occurred to me that I would like to get the names and addresses of those Americans who would voluntarily purchase food from the airlines. I have some things I would like to market to them as well.

[Laughter.]

Senator DORGAN. But let me be serious and say that as the airlines restructure and think through how they address these new crises, it is of particular concern to me that we not jeopardize service to smaller markets, rural markets, and smaller states. I know that can be a temptation to some, but Senator Rockefeller and I have waged a long battle on these issues, and I am going to be watching very, very closely to make sure that we not have an airline industry restructured in a way that hauls people back and forth between the largest metropolitan areas and that becomes a skeleton of the industry.

No industry can sustain the $7 to $8 billion annual losses. They are going to have to do a lot of things inside the industry, and they are, to address these issues. We need to think long and hard about what we can do to ensure that this industry gets turned around as well. I would like to say that I have been and will always be the first on this Committee to object to and oppose most additional mergers that would be proposed to further consolidate an already highly concentrated industry, but I must say that I do not have the same concerns with respect to alliances.

I have reviewed the alliance proposals and think that most of them and many of them can benefit consumers without suppressing competition, and I want to include at the conclusion of my opening statement an editorial by the *New York Times*, dated January 3, that is called Partners in Flight, and I am going to ask Mr. Shane some questions about the alliance issue, because I think there is a need to, in areas where appropriate, be expeditious in approving requests that are thoughtful and that can strengthen airlines. I am not just talking about any one airline, I am talking about a range of airlines, as long as it does not suppress and injure competition.

I will wait and ask questions of Mr. Shane and others, and again let me thank you, Mr. Chairman and Senator McCain, the Chairman-to-be, for holding this hearing.

[The information referred to follows:]

THE NEW YORK TIMES
January 3, 2003

Partners in Flight

America's beleaguered airlines continue to hemorrhage money at an alarming rate. After losing $7 billion in 2001, carriers are expected to report close to $9 billion in losses for 2002, the year in which both United Airlines and US Airways filed for bankruptcy. With the possibility of war on the horizon, and the economy recovering at a languid pace, no relief is in sight.

Congress rushed to the airlines' aid in response to the terrorist attacks in 2001, but rightly declined to approve a broader bailout. In a deregulated industry, companies should be allowed to suffer the consequences of their mistakes in an economic slowdown. However, deregulation works both ways. Congress could do a great deal to help the airlines if it lifted protectionist limits on foreign investment in U.S.-based airlines. That would stimulate competition and provide troubled carriers with fresh sources of capital. The likes of Richard Branson, the British founder of Virgin Atlantic, should be encouraged to start a new airline in the United States, not dissuaded. And if a big global player like Lufthansa wants to bail out United, so much the better.

The Department of Transportation, for its part, must act as if it understands that airlines are entitled to compete in a deregulated industry. Although the government does have a duty to keep airlines from engaging in unfair practices such as below-cost predatory pricing to undermine competitors, it is not supposed to stop them from trying to improve their ability to sell tickets. For example, it is not clear why Transportation has delayed approval of a proposed marketing alliance linking Delta, Continental and Northwest, even after the Justice Department indicated that the deal posed no antitrust concerns.

Troubled carriers everywhere are wooing partners to build alliances. United and Lufthansa are leaders of the global Star Alliance, and American and British Airways head Oneworld. These partnerships allow carriers to expand their networks (because they can book connecting flights on partner airlines), while providing passengers more convenience. The government recently approved such an alliance between United and US Airways, after blocking their merger.

Regulators should hasten to allow Delta to join Continental and Northwest in their existing alliance, which has benefited consumers without suppressing competition. Any further delay would signal an inappropriate regulatory impulse to shield bankrupt carriers from efficient competition. The fact that the government has the right to acquire a stake in some airlines as part of its loan guarantee program makes it even more inappropriate for it to block other carriers' attempts to help themselves.

The country needs healthier "network" airlines that fly coast to coast and an environment that encourages the expansion of nimbler low-cost carriers like AirTran and JetBlue. The proposed alliance serves the former need without imperiling the latter.

Chairman HOLLINGS. Very good. Senator Inouye.

STATEMENT OF HON. DANIEL K. INOUYE, U.S. SENATOR FROM HAWAII

Senator INOUYE. Thank you very much. To say what I am about to say would be redundant. May I just say that for the State of Hawaii, over 90 percent of our people have to rely upon air transportation to fly in and out of our state. You cannot quite do it by automobile, and so to say that it is the backbone of our economy is almost trite. Most of our Nation's air carriers were in trouble financially before September 11, and despite the infusion of federal funds, two of the major airlines have had to take advantage of the bankruptcy laws. However, we hear daily about the number of jobs being lost since September 11th, 80,000 since then, and we hear that an additional 30,000 or 40,000 may be coming around the corner.

When discussing the plight of the air transportation industry, we seem to only concern ourselves with the air carrier. No one is speaking of service providers. There are those who are caterers. What about those who sell tickets, who arrange the tours for us, the vacations for us, those who work in airports? I would hope that something can be done, because under the present programs, there is no federal assistance for any one of them. All we provide is for the air carrier.

Mr. Chairman, may I request that my full statement be made part of the record?

[The prepared statement of Senator Inouye follows:]

PREPARED STATEMENT OF HON. DANIEL K. INOUYE, U.S. SENATOR FROM HAWAII

Our nation's air transportation system is the backbone of our economy. The ongoing challenge we face is to ensure a safe, efficient, affordable national transportation system.

Most of our nation's air carriers were already struggling financially prior to September 11, 2001, and despite an infusion of federal aid, two of the six largest airlines have filed for bankruptcy protection.

In response to the changing economic climate, among other things, carriers reduced fares and reduced capacity. Although planes are relatively full, the amount of revenue generated from each passenger declined while costs escalated.

Airline employment is down by more than 80,000 jobs since September 11, 2001, with as many as 30,000 additional job cuts expected over the next year.

Air carriers are quick to blame labor costs as the primary cause of their financial difficulties, and have pressured labor for greater concessions.

The weak transportation sector has claimed other "victims," such as airline service providers, including caterers, airports and the travel industry that continue to experience revenue losses, with no hope for federal assistance.

I look forward to hearing the testimony today on what actions can and should be taken by air carriers and the Federal Government to ensure the viability of the U.S. airline industry and the industries that depend upon it.

Chairman HOLLINGS. It will be included. Senator Nelson.

STATEMENT OF HON. BILL NELSON, U.S. SENATOR FROM FLORIDA

Senator NELSON. Thank you, Mr. Chairman. As is the case with the State of Hawaii, so, too, in my State of Florida, air transport is critical to a $50 billion a year tourism industry. I would like our witness to address what we saw a few weeks ago in Kenya, a shoulder-mounted heat-seeking missile fired at a commercial airliner.

Were there to be such an attack successfully in the United States, what would that do? What kind of plans do you have to meet such a crisis that would no doubt ground the air transport system, with severe economic consequences?

Furthermore, in your testimony, I would like you to respond to some of the process for the loan guarantees. Roughly about 16 have applied, eight have been conditionally approved. Most of the ones that were rejected were on unanimous votes of the three-member Committee, but in one particular case, an airline that had some economic impact in Florida, it was a split vote that was to deny, and I would like to know the integrity of the process.

And in conclusion, Mr. Chairman, clearly, we have to reflect on the tragedy that occurred yesterday in North Carolina, and this Committee would extend its condolences to all the families of the victims.

Chairman HOLLINGS. It certainly will. Senator Burns.

STATEMENT OF HON. CONRAD BURNS, U.S. SENATOR FROM MONTANA

Senator BURNS. Thank you very much, Mr. Chairman.

I want to kind of look at a couple of areas that I think are important. I was interested in Senator Inouye's comments about people who write tickets, arrange tours and this type thing for tourists and also business travel. The airlines have already disregarded the agencies. They are down to where they do not make very much a ticket anyway, so we do have a problem there.

I am also concerned about, we talk about the business models of the Southwests and the Jet Blues, and those carriers, and how they have had the resiliency to survive after 9/11. That is fine and dandy, but that does not answer the question as to what do we do in our rural states for air service at all?

Before the hub system, I can remember flying out of Billings, Montana. You had three stops before you made the first transfer point or connection, and even though the advertising in Billings, Montana, you could fly to Washington, DC with what they used to be called through service, and it went through Bismarck, and through Fargo, and through Minneapolis, and through Chicago, and finally you got into Washington sometime next week.

Now, we are spoiled in this industry. The other night, I sat next to a guy, we were 5 minutes late getting into Minneapolis, and yet he complained about that 5 minutes all the way getting in there. Here we are, whirling through space at 500 miles an hour, and he is worried about 5 minutes. Maybe we should go back to the trains, and we are spoiled a little bit.

But I am concerned about what happens in rural America on flight service. I am also concerned what it costs. I can go out here at Dulles and get on the Internet and fly nonstop from Dulles to London or to Amsterdam or to Frankfurt on one-third the money it costs me to fly round-trip from here to Billings, Montana. Now, something is amiss here, and I would like to concentrate on that, and also how we are running our security, and also the taxes that are being put on the airlines to increase their cost, and what we have asked them to do for the homeland security part of this Nation. I think those are the areas that are most important to me, other than every seat occupied, and a face in every window. I believe in that kind of a business model.

But we have to take a look at these areas, and the pressures that are being—the unfunded mandate, so to speak, that has been forced on an industry that is struggling right now to survive, and I thank you, Mr. Chairman, for holding this hearing. I think it is very timely.

Chairman HOLLINGS. Thank you. Senator Rockefeller.

STATEMENT OF HON. JOHN D. ROCKEFELLER IV, U.S. SENATOR FROM WEST VIRGINIA

Senator ROCKEFELLER. Thank you, Mr. Chairman. I agree very much with Senator Nelson that the families of 5481 are very much in our minds this morning. I will put my statement in the record also, but it is virtually impossible, Mr. Shane, and thank you for your patience, but this is our first meeting and we have things we have been fighting for for years. We need to get them off our chests and into legislation, hopefully. It is impossible to overstate the impact of the airline industry on this country. We sometimes talk about it as if it were some other kind of industry that had an impact or got attention from time to time, but this is a day-in, day-out, 24–7 absolute bulwark of our economy, and it is in terrific trouble, which puts all of us in terrible, terrible trouble.

We have got a stimulus package that everybody wants to do, and where airlines are, I am not sure. The 80,000 people that have been laid off has been referred to already. This has an extremely substantial effect on the country, so we have a very important hearing.

I was interested to hear Senator Brownback say that 1½ jobs for every airline worker, I have down 18 additional jobs created in the economy for every airline worker. I don't know which of us is correct, but if either of us is correct, it is very significant.

I think this Committee should be proud of itself, the two Mr. Chairmen, for the work that we did after September 11, $5 billion in direct financial assistance, the $10 billion loan guarantee program, the $600 to $700 million per year of the FAA's war risk insurance program. Nonetheless, the industry is still in absolute dire straits.

My second point is that the airline industry is important everywhere. It is not just important at La Guardia and O'Hare and other places. It is important in small communities, like Senator Dorgan said, and there can be no let-up on this concentration, on this focus.

Most of this Nation is rural. Just a small part of this Nation is, in fact, urban. And the people of this country depend upon rural airports. I just sort of picked at random, I do not know how these came up. As airlines are struggling to deal with costs, I am looking directly at Parkersburg, West Virginia; Laurel, Mississippi; Bar Harbor, Maine; Page, Arizona; Brownwood, Texas; all places that are under desperate threat, and other communities, of losing air service as a result of the troubles.

I am not satisfied with merely fighting to maintain service. I want to improve it. That is my job. I represent my people. My people do not either receive CEOs, business people or tourists, or have them leave the state having seen something they like, unless there is air service. I mean, it is a life and death matter for the State of West Virginia. It is a life and death matter.

The airlines industry is in trouble, there are all kinds of problems, the economy is in trouble. We cannot let up, however, on small-community air service, the essential air service program, the pilot program, which has produced 40 different programs to improve airports around the state, including one in Charleston, West Virginia. I want to see not just maintenance, but also significant new rural air service, as well as taking care of the larger airports that we have discussed over the past few years, and which is necessary in order to protect the small airports.

Lastly, I think it is tremendously important that management and labor confront these issues together, and I think there is a good history of doing that, particularly recently, and that management and labor cooperatively work during these trying times for the airline industry.

I am not yet convinced on the binding arbitration approach, and in most cases all parties have demonstrated, again particularly as the crisis has riveted home, a willingness to work together and to take the difficult steps necessary to make the financial reductions at cost to everybody, at pain to everybody, but they have done it, and they have done it more frequently, more recently.

United Airlines agreed to anywhere between 7 and 29 percent wage cuts recently, and US Airways is looking at the same thing, so this kind of shared sacrifice, I think, is something which is still very much possible. It is part of the tradition. It has also been part of the problem of the airline industry, but as the airline industry has sunk deeper into problems, this has flourished more, the willingness on both sides to help, and I do want to talk with Captain Woerth and the airline CEOs to see if they can give us some sense of how that has changed and how that seems to be working.

I thank the Chairman.

[The prepared statement of Senator Rockefeller follows:]

PREPARED STATEMENT OF HON. JOHN D. ROCKEFELLER IV, U.S. SENATOR FROM WEST VIRGINIA

Thank you, Mr. Chairman, for holding today's hearing. The future of the aviation industry is critically important to the future of our economy.

I would like to say upfront, however, that my thoughts and prayers go out to the victims of yesterday's crash of US Airways Express Flight 5481 and their families. It is important to re-affirm that when it comes to aviation, safety is always paramount. It is paramount both to the health of the industry and to security. There can be no aviation security without safety.

I would like to make three main points this morning.

The first concerns the importance of the airline industry to the overall health of the economy. Our economy continues to under-perform. Unemployment is rising, corporate spending is still declining, and the stock market continues to sag. Our economic troubles have worsened to the point, in fact, that leaders on both sides of the aisle are again calling for the enactment of an economic stimulus package.

The airline industry's problems are a microcosm of the problems facing the economy as a whole—80,000 airline workers are unemployed, aircraft orders have been canceled or delayed, and airline stock prices, with a few exceptions like Southwest and JetBlue, are at 10-year lows. And Airbus—with government subsidies—has surpassed Boeing in new orders for 2002, according to recent press reports. As a result of these problems, service is being cut in some places and is stagnating in others.

What troubles me most, however, is the fact that eighty thousand employees have been laid off.

Eighty thousand layoffs—that means that there are now eighty thousand families . . .

. . . who are struggling to pay their mortgage;

. . . who may be without health insurance; and

. . . who are wondering how they're going to pay for their children to go to college.

That is why today's hearing is so timely: improving the health of the airline industry is vital to getting people back to work and to ensuring a quick and full economic recovery.

A thriving airline industry means more air carrier jobs, more aerospace jobs, more airport jobs, and more travel and tourism jobs. It has been estimated that for each airline worker, 18 additional jobs are created in our economy.

Last Congress, we took some extraordinary steps on behalf of the airlines. Shortly after September 11th, we enacted an airline bailout that included $5 billion in direct financial assistance as well as a $10 billion loan guarantee program. Then, late last year, we extended the FAA's war risk insurance program, saving the carriers another $600–700 million per year.

Nevertheless, the industry's ongoing difficulties—and their implications for the overall economy—demand our continued attention.

My second point is that a strong airline industry is also important to ensuring continued and quality service to small communities. As airlines struggle to cut costs, service to smaller communities is often the first to be scaled back. That will directly affect communities like Parkersburg, West Virginia; Laurel, Mississippi; Bar Harbor, Maine; Page, Arizona; and Brownwood, Texas.

It is important that the airlines regain their financial footing so that further reductions in service can be avoided.

I am not satisfied with merely fighting to maintain existing service, however. Quality air service is critical to supporting small business development and for generating economic opportunity. That is why I am committed to *increasing* the number of communities served and *enhancing* the service that already exists—even as we restore the health of the industry.

I intend to explore additional ways in which we can expand air service in rural areas. That means considering new funds for Essential Air Service, expanding the Small Community Air Service Pilot Program, considering other small community air service initiatives like tax incentives, and increasing funds for rural airports.

Significant new rural air service legislation is overdue and I hope to work with my colleagues on a bipartisan basis to accomplish this goal.

That is but one of our key challenges this year. We must also remain committed to re-establishing the strength of this industry. I look forward to re-examining the Air Transportation Stabilization Board. Before deciding whether to extend this program, however, we must determine whether the board has done the job we asked it to do.

I am open to considering any and all proposals for helping this ailing industry. However, I am skeptical of the idea—which some have suggested—that all security costs be shifted entirely to the federal budget. I believe we must move forward with the understanding that security is a shared responsibility between the Federal Government and the carriers.

Lastly, it is important to mention how essential it is that management and labor confront these issues together and work cooperatively during these trying times for the airline industry. In most cases, all parties have demonstrated a willingness to work together and take the difficult steps necessary to restore financial health. At United Airlines, for example, various worker groups have agreed to wage cuts between 7 and 29 percent.

It will take this kind of shared sacrifice to make this industry strong again, and everyone will have to play their part.

I hope that Mr. Woerth and the airline CEOs can provide us more details on how changes are taking place.

The topic of today's hearing is critically important, both for the health of our economy and for the ongoing prosperity of small communities. Thank you again, Mr. Chairman, for holding this hearing. I look forward to hearing from our witnesses.

Chairman HOLLINGS. Senator Fitzgerald.

STATEMENT OF HON. PETER G. FITZGERALD, U.S. SENATOR FROM ILLINOIS

Senator FITZGERALD. I have no opening statement, Mr. Chairman.

Chairman HOLLINGS. Very good. Let me just comment on one thing with respect to that crash in my backyard, and our friend Senator Burns mentioned in the pricing, everyone should understand that when that occurred, I was immediately concerned because I knew there would be residents of South Carolina on that plane, at least some that had come up for Senator Lindsey Graham's swearing in, because that is in his immediate backyard.

None were residents of South Carolina. Why? Because the residents of South Carolina, Senator, they know when they get to Charlotte, it is cheaper and quicker in a sense to just go rent your car and drive down to Greenville-Spartanburg Airport. That is the pricing this crowd has got. They drive from Columbia up to Charlotte to save money and everything else of that kind.

What the airlines have been doing is really losing business, and the nonresidents do not realize that, and that is in large measure about this loss. My deepest sympathy to the families of the 21 lost.

Otherwise, we welcome, the Committee is privileged to have our Assistant Secretary of Transportation, Mr. Jeffrey Shane. Secretary Shane, we have your full statement. It will be filed for the record. You can deliver it in full, or highlight it, if you wish. I think maybe highlighting it would save, as we have a very important panel to follow you.

STATEMENT OF JEFFREY N. SHANE, ASSOCIATE DEPUTY SECRETARY, DEPARTMENT OF TRANSPORTATION

Mr. SHANE. Thank you very much, Chairman Hollings, and then I will, indeed, summarize the statement. I realize time is short and there is an important panel behind me, so I would like to hear what they would have to say as well.

Thank you, Chairman Hollings, incoming Chairman McCain, other Members of the Committee. It is a very special privilege to be here to represent Secretary Mineta before you and to discuss the state of the airline industry, an industry vital to our way of life and to our economic well-being, and to offer some comments on its future.

Senator BURNS. Mr. Secretary, could you pull that microphone a little closer to you?

Mr. SHANE. Is that working better?

The airline industry remains stuck in the most difficult period of financial distress it has suffered since it was deregulated almost 25 years ago, perhaps the most difficult period in modern aviation history. The industry as a whole has experienced enormous losses for two consecutive years and will almost certainly experience them again this year. Among those most severely affected by this downturn, of course, are the tens of thousands of airline industry employees who have been furloughed or laid off, a great many businesses that depend upon the airlines are also suffering as a direct result of the industry's difficulties.

Not the least, of course, as Senator Brownback has said, are the manufacturers, and not just the manufacturers of airplanes, of course, but the manufacturers of all the components of airplanes. We are talking about thousands of businesses throughout the country.

The terrorist attacks on 9/11 contributed heavily to the industry's losses since that time, but changes that were underway well before 9/11 had already begun to reverse several consecutive years of record profitability. Those changes have set the stage for a likely realignment of the industry, the nature and magnitude of which will likely depend on the extent to which network airlines can reduce their operating costs, and the extent to which business travel rebounds.

Hints of that possible restructuring can be observed in the two very different types of carriers that have evolved in the deregulated domestic airline industry, large network carriers on the one hand, and low-cost, low-fare carriers on the other. For the most part, these two types of airlines have served different types of markets, have different business strategies, and focus on different customers, even when they operate in the same geographic areas.

The financial turmoil of the large network airlines is due, in part, to a rapid cost escalation that occurred in their sector of the industry during the 2-year period preceding September 11, combined with a serious decline in the business travel market that their model so heavily relied upon.

Today, each of these airlines operates substantially less capacity than before 9/11. After a period of partial capacity recovery in the months following that day, the network carriers appear to be reducing capacity once again.

Lower-cost carriers, on the other hand, are earning profits, expanding operations and are, in fact, gaining market share. Even in this period of weakened demand, it seems people will fly if the price is right. Carriers whose cost structures allow them to charge lower prices and still earn profits, therefore, are actually experiencing traffic growth even in today's market.

During calendar year 2001, the major network carriers, plus a group of low-fare airlines, incurred operating losses of $10 billion, and we estimate that total losses in 2002 will be approximately $9 billion. Senator Hutchison said $7 billion for 2002, but I think that is based on the numbers that are available as of today. By the time we get the numbers for year end, we think it will be closer to $9 billion.

Those are industry-wide figures. When we break those numbers down by carrier type, we see again the ability of lower cost carriers to maintain earnings even in the current environment. While the six largest network airlines reported operating losses of $10.2 billion for calendar year 2001, the low-fare carriers as a group reported an operating profit of about $.7 billion, $700 million, and it is important to point out that this profitability extended beyond just Southwest Airlines. Five of the seven low-fare carriers that we examined reported operating profits in 2001.

Even though low-fare carriers, AirTran, American Trans Air, Frontier, Jet Blue, Spirit, and Southwest, experienced capacity reductions immediately following 9/11 just as the large network carriers did, the low-fare carriers quickly recovered. In fact, by March of this year, those airlines will have increased capacity by a total of 31 percent over the previous 2 years, with every carrier except Southwest showing, in fact, a double-digit increase. As a result, we project that the low-fare carriers' share of overall industry capacity will increase by nearly half, to 18.2 percent of the overall market by March of this year.

Nobody, of course, can make very firm predictions about the ultimate configuration of this constantly changing industry, still, it seems reasonable to predict that the changes that have occurred during this period of unprecedented challenge will leave the low-cost, low-fare side of the industry with a larger share of the market than they have enjoyed before.

I wanted to speak a little bit about responses of the government, Mr. Chairman, but I think in the interest of time, I will even make that a quicker summary. I was going to talk about things that Members of the Committee have mentioned, the importance of the legislation which created the Transportation Security Administration, the important congressional deadlines that were established to increase security. I agree with Senator Hutchison, there can be no overstating the contribution which that security legislation made to the well-being of the airlines and their ability to survive this period of challenge.

We do argue a lot about the cost of security. The fact is that, without that security, the traffic that they experience today would be much less than it is. That is my conviction, and I think that is the only reasonable conviction anybody could achieve.

We have achieved all of the deadlines. Secretary Mineta deserves enormous credit for that. The TSA and the FAA, and all of the workforce deserve enormous credit for that. The airlines themselves deserve enormous credit for that, and the traveling public deserves our thanks for the patience and endurance that they have shown through the growing pains, through all of the difficulties that they experienced early on.

I think what they experience now is the most secure system they have ever had. There is efficiency in the system once again. I think it is fair to say that the waits to get through the queue to get onto an airplane are not longer than they were before 9/11, and that is an enormous tribute to Admiral Jim Loy and the entire TSA screening force in the Transportation Security Administration.

The ATSB, which I am sure we will talk about in Q's and A's, is another important contributor to the state of the airline industry right now, and I will not say more about it. I am sure we will have a discussion of those procedures and what the impact has been.

And finally, what I will just say quickly is that we have been working for the last several months on a package that we will propose to the Congress sometime later in the spring for reauthorizing AIR–21, that is to say the aviation program's authorizing legislation, which will run out by the end of this fiscal year, by the end of September of this year, and which needs to be reauthorized by that time.

What we are hopeful we will be able to do in bringing that legislation to your attention is offer ideas that will, again, help to contribute to the recovery of this industry, to ensuring that while we look forward to recovery, we maintain competition, expand capacity, and look forward to a robust future in the industry.

In closing, let me just say that the coming months will clearly be challenging ones as the airline industry continues to recover from the economic downturn, and to adjust to the post 9/11 atmosphere. We can be confident that a broad-based recovery will eventually occur, but it is, of course, difficult to predict with confidence when.

While the Department is generally hopeful about the future of the industry, and while we expect it to emerge from its current troubles, some important variables will have a big impact on the timing of that re-emergence, the price of fuel, the possibility of war in Iraq, the timing of a rebound in demand among business travelers, the continuing challenge of maintaining security and, of course, the availability of capital to this industry.

Mr. Chairman, Members of the Committee, thank you very much for the opportunity to testify here today. I certainly look forward to answering your questions.

[The prepared statement of Mr. Shane follows:]

PREPARED STATEMENT OF JEFFREY N. SHANE, ASSOCIATE DEPUTY SECRETARY, DEPARTMENT OF TRANSPORTATION

Chairman McCain, Ranking Member Hollings, and Members of the Committee, I appreciate the opportunity to appear before the Committee to discuss the state of the airline industry and to offer comments on its future.

Improved Aviation Security

Before I begin, however, I would like to reflect for a moment on where we have been since the horrific attacks on our country in September 2001, and the steps that the Department of Transportation has taken to secure airline passengers since that time. One year ago the Transportation Security Administration (TSA) had just been established, yet three very important and challenging congressional deadlines were prominent on our minds—those by which the Federal Government was to assume responsibility for aviation security, provide federal screeners for all passenger screening, and ensure 100 percent baggage screening at all commercial airports in this country.

In setting those deadlines—and a great many others—in the Aviation and Transportation Security Act, Congress made clear that it would accept nothing less than a major overhaul of our aviation security system, and a dramatic improvement in the quality of security for air travelers. The measures defined in the legislation and the deadlines associated with them were extremely ambitious, leading a great many observers to question whether they were simply beyond reach.

On behalf of Secretary Mineta, I am proud to report that as of last week those deadlines have all been met. The fact that the Department was able to do so is a credit to TSA's leadership and workforce, to the Federal Aviation Administration (FAA), airport and airline communities, and to the contractors that provided critical advice and support in connection with accomplishing the statutory objectives as efficiently as possible. In meeting these deadlines, we have made every one of the nation's more than four hundred commercial airports—and everyone who flies—safer and more secure than they have ever been. We have done so while also providing world-class customer service to the traveling public by treating people with dignity and courtesy. TSA's leadership, and in particular Admiral Jim Loy, have rendered a great service to our nation.

But so have the millions of air travelers whose cooperation—particularly during the growing pains experienced earlier in the process—has been instrumental in accomplishing our goal. If all these sacrifices had not been made, we would not have reached our current level of security in the aviation system in such a short timeframe.

Airlines in Distress

Despite the very real success we have enjoyed on the security front, however, the airline industry remains in the midst of the most difficult period of financial distress since it was deregulated almost 25 years ago—perhaps the most difficult period in modern airline history. The industry has suffered enormous losses for two consecutive years, and will almost certainly experience them again next year. Most airlines continue to incur large financial losses, several airlines are in bankruptcy, including two large network carriers—US Airways and United—and several smaller airlines have ceased operating. At the same time, however, a number of low-cost, low-fare airlines have remained consistently profitable.

The terrorist attacks on September 11, 2001, certainly contributed heavily to the industry's losses since that time. But changes underway well before September 11 had already reversed several consecutive years of record profitability. Indeed, the decline in industry profitability for the year ended June 30, 2001, compared with a year earlier, was the largest year-over-year decline ever up to that point in time. These changes had already set the stage for a significant restructuring of the industry, but additional changes are clearly coming. The nature and magnitude of those changes will likely depend on the extent to which large network airlines are able to reduce their operating costs, and the extent to which business travel rebounds as the economy gains momentum.

I should add at this point that while there is reason to be concerned about the current viability of the airline industry, I am not discouraged about its prospects for ultimate recovery. This industry is remarkably resilient. During the early 1990's, a combination of an economic recession and terrorist-related concerns stemming from the Persian Gulf War led to large traffic declines, record losses, and a number of bankruptcies. Yet the airline industry emerged from that period rather quickly, and during the mid-to-late 1990's went through several years of record profits.

Before turning to an in-depth look at the industry's current circumstances and what the future may hold, a brief description of how the operational and competitive structures of the industry have evolved will help us understand the mixed results we are seeing today within the industry, and provide some guidance about likely changes as the industry moves through this very stressful period.

Two very different types of carriers have evolved in the deregulated domestic airline industry we see today—large network carriers and low-cost carriers. Generally speaking the former are pre-deregulation carriers and the latter are new airlines that evolved after deregulation. To a great extent these two types of airlines serve different types of markets, have different business strategies, and focus on different customers, even when they operate in the same geographic regions.

Network systems developed by the large pre-deregulation airlines enable them to provide effective, competitive service to small cities within this country and from all U.S. locations to cities of all sizes around the globe. These airlines have higher cost structures and tend to focus on business travelers as their primary customer base. They have focused their operations on serving the needs of this high-yield segment of the market rather than providing capacity for lower-yield, price-sensitive passengers. The substantially lower costs of low-fare airlines enable them to provide capacity for the latter market—price-sensitive passengers—and to price compete for time-sensitive passengers who are otherwise faced with substantially higher prices.

I bring these two sets of characteristics to your attention because of the very divergent experience of these two types of carriers as the industry moves through these hard times, and because of the implications for future change as a result. The financial turmoil of the large network airlines is due in large part to the rapid cost escalation that occurred during the two-year-period preceding September 11, combined with the decline of the business market that their model so heavily relied upon. Today, each of these airlines operates substantially less capacity than before September 11, and after a period of partial capacity recovery in the months after September 11, these carriers are reducing capacity once again.

But while the network carriers are suffering losses and downsizing their operations, the lower cost carriers are earning profits, expanding operations, and gaining market share. This reflects the fact that despite weakened overall demand, the low-fare demand sector is so large that airlines that have sufficiently low costs to allow them to charge low fares and still earn profits continue to experience robust traffic growth.

Recent Financial Performance

The recent financial performance of the airline industry overall is, by any measure, dismal. My testimony today focuses on the performance of the major network carriers, plus a group of low-fare airlines, that together comprise the vast majority of domestic airline operations.

During calendar year 2001, these carriers incurred operating losses of $10.0 billion on revenue of $85.8 billion, for a negative operating margin of 11.6 percent. During the fourth quarter alone—immediately following September 11—these carriers posted a $4.5 billion operating loss on revenue of $16.8 billion, a decline of 30.8 percent from the fourth quarter of 2000.

The picture improved somewhat for the first six months of 2002, although very large operating losses ($4.3 billion) persisted. The pace of the industry's recovery stalled in the second quarter, however, and as a result, losses continued into the third quarter ($2.3 billion), typically the industry's most profitable. For the first nine months of 2002, these airlines experienced, in the aggregate, a total operating loss of $6.7 billion. They are likely to experience further losses in the range of $2.4 billion for the fourth quarter, bringing total losses for last year to approximately $9.0 billion.

Looking at financial results on an industry-wide basis does not tell the full story, however. Rather, looking at the results in greater detail reveals markedly different pictures for different types of carriers: large network carriers versus low-fare carriers, and even between the larger network carriers, with the higher-cost carriers reporting much larger losses.

For example, the six largest network airlines reported operating losses of $10.2 billion for calendar year 2001, and had a negative operating margin of 13.9 percent. The low-fare carriers as a group, by contrast, reported an operating profit of $0.7 billion, or a positive operating margin of 10.8 percent. It is important to point out that this profitability extended beyond just Southwest. Five of the seven low-fare carriers we examined reported operating profits for 2001. These clear differences between the large network airlines and the low-fare airlines continued throughout the first nine months of 2002.

Similarly, the large network carriers with the highest unit operating costs—American, United and US Airways—reported far larger losses than the other large network carriers throughout 2001 and into 2002. By the third quarter of 2002, while Northwest and Continental were reporting a small operating profit and a small operating loss, respectively, the three higher-cost carriers continued to report very large losses, resulting in negative operating margins ranging from 10.5 percent to 30.3 percent.

Changes in Industry Composition

As I mentioned earlier, large network airlines are reducing capacity while low-cost carriers are expanding operations and increasing market share. Given the thin margins that normally prevail in this industry, even relatively small market share shifts have important consequences. The changes that have occurred during this crisis, however, could have a longer term impact on the make-up of the airline industry.

We are witnessing a large-scale decline in capacity in the mainline operations of large network airlines, a decline that is being replaced only in part by expanded operations of their regional affiliate airlines. For example, comparisons of scheduled capacity—using available seat miles (ASMs)—for the months of March 2001 and March 2003 shows an 18 percent reduction for these carriers, with all six carriers except Northwest reducing capacity by double-digit percentages. While the bulk of this capacity decrease took place between 2001 and 2002, it is continuing into 2003. A slightly different picture emerges, however, when looking at the major carriers' regional affiliates. These carriers also showed capacity reductions between March 2001 and March 2002, but between the March 2002 and March 2003 their scheduled capacity shows an increase of 26 percent.

Scheduled capacity for low-fare carriers, on the other hand, recovered much more quickly after the September 11 attacks. These carriers—including AirTran, American Trans Air, Frontier, JetBlue, Spirit, and Southwest—also experienced capacity reductions immediately following September 11, but by March 2002 their scheduled capacity had more than fully recovered and was up 13 percent over a year earlier. These carriers' capacity is continuing to increase, resulting in a total increase from March 2001 to March 2003 of 31 percent, with every carrier except Southwest showing a double-digit increase. As a result, the low-fare carriers' ASM share will increase from 12.5 percent in March 2001 to 18.2 percent in March 2003, an increase in market share of almost 50 percent.

The Federal Government's Response

In response to the difficulties faced by the airline industry over the last two years, Congress has passed several important pieces of legislation designed to facilitate recovery. I want to offer a brief progress report on the implementation of these provisions.

Loan Guarantee Program: The Air Transportation Safety and System Stabilization Act established the Air Transportation Stabilization Board (ATSB) to review and decide on applications for loan guarantee assistance, with a total of $10 billion provided for potential U.S. Government-backed loan guarantees. Sixteen airlines filed applications by the June 28, 2002, deadline, and the ATSB has approved and finalized three loan guarantees to date. The first was a $380 million loan guarantee to America West Airlines predicated on the carrier receiving a term loan of $429 million and more than $600 million in concessions from its shareholders, employees, creditors, and suppliers. In addition, the ATSB also approved and finalized a $148.5 million loan guarantee for American Trans Air supporting a $165 million secured loan and a $40.5 million loan guarantee to Aloha Airlines in support of a $45 million loan.

The ATSB has conditionally approved three other loan guarantee applications for US Airways, Frontier Airlines, and Evergreen International Airlines, but to date none of the carriers has finalized their loans. US Airways received conditional approval for a $900 million loan guarantee to support a $1 billion secured loan. Because US Airways is reorganizing in bankruptcy under Chapter 11, the conditional approval remains in effect subject to the conditions set forth in the Board's July 10 letter to the airline and the bankruptcy court's confirmation of a reorganization plan. The Board will review the reorganization plan when it is presented and determine whether it meets the conditions for issuance of a guarantee. As set forth in the OMB regulations governing the loan guarantee program, final action on the application will be made in conjunction with the carrier's Bankruptcy Court-certified plan for emerging from bankruptcy.

Frontier Airlines received conditional approval for a $63 million loan guarantee to support a $70 million loan, subject to the carrier providing additional fees and warrants and completion of final loan documents satisfactory to the Board. Evergreen International Airlines received conditional approval for a loan guarantee of $90 million in support of a $100 million loan for that carrier. Similar to Frontier, Evergreen's conditional loan is subject to the carrier providing additional fees and warrants and completion of final loan documents that are satisfactory to the Board. Evergreen's conditional loan guarantee is also subject to resolution of issues related to Evergreen's indebtedness and certain structural and financial enhancements.

The ATSB has rejected seven loan guarantee applications, including those submitted by Vanguard Airlines, Frontier Flying Service, National Airlines, Spirit Airlines, Corporate Airlines, MEDjet International, and Great Plains Airlines. The ATSB was concerned in most of these cases that these applicants' proposals did not provide a reasonable assurance that the carriers would be able to repay the loans, one of the factors the ATSB is required to consider under the OMB's regulations.

In addition, on December 4, 2002, the ATSB decided that it could not approve the proposal of United Airlines for a $1.8 billion loan guarantee, based on its conclusion that the business plan, as submitted by the company, was not financially sound. United subsequently filed for reorganization under Chapter 11 of the Bankruptcy Act on December 9, 2002, and because the Board never formally rejected or denied United's proposal, the airline can still revise its application with the ATSB. However, as the carrier is now under Chapter 11 bankruptcy reorganization, any approval of a loan guarantee to United could be made only if the guarantee and the underlying financial obligation is part of a Bankruptcy Court-certified reorganization plan for emerging from bankruptcy. Given United's situation, this matter most likely will not be resolved in the near term.

The ATSB is currently examining two other loan guarantee applications from Gemini Air Cargo for $29.7 million and World Airways for $27 million.

In summary, of the $10 billion in loan guarantee authority made available by Congress, loan guarantee applications approved to date, or conditionally approved, represent a total of $1.6 billion. Applications still pending, together with further consideration of United's application, would represent as much as $1.9 billion in further loan guarantees. Total potential exposure under the loan guarantee program is therefore likely to be on the order of $3.5 billion.

Direct Compensation Program: The Air Transportation Safety and System Stabilization Act also provided for $5 billion in direct compensation to the airline industry. The application of this law extended beyond the large commercial airlines to thousands of smaller direct and indirect air carriers. More than 450 applications for compensation were submitted to the Department and, to date, over 400 air carriers have been paid $4.6 billion in compensation.

Total compensation provided under this statute is likely to be approximately $4.7 billion because some carriers didn't incur sufficient losses to qualify them for a full share of the $5 billion compensation. Most large passenger airlines have received the maximum amount of compensation authorized by Congress. At this time, the only carriers awaiting full payment are those that filed either incomplete or delinquent applications, a small number whose claims continue to be disputed, and small carriers whose compensation was changed by the Aviation and Transportation Security Act.

War Risk Insurance: With respect to war risk insurance, the FAA has been providing third party war risk coverage to U.S. passenger and freight carriers since shortly after September 11, 2001. The Homeland Security Act of 2002 mandates that this coverage be continued and expanded. Specifically, the Act requires that these policies be renewed on the same terms as the policies that were in effect on June 19, 2002, and that they be expanded to include coverage for hull, passengers and crew. In addition, an air carrier's total premium for all of the coverage can be set at no more than twice the premium in effect on June 19, 2002, and the coverage must begin with the first dollar of any covered loss incurred. Using existing authority—because the Act's provisions are not effective until January 24, 2003—the FAA implemented these changes when it extended the air carriers' policies on December 15, 2002, for another 60 days. After January 24, the FAA will continue to offer coverage as required by the Act.

Other Programs: In addition to the programs that have been approved by Congress since the September 11 attacks, the Department continues its work in a number of other areas to ensure a healthy aviation industry. For the past several months, teams of individuals from across the Department have been developing potential ideas to include in the Administration's AIR–21 reauthorization proposal, which we intend to submit to Congress later this spring.

We are also continuing our work in promoting safety in the industry. We are mindful of the tragic crash that occurred in Charlotte yesterday and offer our condolences to the families of those individuals involved. Nevertheless, flying on commercial airlines continues to be the safest way for Americans to travel. As you may know, in calendar year 2002, for the third time in the last decade, there were no recorded deaths aboard scheduled commercial aircraft. As Secretary Mineta has pointed out, while we have built unprecedented new levels of security into our system, it also has retained its status as the safest system in the world. We compliment all those involved in ensuring the safety of the flying public, each of whom can take pride in this impressive accomplishment.

Finally, while the congestion experienced in the summer of 2000 seems a rather distant memory, we need to carefully evaluate the capacity that the aviation system will require in the years ahead. One way in which the Department is working to enhance capacity is through an environmental stewardship initiative launched by President Bush last fall. Late last year Secretary Mineta identified the first group of projects, including Philadelphia International Airport's proposed new runway, that have been selected as targets for accelerated environmental review. A number of other airport sponsors have submitted their projects for consideration under this initiative, and we plan to announce another set of targeted projects in the near future.

Industry Outlook

The prospects for revenue recovery in the airline industry will need to be closely watched as carriers continue to recover from the September 11 attacks and as some work to emerge from bankruptcy. If this downturn is like others we have seen in the past, significant revenue recovery will eventually occur, but how much and when remains to be seen. The airlines' recovery has clearly stalled somewhat since early 2002, and industry observers do not expect any significant improvement in the near future.

Other factors further complicate the revenue picture for the large network carriers. First, while a core element of their business model has been the pursuit of high-yield business travel, studies show that this market is becoming more price sensitive, and it is quite possible that the revenue potential for this portion of the market may have declined permanently.

Second, the decline in business demand coincides with a sharp increase in network airline unit costs, which opens a wider spread between their costs and the costs of their low-fare competitors, several of which are expanding their services. This began in 1999, well before September 11, and even before business travel demand began to collapse in early 2000.

Third, whether or not the business market remains more price sensitive, the ability of the network carriers to charge high fares is gradually being eroded by the expansion of low-fare carriers. Every time a low-fare carrier enters a market with enough service, the ability of the incumbent network carrier to charge business passengers high prices substantially declines. For many years low-fare competition was primarily limited to large, short-distance markets, but this is no longer the case. Low-fare service has been introduced in transcontinental markets by several carriers, particularly JetBlue, and into lower density markets by carriers like AirTran, which now operates a low-fare hub at Atlanta.

The challenge faced by large, networking carriers is clear: the continued profitable growth of several low-fare airlines demonstrates that people still want to fly. While major carriers have been seeking ways to restructure their operations—including capacity reduction, fleet retirement, cancelled or deferred orders for new aircraft, furloughed employees, closed stations, and hub de-peaking—it will take time for such efforts to produce major results. Moreover, absent major reductions in labor costs it is unclear whether these efforts will produce the cost savings necessary for the large network airlines to maintain their current position in an increasingly competitive airline industry.

The coming months clearly will be challenging ones as the airline industry continues to recover from the economic downturn and to adjust to the post-September 11 atmosphere. We have been encouraged by the steps being taken by major carriers to address their cost structures. As a result, the industry model likely to emerge from the current economic cycle will probably not be terribly different from its pre-September 11 predecessor. The success demonstrated by low-fare carriers in recent years, however, could cause more fundamental structural changes in the longer term, especially if the large, network carriers are unable to control their costs.

Conclusion

Mr. Chairman and Members of the Committee, thank you for the opportunity to testify here today. I look forward to responding to any questions you may have.

Chairman HOLLINGS. We do have good attendance this morning, and so I will cut my questions short.

Secretary Shane, by just going to the money, now, we authorized $500 million to harden the cockpit doors and other security measures. What about that money?

Number one, we had a deadline for April of this year, 2003, on the hardening of the doors. Otherwise, there have been other bills for security measures that we have authorized or appropriated for that they have sent their bills to the Department of Transportation, to you, and they are just waiting for their money. Can you tell us about paying the bills, and sufficient money, or more that is needed? That is what the Committee wants to know about.

Mr. SHANE. Yes, Mr. Chairman. On the cockpit doors, the President's budget for fiscal 2003 contained $100 million, I believe, which would be money available to the airlines today, and will be available to them as soon as we have a budget, so I am confident that when the appropriation is done, that money will be going out.

On the other very important bill that we paid, it was, of course, the compensation that was due under the stabilization legislation, and I am happy to tell you that of the $5 billion, something like $4.7 billion have already been paid out, and I believe—I will check and will correct this for the record if I am not correct, but I believe that all of the money that can be paid out has been paid out. In other words, everybody that is entitled to anything under that legislation under the law as it was written has received from the Department of Transportation what it is entitled to.

Chairman HOLLINGS. But other security needs, now, the Committee found a need for $500 million, and you say there has been appropriated $100 million. Is $100 million sufficient?

Mr. SHANE. The President's budget contained a request for $100 million, and I have to believe that the conclusion that we made within the Administration was that $100 million would be closer to the mark. I cannot give you more detail than that right now, but I will certainly be able to improve the record after checking.

Chairman HOLLINGS. Very good. Senator McCain.

Senator MCCAIN. Thank you, Mr. Chairman.

Thank you, Mr. Shane. In your testimony, you point out that the six largest network airlines reported operating losses for the calendar year 2001, and that is obviously true of 2002, and yet the low-cost carriers as a group reported an operating profit. The difference is in labor costs, is that right?

Mr. SHANE. Not entirely.

Senator MCCAIN. What is the major difference?

Mr. SHANE. I think it is a combination of lower operating costs overall. Southwest Airlines, I think pays something like the scale that the large networking carriers pay. It moves its airplanes much more efficiently, and it can do that given the nature of the business model that they pursue, so they get much more utility out of their assets.

There well may be lower labor costs in a whole variety of the other low-fare carriers. I have no doubt, especially the new ones coming on would be able to enjoy that benefit at least for a while, so that has something to do with it.

Senator MCCAIN. Well, is it an indictment of the hub-and-spoke system?

Mr. SHANE. It is difficult for me to imagine a national airline industry in this country without a hub-and-spoke system, if, indeed, we are supposed to have service to the small communities.

Senator MCCAIN. But yet, Southwest does not use the hub-and-spoke system.

Mr. SHANE. Correct.

Senator MCCAIN. And they are all over the country.

Mr. Shane, a January 3 editorial in the *New York Times* stated that Congress could do a great deal to help the airlines if it lifted protectionist limits on foreign investment in U.S-based airlines. That would stimulate competition and provide troubled carriers with fresh sources of capital. What is your position on lifting the limits on foreign investment?

Mr. SHANE. My position for many years is that it seems strange in this day and age to have a law that actually limits the access that U.S. airline companies have to the global capital market. That is the net impact of our restrictions today. There are a whole host of issues that would have to be examined with the relaxation of the current limits on foreign investment in U.S. airlines, but overall it seems to me it is a debate we really need to have. There is no reason to restrict the access to the extent that we do to the global capital market today.

Senator MCCAIN. I received a letter from the American Antitrust Institute, which bills itself as an independent nonprofit research education and advocacy organization, supporting the laws and institutions of antitrust. The president of this organization believes that current domestic alliances go beyond simple code-sharing. He says that the relationship set up by domestic alliances, and referring specifically to the Delta-Continental-Northwest plan, require continual and intimate coordination of virtually all aspects of operation, and are intended to provide the consumer a seamless experience.

He states that this proposed alliance is uncomfortably close to being a three-way merger, and it is likely to put the remaining non-allied carriers, American, Southwest, and other small, low-cost carriers, at a competitive disadvantage that will result in fewer choices for the consumers.

Do you have a position on this?

Mr. SHANE. Yes. I think that with every one of the alliances that is proposed, the Department has an absolute obligation to review precisely those issues and, indeed, that is what we are doing currently in the context of the Delta-Northwest-Continental proposal.

Delta, Northwest, and Continental are impatient with the Department because we have been looking very closely at those issues. I am confident that we are going to come to closure in our review of that alliance, and will be in touch with the proponents of the alliance very shortly, but it has taken us a while because of the very important responsibilities that the Department has under the law.

Senator MCCAIN. You point out that the large network carriers with the highest unit operating costs, American, United, and US Airways, reported far larger losses than the other large network carriers. In fact, by the third quarter of 2002, Northwest and Continental were reporting a small operating profit and a small operating loss respectively, while the three higher-cost carriers were reporting very large losses. Can the airlines bring down the costs on their own, and what do you see is the difference here?

Mr. SHANE. It is difficult to comment on the differences because one would have to know an awful lot about the internal management of airline companies, and from the vantage point of the Department——

Senator MCCAIN. Is the moral of the story that every airline does not have to be unprofitable?

Mr. SHANE. That is quite correct, and what I see happening in the industry right now is a widespread recognition, even among the highest cost carriers, that their cost structure is not sustainable in the current market or any future market one can imagine, so there is a wholesale effort right now on the part of every carrier, and I think we will all hear a lot more about it from the CEOs that will be on the next panel themselves, a wholesale effort to reduce cost, and more draconian measures taken in that regard than we have ever seen before.

Senator MCCAIN. The industry is asking for tax relief. Should we consider that?

Mr. SHANE. There has been an enormous contribution to the airline industry through the kind of compensation and loan guarantee legislation that has been made available thus far. The Administration's position, I am sure, is that tax relief is not an appropriate measure to take at this particular moment.

Senator MCCAIN. Under the present environment, do you believe there is inevitably going to be more consolidation in the airline industry?

Mr. SHANE. I think it is reasonable to expect there will be some proposals in that regard. Again, it is difficult to predict, given all the variables we have in front of us. I do not see the industry consolidating down to just a few airlines. I think the evidence to date is just the reverse, that we will see a proliferation of new airlines in the event that we have some failing carriers, or even some consolidation in the industry.

Senator MCCAIN. Well, in answer to my question, you have come up with some responses that will require legislative action, and I would hope to hear from the Administration on some of these proposals so we can consider them and act on them if necessary.

Thank you, Mr. Chairman.

Chairman HOLLINGS. Thank you. Senator Brownback.

Senator BROWNBACK. Thank you, Mr. Chairman. Mr. Shane, thank you for being here, and you heard my comments about the aircraft manufacturing industry. That is what I want to point my questions toward if I could, and I recognize it would probably be better if it was toward the USTR, or the Commerce Department. I think I referred to you as the Commerce Department. I apologize for that, but I would like to get your responses.

2001, we had Boeing Aircraft deliveries 527. This year is projected 275 to 285. If that holds true, that would make the Boeing Company in second place behind Airbus for production for the first time. As domestic airplane manufacturers were bracing for losses, and despite a downturn in the global aviation market, Airbus was announcing last August plans to increase their industrial presence in the United States.

Have you looked at this issue? Is Airbus subsidizing their way into taking more and more of this global market production share at a time when the market is in a downturn?

Mr. SHANE. I cannot report to you any detail on that. The Administration is taking it very seriously. It is a worrisome development, and as you know, Senator, there is an understanding with our European colleagues, the large aircraft sector understanding, which was signed in 1992, which was supposed to establish the framework in which large aircraft sales are pursued.

It may well be—and you are quite right, this is the province of USTR, and so I want to be careful about not getting too far out of my depth here, or out of my jurisdiction, more importantly, but we will certainly be in touch with USTR to take a close look at these trends, and to determine whether or not some further action or some response is required.

Senator BROWNBACK. I talked directly with a number of aircraft manufacturers, and they cannot believe that Airbus could be making money during this time period when there is such a downturn globally in aircraft production, and they just see it as the only way you can do that is to have it heavily subsidized from outside sources, from government sources, for them to be able to take that over.

And this has been a long-term fight. We have been in this for some period of time, but I really think the Administration has to step up on the trade field here and press Airbus, and press the European Union about this, and I hope you will push that within the Administration. I certainly will be.

If I could, one other issue I wanted to focus you towards is the Commission on the Future of the U.S. Aerospace Industry and its final report to Congress. Are you familiar with that report?

Mr. SHANE. I am, Senator, yes.

Senator BROWNBACK. The recommendations in that, they are basically saying, look, we have pushed our research a lot more into space, space research, but we have not pushed much research into the aerospace industry that we have presently, and we need to do more in that sector. What are your thoughts about that, and that of the Administration?

Mr. SHANE. I think one of the big worries that we have in the current downturn in this terribly challenging environment is that we will forget, because we have a trough in demand, that we have an absolute obligation to maintain the movement toward greater capacity in the system. If we are going to get through this, and when we get through this, we are going to have more demand that we can accommodate in the present system, as we did as recently in the summer of 2000. It is terribly important not only that we continue to build runways at airports, but that we use technology as intelligently as possible to make sure that we are extracting as much capacity out of the present system as we can. That is what the aerospace commission was talking about, and I am fully in support of that. I think the Commission should be complimented on focusing attention on some issues that have not been getting top-level attention up to now, and I am hopeful that they will.

Senator BROWNBACK. What about the area of basic research in the aviation industry? What are your thoughts on what the report says on that?

Mr. SHANE. Well, the basic research into avionics—do you mean about the actual flying of an airplane?

Senator BROWNBACK. They had it on avionics, on wing design, on more efficient engines, and then also on the systems to be able to land aircraft safely, successfully, and quicker as a part of that as well, the landing systems as well.

Mr. SHANE. I think we need to ramp up our efforts in that regard. I think we really need to begin to point toward a system that is going to deliver the kind of major increment in capacity that we are going to need beyond 2020. We know that the Europeans have a plan. They call it the Vision for 2020.

We have got some plans on the shelf in the United States as well. There are some interesting ideas about what the air transportation system should look like and what the air traffic control system should look like, but what we do not have right now, I think, is the quality, the sort of centralized initiative that will take us to the goals which a lot of people in the industry and observers of the industry believe we should be heading toward, and I am hopeful we are going to be able to deliver that in the near-term.

Senator BROWNBACK. Thank you, Mr. Shane, for your input.

Chairman HOLLINGS. Senator Lott.

Senator LOTT. Thank you, Mr. Chairman, and thank you, Secretary Shane, for being here.

You had indicated that the Administration would have some proposals to be considered in the reauthorization by sometime this spring. I would like to urge you to—I know you have got a lot you are working on, a lot of issues, and they are very important, but I hope that you will not wait too late into the spring, because this is something that I think the Committee will want to consider earlier rather than later, even though the House has got to decide what their schedule is going to be, but I hope you would make those recommendations as soon as you can.

Just a couple of questions, because again I want to hear the other panel. On the cockpit doors, and maybe I should ask the next panel this, but how far along are we in getting those doors strengthened? Is that program pretty well completed? What is the situation?

Mr. SHANE. First of all may I say, Senator, that we look forward to working with you in your capacity as Chairman of the Subcommittee, and also with Senator Rockefeller in the Ranking position. We look forward to a very interesting and productive session.

The cockpit door program, I believe is on track. Boeing and other manufacturers of the kits that are necessary to retrofit the doors tell us that they have produced them in sufficient numbers to retrofit the entire U.S. fleet and, indeed, I think it is fair to say that the entire global fleet, at least that part of it that flies to and from the United States, should be successfully retrofitted by the April 2003 deadline. I am not aware that there are any hiccups in that schedule as of the present time.

Senator LOTT. As you know, the aviation industry continues to say that there is a need for a reduction in regulatory and security cost burdens. I know you are looking at all that and will have recommendations, but let me ask you about one in particular. Part of the security is the air marshall program. Everybody understands that has been underway, but we hear that there have been some difficulties with it.

What is your assessment of how that program is working, and what the needs are for the future, and also, there is a case where, I guess, the airlines are bearing the cost of providing those seats, so just briefly—and this will be my last question so we can move on—talk about that particular area, because I think that is one we are going to want to take a look at.

Mr. SHANE. I can only talk about that—for reasons you are aware of—in the most general way, Senator Lott. The program has been ramped up dramatically. I think it is one of the big success stories of the Transportation Security Administration. I think the best thing to say is that we will be happy to provide you with whatever detail you would require, but I would prefer to do that in a closed session, or privately.

Senator LOTT. Thank you, Mr. Chairman.

Chairman HOLLINGS. Thank you very much.

Senator DORGAN.

Senator DORGAN. Mr. Chairman, let me ask Mr. Shane what we can expect with the Administration's support of the Essential Air Service program. We will be receiving a budget from the Administration very soon. The Essential Air Service program is a very important program for many of us in smaller states. What, Mr. Shane, can we expect from the Administration with respect to funding?

Mr. SHANE. Well, I do not think I am supposed to say what you can expect from the Administration on funding, because that decision is going to be made somewhere way above my pay grade, and it has not been made just yet.

What I can tell you, Senator, is that when it comes to essential air services, the Department takes very seriously every requirement that Congress has imposed in that regard. We take the importance of service to smaller communities throughout this country as a very important part of our responsibility. We have attempted to carry out the Essential Air Service program as efficiently as possible, spreading support for that program as widely as possible, given the always scarce resources that are available for the program, and we will continue to do that.

Senator DORGAN. You said you do not think you are supposed to say. Do you know?

Mr. SHANE. I do not know. As of this point, I do not.

Senator DORGAN. So you cannot say?

Mr. SHANE. That would have been a better answer. I cannot say, but even if I knew what the answer was, I probably would not be authorized to tell you right now, and I apologize for that.

Senator DORGAN. Mr. Shane, what can be done to protect smaller communities as we see some of the restructuring, and the shakeout from restructuring as it affects small communities? Senator Rockefeller, myself, Senator Burns, and others are very, very concerned about this, and do you see other things that can be done, other than supporting a strong EAS system with respect to this restructuring?

Mr. SHANE. One hoped all the way back at the time that the industry was deregulated that the creation of an open market where airlines could pursue commercial opportunities wherever they appeared would produce sufficient service at a whole variety of markets of all sizes and, indeed, the essential air services program is authorized initially for 10 years, the assumption being that at the end of 10 years there would not be the need for any further subsidies of that service.

That has not turned out to be the case. I think many communities do get service now that would not have expected it in a prederegulated market—in a regulated market, I should say, but not all communities that deserve services are getting it, and so there needs to be a continuing program.

I do not have bright ideas beyond trying to make the industry as robust as possible in the hope that the hub-and-spoke system will produce those kinds of spokes to the smaller communities that essentially, that have to have this essential service, or the path we have been on. I do not have any bright ideas about alternative solutions to this problem.

Senator DORGAN. Let me ask about alliances for just a moment. You heard Senator McCain, describe an editorial that was critical of alliances? If carriers were to do what was implied in the editorial, it would be illegal, would it not? I think it would be violative of antitrust laws if several carriers got together and decided we are going to run these carriers jointly, and make joint decisions about things. We are not going to have a merger, but we are going to have an alliance in which we all decide how we are going to work together to manipulate our fares. That is just flat-out illegal, is that not the case?

Mr. SHANE. If they were coordinating prices and capacity, yes.

Senator DORGAN. Right. And the Department has approved alliances in which airlines have taken a piece of what was pre-Mr. Kahn, pre-Professor Kahn, where airlines running their own airlines would nonetheless create certain code-sharing arrangements so that you could get off one carrier in an airport, and get on another carrier and have bought a ticket through both carriers. Those carriers were not working together in any way in their operations, but back in those days you could actually do that.

That was part of what, in my judgment, we should have kept from the old system, but we did not. Now some airlines, short of mergers, are saying, let us create alliances that take that piece back and allow us to do code-sharing and other things, but in my judgment, you have approved some alliances because you understand that it is not a case where these carriers are running each other's businesses.

They still compete. It is just that in certain circumstances they create something that allows the customer to be treated in a much different way, a better way for the customer. Is that not the case?

Mr. SHANE. I think that is the case, and it is part of the answer to your earlier question about how best to foster service to smaller communities. Code-sharing relationships have been an enormous benefit to smaller communities, because they have created that through service and put them on the aviation map for the first time.

Senator DORGAN. And I feel that way, too, and I feel very strongly, perhaps more than anyone on this Committee, that if we have additional mergers, I am going to be the first to say not only no, but hell no, we do not need more concentration in this industry. If I felt that alliances were anticompetitive I would be here spending all my time speaking against alliances, but I do not think they are anticompetitive. I think they are pro-customer, but still produce aggressive competition.

Let me ask the question, if the airlines themselves are trying to find ways to create alliances that help them, but also retain competition and help the customer, what can they expect from the Department of Transportation in terms of taking a hard look at these and making a decision one way or the other. The reason I ask is that there was one alliance that was asked about earlier, that I think was submitted in August to the Department, and I do not think you have made a decision at this point. You did not indicate when you might make a decision, but given the financial circumstances of airlines, when anyone proposes something that might help them, the customer, and still retain competition, is there not an urgency to get these things done?

Mr. SHANE. There is, and we do not miss the point.

United and US Airways proposed an alliance and the Department approved it relatively quickly. It did not pose the kinds of anticompetitive concerns. At least, it did not propose anticompetitive concerns that could not be addressed fairly directly by a combination of the Department of Justice and the Department of Transportation. That was done, and they were able to proceed with the alliance.

The one that is pending before the Department right now, we will respond to that I think very shortly. There is an extension right now of the time under the statute. This is a provision of AIR–21, Senator, that allows us to look at these alliances for up to, I think, 150 days. We have extended that time currently up until the 21st or the 20th of this month.

I believe that before we hit that deadline, we will have brought this particular matter to closure. I cannot be absolutely certain of that because the alliance partners themselves will have something to say about that, but what we are hoping to do is to have an answer, and hopefully we will be able to move on.

Senator DORGAN. I do not want to spend a lot of time on this. I think there are circumstances in which these can work. The Justice Department, I understand, has indicated there is not an antitrust issue or concern here.

Mr. Shane, are you traveling any place soon? Would you pay for food?

[Laughter.]

Senator DORGAN. You do not have to answer that.

Mr. Chairman, thank you very much.

Chairman HOLLINGS. Senator Inouye.

Senator INOUYE. Thank you very much.

Mr. Shane, in the coming weeks, there will be much discussion among Members on the future of the industry, and in such discussion, certain words and phrases will appear more than others, such as mandatory binding arbitration, and as my colleague mentioned, mergers. May I get your position on mergers and mandatory binding arbitration in airline negotiations?

Mr. SHANE. Yes. Mergers are actually the province of the Department of Justice under the law today. The Department of Transportation looks at certain agreements in the airline business. If it is an international agreement that has a cross-border element to it, that comes before DOT. If it is an alliance of the kind I was just discussing with Senator Dorgan, that gets reviewed by the Department of Transportation and the Department of Justice. The actual review of mergers, classic mergers would be solely the province of the Department of Justice, and we would presumably offer our 2 cents worth as they reviewed that.

It is very difficult to have a global position on something like mergers in the airline business, because first of all the environment is changing every day and it is not particularly robust right now. Second, every case is different, and that is the story of even the alliances that DOT reviews. I think it is dangerous to try to pronounce in any kind of monolithic way on mergers in the airline industry.

I think what we will do is, as a government we will look at each case that comes before us and form a judgment based on what is best for consumers and the industry.

The second part of the question is binding arbitration.

Senator INOUYE. Before we go to that, you said that you can put in your 2 cents worth, but I am certain you will put in much more than 2 cents. By your response, do you mean that there are acceptable mergers and unacceptable mergers?

Mr. SHANE. I think there may well be acceptable mergers.

Senator INOUYE. What would be an acceptable merger?

Mr. SHANE. If two carriers are both *in extremis,* or one of them is, and it looks as though the consolidation of those two carriers may keep service alive in a whole host of markets that will lose that service for at least some period of time, there cannot be any suggestion that there is anything anticompetitive in a merger of that sort. You would actually just be losing service. There would not be competition for those markets, they would just not have service, so it becomes a very different kind of problem for the Administration to look at. That is at least a logical possibility, a merger of that sort, and so that is why I say I do not want to pronounce in any way against or for mergers as a monolithic proposition. I think we really do have to be open-textured about it in the way we look at each case before us, or I should say the Justice Department should be in the way they look at every case before them.

On the second part of the question, I am certainly aware of the issue of whether some change in the Railway Labor Act would be warranted. I have no position on that. I think it is an issue that is worthy of important amounts of attention both within Congress and within the Administration. There is a healthy debate about that, and I have not formed a view, quite honestly, and I do not believe the Administration has a position at this point, either.

It sounds like an unsatisfactory answer, I am afraid, but I think that is the state of play right now.

Senator INOUYE. Thank you.

Chairman HOLLINGS. Senator Nelson.

Senator NELSON. Thank you, Mr. Chairman. I want to compliment you and the TSA on the introduction of the new equipment and the overall operation of the TSA. I have been quite pleased in what I have seen, and I go out of my way to compliment them when I see them, so congratulations.

I had raised two questions, and if you would comment on both, the integrity of the decisionmaking process with regard to the loan guarantees, and what we would do with a major disruption of the air transport system due to some additional terrorist act such as what we saw attempted in Kenya.

Mr. SHANE. On the ATSB, the Air Transportation Stabilization Board, first of all I think you are probably aware, Senator, I am not the Department's representative on the Board so I do not sit in on the meetings, but I certainly participate in our own internal meetings about what our representative, who is Kirk Van Tine, the Department's General Counsel, will or should say, or vote upon during those meetings.

I am impressed with the quality of the Board's deliberations. The statute, I think, was written very carefully and established, I think, very sensible criteria, prudent criteria. You are not just creating another investment bank. We did not need another investment bank. Obviously, if investment banks were sufficient, then you would not have to have an ATSB. There needs to be something more, a somewhat more forgiving standard, but in our interest of protecting the taxpayers' stake in all of this, I think there has to be a measure of prudence, and the Congress has built that prudence into the criteria for the Board—for the Board's deliberations. That prudence has been reflected in the regulations put out by OMB in anticipation of these applications.

What I see happening is, I think, a very careful financial analysis, which you would insist upon, it seems to me, if someone were asking for a major commitment of taxpayer resources, and the establishment of some expectation of a reasonable ability to repay a loan, or the taxpayers would be on the hook for whatever amount it was.

That is what the board is doing. It is doing it, I think, in a dispassionate way. It is applying the same standards to every applicant that comes to the door, and I think the results have been actually beneficial to the industry. There have been a number of rejections. United Airlines, I would emphasize, because that is, of course, one that is prominently in everybody's mind right now, has not been rejected, as such. Their application continues to be pending before the ATSB, and they have the ability to come back with a different business plan, so that is not a rejection.

The ones that are rejected simply did not make the cut in terms of the criteria established by Congress and established by regulation, the same criteria that were applied to those who received either a loan guarantee or, in a few cases, a conditional loan guarantee, so I am very pleased with what I see happening at the ATSB, and I think Congress should be proud of having created that body. I think it is a perfectly balanced result.

Now, the prospect of a catastrophe along the lines that you describe is—it is no longer unthinkable, unfortunately, because we did see that episode in Mombasa. I think all I can say in an open forum like this is that the Administration is taking that prospect seriously, and is, indeed, thinking hard about what responses there would be.

Again, and I apologize for doing this, I think it is the kind of subject that is better-suited to a smaller and perhaps a closed session.

Senator NELSON. I agree, and perhaps, Mr. Chairman, Mr. Future Chairman, I would encourage such a discussion in an appropriate classified fashion, because that is something that we have got to face.

Senator ROCKEFELLER. (presiding) Senator Burns. Him not being here, I will ask my questions.

You are right, you are not the person on the ATSB, but I do not want it to roll off quite so easily. It is carefully written legislation. United was discussing the idea of bankruptcy, that therefore its business plan obviously could not be complete, but one thing that has always happened in ATSB is that when a major carrier, so to speak, asked for a delay in order to do more work, it was granted. That has always happened. It was rejected, the delay was rejected, and you talked about the taxpayers having to pick up the cost of an unpaid loan were that to be the eventuality.

I often like to say these are last year's figures, but there are not managed care plans in 81 percent of the Nation's counties, which is just another way of saying that most of the Nation is not served by the kind of highly efficient heavy traffic airlines, and for the ATSB to reject a seemingly reasonable request and it was extraordinary to me, and highly damaging to the taxpayer and to the country.

I wish to know why it was that a longstanding rule about granting delays was seemingly bypassed quite easily, and if there needs to be any adjustment made in legislation as a result of this, because it was a devastating blow to one of the Nation's very largest airline carriers, and I thought a shocking decision.

Mr. SHANE. Senator, I do not think legislation is necessary to address that. That was, of course, a controverted vote within the board, as you know. At the end of the day—and much of the reasoning of the board is, of course, on the record. There were letters exchanged with United over a period of time. There was quite a lot of time spent with United Airlines, as I understand it, in leading up to the moment when the board had the vote on whether or not to grant some further delay.

I have to infer from that record that the board concluded that there was nothing that United was planning to submit within any additional period that would have been granted that would have changed the result, and the board must have felt—I am surmising here, because again I was not present at the deliberations. It must have felt that United would be better advised of the reality of the situation sooner rather than later.

It is undoubtedly a judgment that might have come out differently with different individuals voting. This was a close call, presumably, but I do not think that result in that case ought to be the stimulus for an entire overhaul of the stabilization legislation. I think the legislation is working very well, and we do not know the end of the story of United Airlines and the ATSB.

Senator ROCKEFELLER. I appreciate your, as it is, speculation on the matter and respect it.

To follow up what Senator Dorgan was talking about on the essential air service program, I need to make just one point and ask one question. The funding of it was bizarre. The tracking of its funding was bizarre. It was severely underfunded for years and years and years. It was started by my predecessor, I believe, Jennings Randolph, many years ago, and so it started out from about $26 to then $50 million, and then as part of the Air Stabilization Act last year, when we did many other good things, it was increased again up to $113 million, and so to say the essential air service program has a solid base of support for funding is to ignore the trail which the funding increases pass through in order to arrive at a figure.

So, in that so many of us, Senator Burns, and I am sure, Senator Lott and all of us, is there any instinct on the part of the Administration to not only continue this program at its current level, but in fact to add to it because of the overwhelming power of the airline industry economically for the good or ill of our citizens?

Mr. SHANE. I understand the question completely. It is the right question to ask. I do not have an answer for you right now. It is simply a conversation that I have not had with anybody at the Office of Management and Budget or even in our own front office, so it would be a waste of your time to hear an answer from me, because it would not be the instinct of the Administration per se. It would just be one person's opinion.

Senator ROCKEFELLER. I understand that, but it was not a waste of time to ask it.

Secretary Shane, I thank you very much for your patience.

Senator ROCKEFELLER. Senator Fitzgerald.

Senator FITZGERALD. I will just have a couple of questions, Mr. Chairman.

Mr. Shane, thank you for being here. I wondered if you had taken a look at the debt ratios of the major carriers, or all the airlines, in preparation for your testimony here, and whether you had any thoughts about even when the airlines do turn around, perhaps in 2004, are they not going to be starting out with very high levels of debt, higher perhaps than ever before even the last downturn at the beginning of the last decade?

Mr. SHANE. The answer is no, I did not specifically look at those debt ratios, but yes, I agree with you, I think it is fair to say that they will start out with very high debt ratios once they are up and running again.

Senator FITZGERALD. So, even when they are profitable they are going to be struggling with enormous debt service cost.

As you know, in my State of Illinois, we have had a lot of discussion over the expansion of O'Hare Airport, and Mayor Daley has proposed a $15 billion expansion program, and no one has really ever said how that would be financed, and I guess one way to finance it would be by relying on passenger facility charges and increased landing fees at O'Hare, but the landing fees at O'Hare are already pretty high, and that adds to the airline's cost of operating out of O'Hare, does it not, when those fees are raised at O'Hare or any other airport?

Mr. SHANE. Certainly.

Senator FITZGERALD. And if Chicago were to issue, say, $6 billion worth of debt to fund just the runways, another $4 billion for their terminals, that would result in a lot of debt service for the airlines operating out of that airport, would it not, indirect debt service, that would be amortized by increasing the landing fees at O'Hare?

Mr. SHANE. I must say I am speaking without any knowledge of what Chicago plans in respect of the financing of their proposal.

Senator FITZGERALD. Nobody has any knowledge of what they are planning on financing.

Mr. SHANE. Certainly, if indeed it is going to be—if the idea is to recover these costs in landing fees, then I think your assumption would be correct, it would raise the cost of doing business in Chicago.

Senator FITZGERALD. Do you know what level the airport improvement fund is at now, about how much in annual revenues it is generating? There is an excise tax that funds that, is that not correct?

Mr. SHANE. Yes, and I do not have a number in my head. I would be happy to provide it for the record.

Senator FITZGERALD. One other thing. Have you noticed any trends nationwide about moving to smaller jets? I notice at O'Hare, they reclaimed the title of the world's busiest airport last year, but they actually had less passengers than the year before, and it appears that that was because there was a big trend towards smaller regional jets in the past year. Have you seen that phenomenon around the country?

Mr. SHANE. Absolutely. The regional jets seem to be the most popular aircraft of all right now. Carriers are bringing on more and more of them. I understand if you wanted one you would have to wait 5 years to get one, because the order book is so full, even in this environment. It goes to a discussion that we had earlier about the quality of service to smaller communities.

These regional jets are made in heaven for thinner markets, for markets that have been getting either a subsidized airplane with a couple of propellers one time a day with 19 seats on it, and really never becomes anything like a commercial market.

There are ways of moving these airplanes around quickly enough so that you can actually offer more frequent service to communities of that kind, and you can actually make money at it when the circumstances are right.

The challenge that it poses, that the advent of the regional jet poses, goes back to the exchange I had with Senator Brownback. It is about the capacity of the system. Obviously, if you are moving a lot of people in smaller airplanes, you are going to have a lot more operations. That puts a tremendous burden on air traffic control, it puts a tremendous burden on the airports, on our runway capacity, and so forth, which is exactly why the Commission on the Future of Aerospace was right to focus on the need for ramping up our technology investment and ramping up our research to make sure that we have the capacity to accommodate this air transport market, whatever it looks like in the future.

If it is nothing but regional jets, and a lot more of them than are the airplanes flying around today, we should be able to accommodate them. We should be able to accommodate personal jets. I have no idea what the market is going to look like. Nobody can.

Senator FITZGERALD. And it may necessitate our rethinking about how we set up airports. If there are going to be a lot more planes, but smaller planes, we might want gateways designed for that.

Mr. SHANE. I expect that is the case in many locations, for sure.

Senator FITZGERALD. And I would just point out that this trend which you have identified is diametrically opposed to Senator Durbin and Mayor Daley's World Gateway at Chicago, which was going to build new terminals to handle the big Airbus that handles 600 people, and the Boeing 747 400's, and that bill was going to put a gun to the head of the FAA and say they must approve that plan, and I think we have identified right here a defect in that.

So thank you very much, Mr. Shane.

Senator ROCKEFELLER. Just before I thank you again officially, I want to submit for the record the statement that I have on Airbus and the subsidies and the effect on our domestic airline construction industry.

[The information referred to follows:]

Hon. John D. Rockefeller IV's Remarks from the April 23, 2002 Aero Club Lunch

Thank you very much, Shelly, for that kind introduction. And I thank the Aero Club for inviting me to talk to you all today. It's a pleasure to be here.

The past seven months have been an extraordinary and challenging time for American aviation, in ways no one could have anticipated. September 11 changed the world, and changed all of us. In addition to the staggering and tragic loss of life, and the ongoing and very serious threat to our security, the American aviation and aerospace industry was thrown into a tailspin.

Fortunately, the affected industries and the Federal Government acted rapidly. Together, and to your great credit, all signs are we have restored public confidence in our system: the American people are flying again.

But as I think about that very real accomplishment, I can't help but think of another potential crisis looming before us. In the coming months and years, we must match our ability to respond to this terrorist threat, with a similar drive to restore what I fear is a serious drop in our aviation and aerospace competitiveness around the world. And that's what I would like to talk with you about today.

For too long, the erosion of our leadership and of our dominance around the world has been disguised—by the size and proud history of our aerospace companies, by the turnaround in general aviation, and by the surge in U.S. travel. But the signs of trouble are everywhere:

- The U.S. trade surplus in aerospace declined last year for the third year in a row—from $41 billion in 1998 to just $26 billion in 2001.
- In 2001, Airbus won more new orders than Boeing for the second time in three years.
- The U.S. has largely missed out on the regional jet boom—with a $5 billion trade *deficit* in this fastest growing segment of commercial aviation.
- And we now run a very significant 3-to-1 trade deficit in civilian helicopters.

These are disturbing trends for an industry that is a pillar of American economic strength and national security. And they are trends that will accelerate if we do not act—rapidly, effectively, and collectively.

In my view, our long-term decline is rooted in two basic phenomena:

1. Here in the United States, aerospace R&D spending has dropped by more than half; and

2. Around the world, foreign governments and national carriers are pursuing an aggressive, possibly illegal, campaign of subsidy and discrimination.

The result is that our manufacturers are weakened, which means they can't invest to develop the new technologies our carriers need to expand. So our carriers can't place the new orders our manufacturers need to fund their research. It's a vicious cycle.

The first thing we need to do is fix what's wrong at home. The greatest source of American competitiveness is innovation, but in recent years, we have not been investing enough to support basic aerospace research—

- From the late 80's to the late 90's, U.S. funding for aerospace R&D fell from $34 billion to $15 billion.
- Aerospace has shrunk as a share of national R&D dollars from almost 20 percent at the end of the Cold War to less than 10 percent now.
- Today only 5–6 percent of government R&D funding goes to aerospace—a shocking figure, given the importance of aerospace and aviation to our country.

Much of our aerospace and aviation infrastructure is anchored in research initiated two or three decades ago. Because of the lead times involved, the current R&D shortfall may not affect our products for years. Unless we act, and act now, the day may come when we are forced to cede technical leadership in this vital field to Europe or the Pacific Rim.

Of course, increasing R&D won't, by itself, sustain U.S. leadership in aerospace if the playing field is tilted against us. And it is long past time we recognize that actions by foreign governments and companies violate the letter and the spirit of international trade rules.

This problem really begins with Europe. Europe has the next-largest aerospace sector, and a long tradition of governments promoting so-called "national champion" industries. But increasingly we see Europe's success inspiring copycats, like Brazil, China, Japan, and Southeast Asia. Thus, our ability to deal effectively with Europe—or not—will determine our future prospects with nations all over the world.

The core problem is government subsidies in the development and production of commercial aerospace products. For a while, we deluded ourselves into thinking that this problem would go away. But, in fact, the opposite has happened. The flood of Airbus subsidies, including interest, is estimated to be at least $30 billion. And that total will increase by at least another $4 billion as European governments subsidize the development of the new A380 jumbo jet.

Separately, the British Government has extended well over $1 billion in subsidies to Rolls-Royce over the past decade to develop aircraft engines, and last year announced it would provide an additional $400 million to fund the development of an engine for the A380. Earlier this year, the European Union specifically cited Airbus as a model when trying to cajole European governments into providing subsidies for Galileo, the new European GPS [Global Positioning System].

And subsidies are just the beginning.

Last year the European Commission arbitrarily killed the GE/Honeywell merger. And Europe fought efforts to block the access of "hush-kitted" U.S. aircraft to European airports—an effort that was ultimately rejected by the entire International Civil Aviation Organization (ICAO) ["*eye-KAY-oh*"].

Last year, the French Government said it was prepared to sell off 25 percent of its jet engine maker to an international partner. But when GE expressed interest, the French Government clarified that by "international" it really meant "non-American."

And in the defense aerospace sector, there is an effort to create "pan-European" projects that freeze U.S. products out of military contracts.

We have to fight back immediately, at home and abroad.

At home, we need to use our tax code to encourage American aerospace companies to devote resources to risky, long-term research—by making permanent the R&D tax credit. And restoring federal funding for aerospace R&D must become a national priority.

Overseas, we must fight back, with every weapon at our disposal.

1. (It is time for us to start talking seriously about mounting a WTO challenge to the EU's financial supports in aerospace. There was a time that taking Airbus to the WTO would have been considered a *de facto* declaration of trade war. But no rational person seriously thinks the U.S. wants to drive Airbus out of business. A WTO case would simply ensure that Airbus plays by the same rules we do. And the Europeans have shown they certainly have no hesitation about challenging U.S. trace practices at the WTO—whether it's our tax policies or tariffs on steel.

2. *We must develop a unified and comprehensive response to foreign regulatory decisions that discriminate against U.S. aerospace products or producers.*

Whether in antitrust measures, noise rules, or safety standards, foreign governments must know that if they discriminate against U.S. interests, there will be more than an expression of dismay. There will be a strong and concrete U.S. counteraction.

3. *And we must maximize every bit of the leverage we still have.* If U.S. aerospace companies are excluded from investment or merger opportunities in Europe, we should make clear that we will prohibit European companies from making acquisitions in the U.S. If illegal European subsidies to certain companies continue, then those companies should be refused access to lucrative Pentagon contracts in the United States.

Over the last 30 years, I have had a front row seat for the American steel industry's grim decline. I have seen a strong, confident, wealthy industry reduced to near death by a combination of factors remarkably similar to those facing you: a decline in government support for R&D; systematic and remorseless trade discrimination; and a reluctance to pull the industry together and mount an organized fight until it was almost too late.

The silent mills and unemployed steelworkers who still dot the Ohio Valley are monuments to an industry that found itself in this very situation—and to government policies that put diplomacy and tact ahead of America's companies and workers. Government policies that lost a trade war in steel.

That can't happen again. I stand ready to support you and help you, in the Aviation Subcommittee, in the Commerce Committee, in the Finance Committee, and in the Foreign Relations Committee. On Capitol Hill, in West Virginia, in Seattle, in Chicago, in Brussels and at the WTO.

But you have to engage in the fight, too, to a far greater extent—airlines *and* manufacturers, general aviation *and* commercial aviation, labor *and* management. I know you face very real and immediate problems and needs, but I implore you to focus on the big picture and to take ownership of the future. Aviation is too important to our society, our economy, and our national security for us to decide we don't have the political will to defend our global leadership.

There is time, but not much. Let us work together to build a strategy and take the actions we need to prevent a long, slow decline of the American aerospace and aviation industry.

Senator ROCKEFELLER. Secretary Shane, thank you again very much. You have been very patient. Again, this is our first hearing. We are eager and will grow more eager as time goes on. I now call upon our next panel, Mr. Donald Carty, Chairman and CEO of American Airlines, Mr. Richard Anderson, Chief Executive Officer, Northwest Airlines, Professor Alfred Kahn, Cornell University, Mr. Duane Woerth, President, Air Line Pilots Association, and Mr. Kevin Mitchell of the Business Travel Coalition. If you gentlemen could have a seat, we will start, Mr. Carty, with you.

STATEMENT OF DONALD J. CARTY, CHAIRMAN AND CEO, AMERICAN AIRLINES

Mr. CARTY. Thank you, Senator Rockefeller, Chairman McCain, Members of the Committee. Thank you for the opportunity to appear before you today. All of you I know are familiar, we have been discussing already this morning the economic trials our industry is going through. These trials are as well-documented as they are severe. In the written testimony that I have submitted, I offer some facts and figures that illustrate that in this industry's 75-year history, a history long under stress and short on economic success, these really are, as one of the Senators said earlier, the most challenging times that we have ever faced.

Now, many of the forces that are driving our current problems are dramatic. They are visible. We have talked about them this morning, the economic downturn, the steep fall-off in business travel, and in the wake of 9/11 widespread concerns both about security and the hassles associated with new security arrangements.

Less publicized, but equally troublesome factors include dramatically higher security and insurance costs, as well as the raft of fees and taxes which have been imposed on air travelers that are ultimately, in this kind of marketplace, absorbed by the airlines themselves.

Now, while there is no shortage of culprits to explain our situation, as a representative of the largest airline in the world I definitely want to acknowledge the point that both Senator Hollings and Senator McCain made at the outset, and that is that our industry would have been faced with fundamental change even without 9/11, or even without the economic slowdown. Those events have simply accelerated the need for change.

In recent years, the growth of discount carriers has allowed them to reach a critical mass, and now they compete on roughly three-quarters of the routes that we fly. While they only represent 20 percent of the capacity, they are now influencing competitive activity in some three-quarters of our markets, and this, of course, along with the explosion of e-commerce, which has made airline pricing completely transparent to anybody with a PC, preceded and accelerated the airline revenue decline that was driven by 9/11 and the sluggish economy, and coincident with our revenue struggles, we have seen rapid increases in our labor cost, our distribution cost, and certainly our tax cost.

Now, from an American Airlines perspective, dramatic change really just represents more of the same, because for 75 years, our history has been marked for the most part by continuous change, and while the evolve-or-perish theory has long been a way of life for us, I would like to put to rest the notion that the large hub-and-spoke network model is no longer viable and no longer important.

The ability that we enjoy in this country, and some of you observed this in your own comments, to allow us to move from virtually any medium to large community and many small communities around the country on one side of the country to a counterpart on the other side, as well as dozens of international destinations at a reasonable cost and within a reasonable level of convenience is very much a product of the hub-and-spoke system.

The large airline model will remain viable as the mobility that it has created for people has become fundamental to our Nation's economic infrastructure. In fact, we owe it to our customers, we owe it to our employees, we owe it to our shareholders and the communities that we serve throughout the country to meet what are our economic challenges head on, and to do that we have to acknowledge that, given the bursting of the economic bubble, the rise of discount carriers and the rapid growth of online travel distribution, it is going to be a very long time, if ever, before the airline revenues approach the levels that were reached in the late 1990's and in the early part of the year 2000, and that means very simply we have to attack our expenses. We have to find new and inventive ways to deliver value to our customers, and to do so at a lower cost.

Now, at American we have set out to remove $4 billion from our permanent cost structure. That means every aspect of our business has to be reexamined, and literally, we have launched at American hundreds and hundreds of projects to reduce expenses and to restructure the way we do business.

Now, my written testimony provides a number of details on at least some examples of those efforts, but let me now say for the record that our efforts to date have been grouped into seven major areas of our business. We have reexamined our schedule efficiency, we have reexamined the complexity of our fleet and moved toward simplification, we have moved to streamline interaction with our customers in every point of contact with our customer around the airline, we are in the process of changing and reexamining the way we distribute our product and the cost of distribution, we are reexamining the way we price our product, we are reexamining our inflight product offering, we are looking at our flight operations themselves and, of course, we are attacking rigorously our overhead in the form of our headquarters and administrative costs.

Now, when we have fully implemented all the changes that we have identified in those seven areas, we will produce annual savings for American Airlines of over $2 billion. Now, that is a big number, which means, unfortunately, however, that we are only halfway home. There is going to be a lot more for us to do.

The most important factor that I have not touched on at all, and the biggest expense item that of course we have—and has been alluded to a number of times this morning—is labor costs. Labor costs continue to represent about 40 percent of our total operating cost, and labor is more than three times the next biggest expense that we have.

Now, at American I think it is fair to say our people have risen to every challenge circumstance has placed before them, and with the layoffs we have been through, which are now well over 20,000 people, along with all the uncertainty that surrounds our business, they have been through an enormous ordeal already, so we have been very loath to address labor costs explicitly until we in management had done everything under our control to align the company with the realities of today's marketplace.

In the meantime, we have tried to work hard to build credibility between management and labor, obviously not always successfully, but it has certainly been our focus. Credibility is based on telling the truth, and the truth is that the future of our company is not going to be assured until we find ways to significantly lower our labor cost. It is a harsh reality, but as I continue to tell our employees, together we have the opportunity to demonstrate to ourselves and to the world that an airline can save itself by working together, and by working together cooperatively and creatively, and it is my hope and expectation that we are going to seize that opportunity at American Airlines.

Now, I have to confess that I have been walking a bit of a tightrope this morning. I am, I believe, blessed with the greatest team in the industry, whose members by and large share an unshakable belief in American Airlines, and I cannot help but be upbeat about that, and yet I fear sometimes that my optimism masks the urgency and the magnitude of our crisis and the importance of your role in working with us to preserve the vibrant air transportation system that our country needs and our country deserves.

Indeed, as we scan the horizon we are now confronted with two new clouds. One, of course, is the recent run-up in fuel prices which threatens to wipe out much of the progress all of us in the industry have made in reducing costs, and the other, of course, is the possibility of a war in the Middle East, which would at once further depress demand for air travel and could quite possibly exacerbate the fuel problem.

Now, a year ago this Committee and the leadership of Congress rallied in a time of crisis to provide us a lifeline. In fact, I think it is fair to say you literally saved the airline industry of the United States, and I think it has also not been said often enough by all of us that we are immensely grateful for that.

We do continue to need your help in the areas of security costs and the area of taxes, but my mission today is not to ask for relief, but rather to let all of you know that at American Airlines we are exhausting every conceivable means of self-help, and we are far from done.

Mr. Chairman, Members of the Committee, we are most grateful for both the reality and the symbolism of this Committee choosing the concerns of the airline industry for one of its first hearings of this Congress, and we do look forward to continuing this dialogue and working with you throughout the year.

[The prepared statement of Mr. Carty follows:]

PREPARED STATEMENT OF DONALD J. CARTY, CHAIRMAN AND CEO, AMERICAN AIRLINES

Good morning Mr. Chairman and Members of the Committee. Thank you for the opportunity to appear before you today to discuss the airline industry.

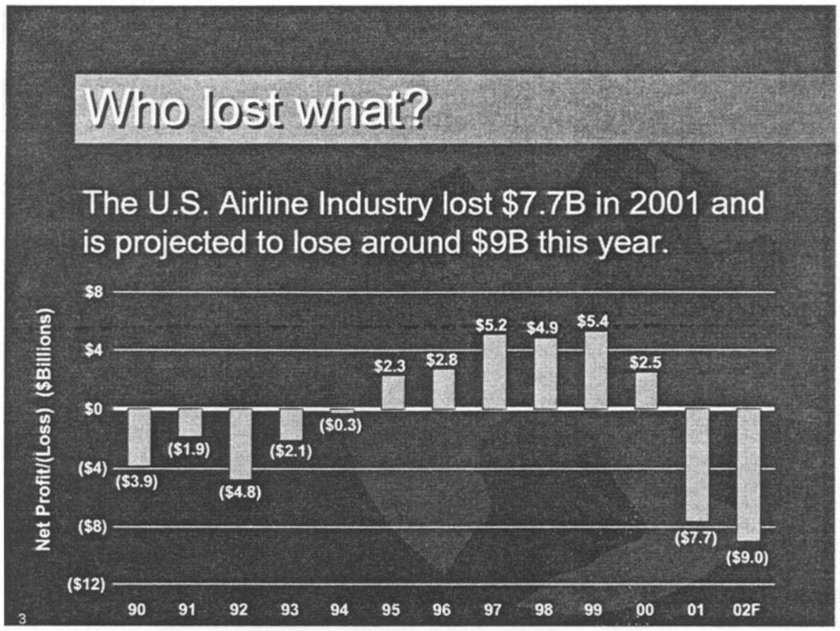
I am here today with two goals. First, to emphasize the magnitude of the problem that we as an industry face. Second, to convince you that we are responding to the crisis with a degree of self-help that is unprecedented in our industry's history.

What this testimony represents is a condensed version of a presentation that I have been making to our employees in dozens of meetings around our system. These meetings have immensely encouraged me because our employees have shown an unwavering sense of seriousness, knowledge, and commitment to fix the problems.

When we began the process of radical change at American, we decided that, as management, we could not possibly ask our employees to make sacrifices without, first, having done everything possible in our control to solve the problems and, second, taking the lead in making the same sacrifices ourselves. Both of these are important elements in making the permanent changes we need simply to survive.

I usually begin my presentations to employees by showing some commercials from various ad campaigns we have done over the years. I do so because, while the music and pictures may change a great deal, there is one constant at American that has always been our core strength: the high quality of our employees. At American, we understand this business is all about our employees, what kind of job they do, and their professionalism. That is going to continue to be at the heart of our culture and at the heart of the marketing to our customers.

With that said, it can't be stated strongly enough that the magnitude of the problem we face as an industry is absolutely staggering. So I will begin with some facts about the industry as a whole and then get much more specific about what we at American are doing about our own problems.



[Slide 1]

Let me start with some industry data. What you see on this first slide is a history of the profitability of the industry. You will recall, we had an economic downturn in the early 1990s, compounded by the Gulf War. We, like the rest of the economy, moved into a healthier period in the late 1990s, the longest period of sustained economic growth in recent U.S. history, with tremendous growth in the demand for travel.

Then in April of 2001, we began to see the impact of the economic downturn that was occurring. It started in the high tech and telecommunications industries, but quickly spread across the U.S. economy. American Airlines, in particular, was hit very early because of the level of capacity we operated in a number of markets where the high tech industry was concentrated, such as Dallas, Austin, Boston, and San Jose.

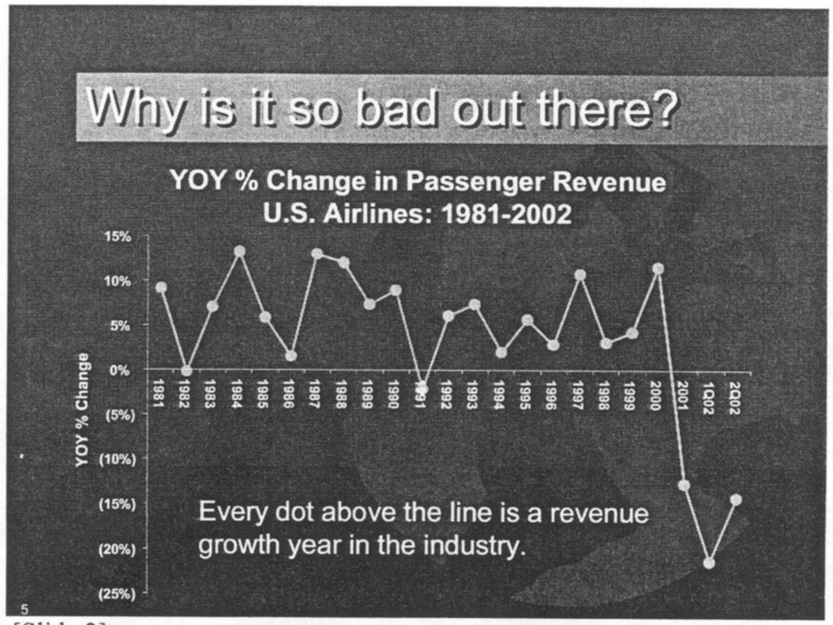
By the summer of 2001, we were already experiencing the financial consequences of the economic softening and recognized that the third quarter, typically a strong period, wasn't developing the way we had hoped. We knew then that we weren't going to have satisfactory financial results for the entire year.

At American, we began taking corrective action as soon as the downturn became apparent. A number of cost cutting measures were quickly initiated. Then came 9/11 and the devastating effect those terrible events had on our industry.

The very large losses recorded in 2001 and 2002 were the result of a weakened economy, the impact of 9/11, the fear of flying, followed by the public's aversion to the perceived hassle of flying due to the new security procedures. In addition, the new costs of increased security and insurance had a significant impact. In short, by the end of 2001, we had flown in economic terms into the "Perfect Storm."

To make this chart completely clear, the $7.7 billion lost in 2001 was *after* the government compensation of $5 billion. In other words, our actual losses were closer to $13 billion for the industry in 2001.

Many of us expected that the economy would begin to recover by the middle of 2002. We were also hopeful the effects of 9/11, which drove a great deal of traffic from our airplanes, would also dissipate, and that we would recover by year-end. Obviously that hasn't happened. In fact, Wall Street analysts now estimate that the industry lost $9 billion for the full year.

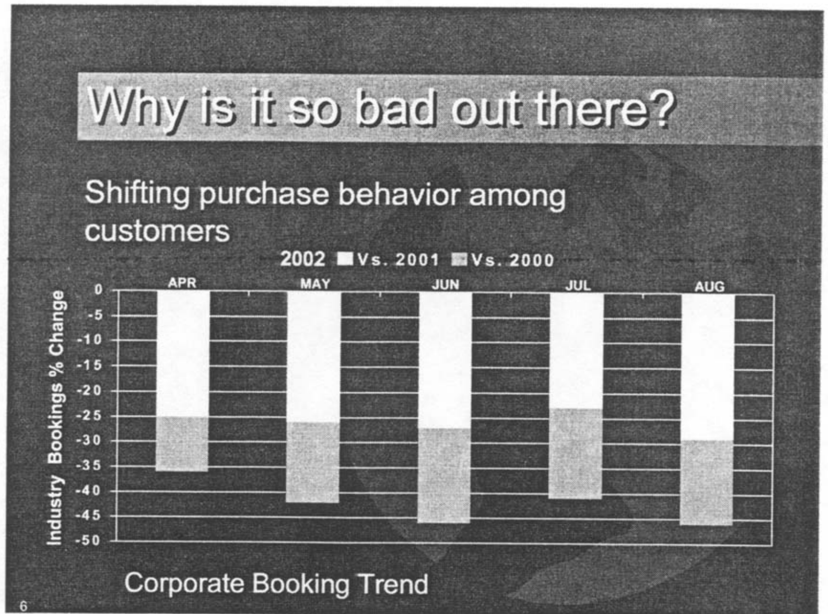


[Slide 2]

To give you some idea of the order of magnitude of the impact all of these events had on the market, Slide 2 shows the percentage change in total airline revenue for the whole industry year-over-year, for the past twenty years.

The graph shows that while revenue growth has fluctuated, historically it seldom went negative. However, for the period 2000–2002, revenue has literally "fallen off a cliff." Not only is the economy weak, but the airline industry's share of the economy is completely unhinged from anything we've ever seen before. At no time in the history of aviation has the industry suffered such great losses.

The next slide shows a major source of the recent problem.



[Slide 3]

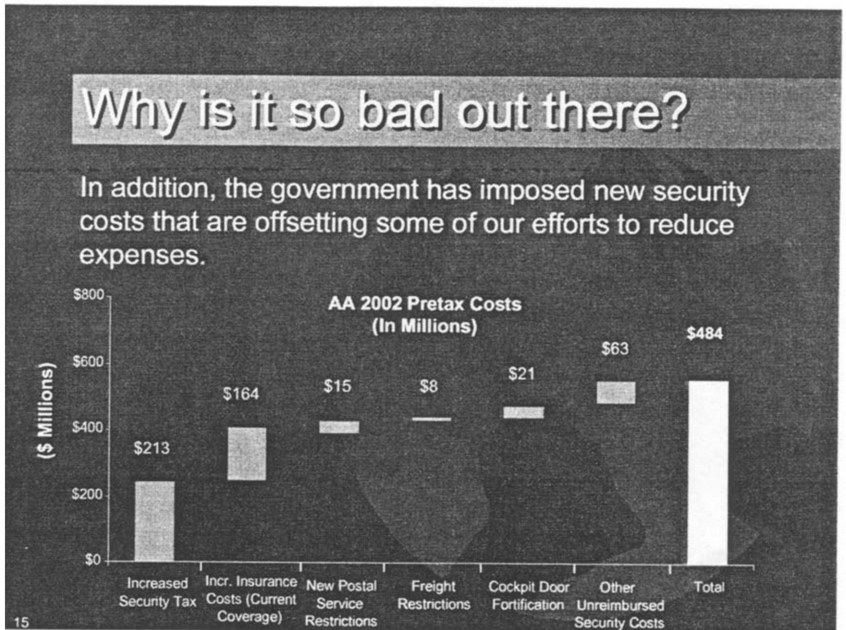
Since mid-2001, business travel has dropped precipitously. Corporate accounts tend to give us the best, high-frequency, high-yield business. These bars measure the deterioration of the amount of business trips that are taken. Comparing April 2000 to 2001, travel by the best corporate accounts for the entire industry (not just American) was down 25 percent during this five-month period. If you compare the year 2002, it's actually down over 40 percent.

In addition to the loss of business travel, the traditional network carriers must increasingly respond to the growth of discount carriers who generally set the price for leisure travel. In 1992, when we had our last economic downturn, these carriers represented 4.5 percent of the business. Today they're up to 18 percent and it looks like they'll be over 20 percent in 2003.

But that figure greatly understates their impact. While they are 20 percent of the capacity, discount airlines now operate in 70–80 percent of the markets served by the network carriers. The bulk of the markets not served by the discount carriers are the small communities, still served exclusively by network carriers and their affiliates. In short, low-cost carriers are influencing pricing in virtually every major market.

I raise this point not to complain, but to recognize a fundamental fact—the competitive landscape of our industry has changed forever. We cannot plan our business in anticipation of large increases in revenue and, therefore, must restructure to reduce costs.

Complicating this challenge is the problem that the post 9/11 world and resultant new security and insurance impacts have combined to drive our costs up dramatically. The impact on American Airlines alone was nearly half a billion dollars in 2002. Slide 4 indicates six elements contributing to that total.



Slide 4]

The first column represents increased security tax. Although the security fee is technically a tax on our passengers, it actually became a cost to us. In the current marketing environment, we can only put passengers on the airplane by stimulating the market with price. To the extent we have to lower our prices to attract passengers, there is no way we can simply "tack on" a security tax without driving away passengers. In reality, the airlines are paying the tax because we have to get the total fare, including all fees and taxes, low enough that people are willing to fly. As a result, the security tax is costing American more than $200 million.

The second column represents increased insurance costs. This year, our insurance premiums increased $164 million. Of course, we are immensely grateful for your extension of the war risk program, without which this increase would be much greater. We hope that the current situation will be resolved in order for us to fully utilize this benefit.

The third column represents increased costs due to new postal service restrictions. We have not been allowed to carry mail over 16 ounces. At American alone, that cost is at least $15 million a year.

The fourth column represents additional freight restrictions that the government has imposed on us, costing us $8 million annually.

The fifth column addresses cockpit door reinforcement. Reimbursement for the mandatory cockpit door replacement has not equaled the costs incurred, with $21 million in additional costs.

The final column represents over $60 million in costs that we believe the government indicated they would pay for, such as catering security costs, that we have not received.

In total, that's nearly half a billion dollars in new costs for American. The industry's cost for security is over $3 billion. This, by the way, does not include the hundreds of millions in annual payments that carriers make to the Federal Government for security reimbursement costs.

As we have said in the past, we believe that the public policy debate should be about national security, not airline security. We believe that protecting citizens against terrorism anywhere—in airplanes, trains, buildings, shopping centers or stadiums—is a government function. Unlike other industries, airlines are bearing a tremendous amount of the cost burden for security. Is there any reason to tax airline passengers for protection when we don't tax the people in Times Square on New

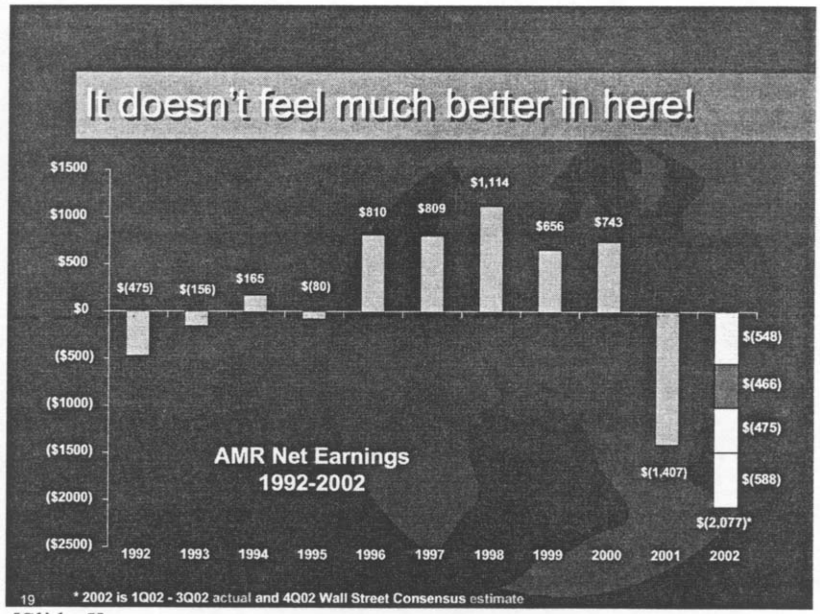
Years Eve who were protected by the government, or citizens entering public buildings?

At the same time, I should acknowledge the very positive contributions of the TSA under the leadership of Admiral Loy. The agency is focused on providing excellent security, while, at the same time, helping us improve customer service. More needs to be done, but great progress has been made.

Moving from a discussion of the industry to the specific challenges we have at American, I explain to our employees that the only way we have survived these unprecedented losses is to borrow money. So the more money we borrow, the more interest we're going to have to pay, and the tougher it is to recover and return to profitability.

Second, I explain that low-cost carriers are everywhere—that's not going to change. While the network carriers have to retrench for economic reasons, the low-cost carriers are continuing to grow. It's a reality that's here to stay as we think about the next twenty to thirty years at American Airlines.

Furthermore, technology has made it easier to shop for the lowest prices. The majority of the traveling public has access to the Internet. In the airline business, you can find the lowest fare in 30 seconds. So our pricing is and will continue to be much more transparent than pricing for many other consumer products.

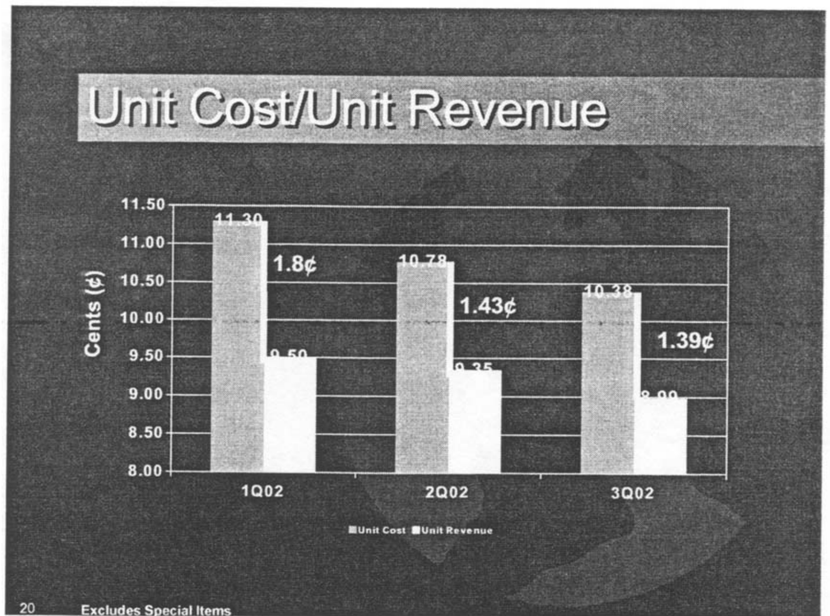


[Slide 5]

American has been uniquely challenged by the fact that the regions which have shown the greatest market softness were the domestic markets and Latin America, where American has the largest presence. We also saw relatively weak revenue and traffic at London Heathrow, where American has the largest of its European operations.

In addition, we continue to suffer from being the only international carrier not permitted to codeshare with our largest European partner. The DOT now has before it an application for a limited codeshare agreement between AA and British Airways. Expeditious approval of this codesharing, explicitly authorized under the U.S.–U.K. bilateral agreement, will permit American to begin marketing destinations beyond London that we cannot economically serve ourselves. This is a critical first step if we are to compete on equal footing with other major U.S. carriers.

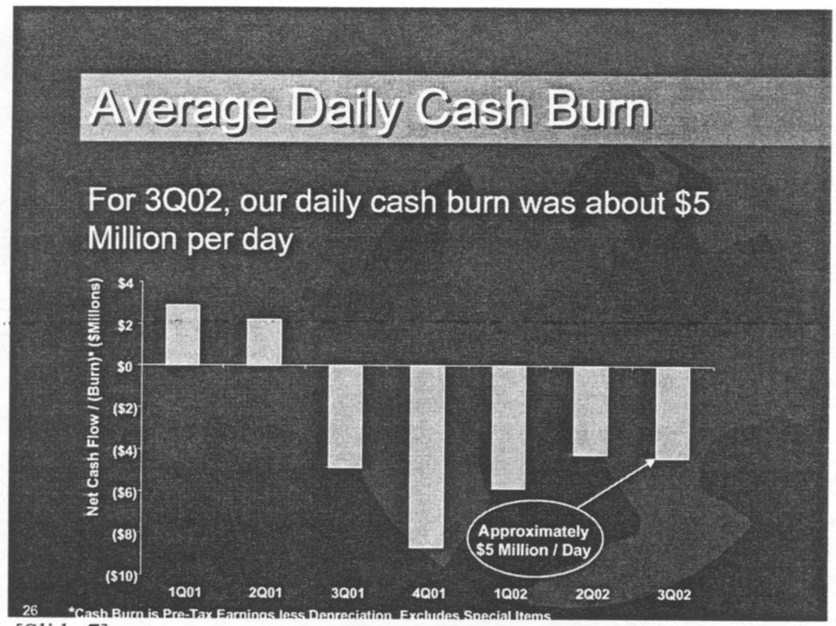
As we refocus our planning in 2003, we are shifting capacity to markets with stronger demand. We will adjust slightly our international routes and continue to curtail domestic capacity because of continued weakness in these markets.



(Slide 6)

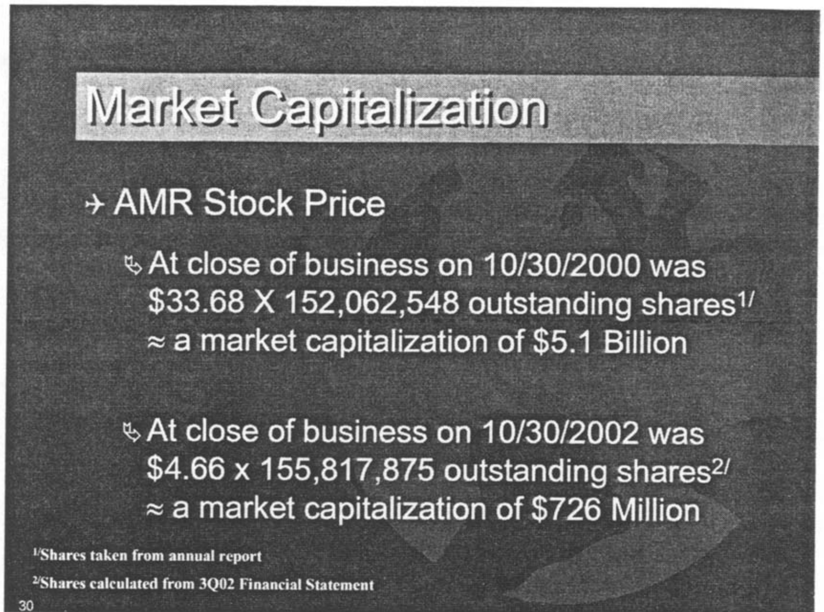
This slide shows revenue per seat mile and cost per seat mile. We are getting our costs down and are making steady progress in narrowing the gap a bit, but we continue to have a tremendous difference between what it costs to run the airline and the amount of revenue our customers are willing to pay. The difference leads to increased borrowing.

Obviously we can't continue to do this for very long. The fact is we have been borrowing money just to pay the fuel bill and meet payroll.



[Slide 7]

For example, American had $2.5 billion in cash a year ago, and we still have $2.5 billion today. The problem is, in order to maintain that number, we've had to increase our capital borrowing. Since 9/11, American has borrowed approximately $6.5 billion, which has caused our debt to skyrocket. The chart in Slide 7 is sobering indeed. It indicates that in the 3rd quarter we were running through about $5 million a day in cash. At that rate, we don't have forever to fix our problems.



[Slide 8]

Devalued stock prices at all network carriers—not just American—have resulted in an all time low market capitalization for the industry.

If you think about this in historical context, in October of 2000, our stock was at almost $34 a share, a market capitalization of about $5 billion. At the close of business two years later (October 31, 2002) the stock was at $4.66, making it worth about three-quarters of a billion dollars.

Historically, American has relied on a relatively small number of our business customers being loyal to American. We began to recognize in the 90's that model was going to get tougher and tougher to sustain. With the downturn in business customer travel, we've had to find new ways to generate revenue.

There are many things we do as a large carrier that customers value and will always value. Customers do value convenience, network, and service. Nonetheless, we believe that to compete effectively, we have to get annual costs down by roughly $4 billion, permanently.

We are trying to reinvent ourselves as quickly as we can in a time of immense financial crisis. This is a plan we would have gradually implemented over five or six years. Now there's pressure to get there faster, and there's pressure to survive so we can get there at all.

At American, every aspect of our business is being reexamined. Literally hundreds of projects have been initiated to reduce expenses and restructure our business model.

These efforts have been grouped into seven major areas of the business. The first area of initiatives is scheduling efficiency.

As you know, American and many of our major competitors, both in the U.S. as well as foreign flag carriers, operate a hub and spoke scheduling system. This system has proven to be a very efficient means of providing frequent service between communities that otherwise would not have enough local traffic demand to support that service level. Business travelers have told us time and again that schedule frequency is a critical feature.

Just the same, the traditional approach to hub and spoke scheduling, in an effort to drive passenger connect times to an absolute minimum, has resulted in less efficient asset utilization. Historically, we have needed extra airport gates and manpower to support a schedule where the incoming bank of flights and outgoing bank of flights all arrived and departed within a narrow time window. In the current environment where there is less business demand traveling on higher fares, this scheduling approach is less effective.

In April 2002, we moved our Chicago hub operation to a depeaked schedule. We expanded this initiative to our Dallas-Fort Worth hub in November 2002. The gist of this concept is that planes arrive at uniform rates throughout the day. Ground times at the gate are based on how quickly our crews can turn the aircraft, rather than waiting to meet directional banks of aircraft.

The cost savings at O'Hare and DFW from this change have been significant. At O'Hare, we were able to operate the same number of frequencies with five fewer aircraft, four less gates, and we realized a 5 percent increase in employee productivity. These changes have also reduced congestion and delays at these airports, contributing to improvements in on-time performance, not only for AA but also for the industry. By de-peaking both O'Hare and DFW, we have been able to make improvements in our spoke airport gate and manpower productivity as well.

The impact to local Chicago and Dallas-Fort Worth passengers is all positive, with better spacing of flights throughout the day. This, in turn, helps to reduce waiting time at check-in and security. For connecting passengers, the average connect time has gone up roughly 10 minutes. When viewed in context of the overall trip length for connecting passengers, this is a fairly modest change. This fact has been reflected in our share of connecting passengers, which has actually been up slightly since the change.

The second major initiative we undertook was fleet simplification. As a carrier with service ranging from small cities in the U.S. to our hubs, large transcontinental U.S. markets, as well as an extensive international schedule, American will always need to operate with a few different fleet types. During the boom years, carriers like American could afford the extra costs of maintaining a large number of fleet types. This was possible because business travelers were willing to pay more for their travel and major carriers responded by offering specialized products. But in today's marketplace, the costs of having a diverse fleet outweigh the revenue we are able to generate. As such, we had begun work to simplify our fleet well before September 11.

In June 2001, American operated 12 different fleet types, requiring unique crew training, and 30 different subfleet types. Through aircraft retirement and standardization during the next few years, we will reduce the number of fleets requiring unique crew training to five and decrease the number of subfleets to ten and possibly fewer. When compared on the number of aircraft units per unique fleet type, American should be second only to Southwest by 2006.

The third area is to streamline our interaction with every single customer by simplifying processes and using automation to achieve better customer service and increased productivity. We are working aggressively to eliminate the need for paper tickets and to expand the availability and functionality of self-service devices to make our airports more efficient. Similarly, voice recognition and new automation tools will improve the efficiency of our reservation offices. At the same time, we will be shifting our reservation activity to our even lower cost platform by encouraging the increased use of the Internet. An example of this is providing customers the ability to book AADVANTAGE award travel on AA.com. This is all about having a customer service experience that's easier for the customer and less labor intensive for American.

The fourth area we are addressing is distribution and pricing. Distribution costs represent our third largest expense after labor and fuel. These costs include commissions, booking fees, credit card fees and a variety of other costs of making the sale. As part of the longterm restructuring of our business, we have targeted a number of strategic initiatives that will significantly reduce these costs—including a substantial reduction in commissions—without depressing revenues or adversely affecting customer service.

Over the past several years, Computer Reservation System booking fee expenses have increased far faster than inflation—about 7 percent annually since 1995—even as technology costs have fallen. In 2002, we spent more than $400 million on booking fees, or about 2.4 percent of passenger revenue.

Booking fees have risen dramatically, largely because of outdated DOT regulations which do not allow us to bargain with individual Computer Reservation Systems, as we can with anyone else whose services we buy. Fortunately, the DOT has recently proposed new rules that would change this one-sided business relationship. We applaud the Department for this step and hope they move promptly with these proposed rules so that we can get this cost item under control.

As for our own efforts to reduce booking fees, we have recently launched the EveryFare program. The EveryFare program makes lower web-only fares available through participating travel agents who are willing to help us achieve lower distribution costs, equal to the costs on the Internet, for all bookings. This program is truly a win/win for consumers, travel agents, and American. Customers needing the assistance of a travel agent can still get access to our low-internet fares, and American will gradually reduce its total booking fee expense.

Our fifth area of cost reduction is our inflight product offering. The logistics behind providing meals on short domestic flights with limited ground time are extraordinary. While many customers have valued the level of meal service we have provided, few have valued it as much as it costs to deliver. This is particularly true given the increased security requirements for catering services after September 11. Increasingly, more and more of our customers simply want to make their own choices, prior to boarding the aircraft. To align with this evolving customer value equation, we have reduced the level and complexity of food service on most of our shorter haul flights.

This simplification of our inflight product is not limited to food service. We recently announced that there would no longer be any charge for in-flight movies, provided that customers bring their own headsets. For customers not bringing their own headsets, we sell headsets onboard. The net impact is more customer self-sufficiency and less logistical challenges for American, resulting in lower overall costs.

Our sixth area of emphasis is flight operations. In an effort to make our flight operations more efficient, we're focusing on the fundamentals of the business: operational safety, performance and efficiency. AA's arrival performance this year has improved in every quarter as compared to 2001. Over 84 percent of our flights arrived on time in the third quarter of 2002. Everyone in the operation has contributed to this improvement.

In addition to flight and maintenance savings generated by fleet simplification and depeaking, AA is also making changes to lower other operational costs. Fuel is our second largest operational expense after labor. We have taken a number of steps which, while seemingly small, result in significant cost savings. The largest improvement is that we have reduced aircraft auxiliary power unit fuel usage by half during the time the aircraft is parked at the gate. This has been achieved by acquiring ground equipment to provide power and air-conditioning to the aircraft and through comprehensive training and awareness programs for airport and flight crews. Fuel reductions have also been achieved by running aircraft taxi operations to and from runways on a single engine and by more closely monitoring excess ramp arrival fuel levels.

We are also implementing changes in our maintenance areas, which will enable us to operate more efficiently. Portable technology, which gives mechanics and inventory clerks up-to-date information on parts availability, will significantly improve productivity. Automation of the work card system will also allow our mechanics to maintain aircraft more efficiently.

Returning to profitability and running a safe airline are not mutually exclusive. As we continue to focus on operating a streamlined and efficient company, our employees know that the most important contribution they make is doing their jobs safely.

The seventh and final area of cost reduction initiatives includes looking at ways to streamline our headquarters and administrative functions. As American's losses continue to mount, we're leaving no stone unturned, reducing everything from staffing to paper paychecks to the way we buy our supplies. So far, we've implemented and/or identified cost-savings in management productivity, supplier strategy, facilities consolidation, capital spending, human resources and accounting. Combined, these savings total more than $500 million in reduced annual expenses. Here's a closer look at what we've done in each of these areas.

We are lowering the cost of purchasing goods and services by rigorously examining everything we purchase and determining ways to save every possible dollar. We are combining volumes of business with suppliers to get higher discounts, reducing inventory levels, rolling out global sourcing strategies, utilizing eBusiness tools and identifying opportunities to lower our suppliers' costs that are passed on to us.

In conjunction with looking at how we work, we're looking at where we work. Every square foot of space we can give back to the landlord saves us money.

Airport construction projects have been either deferred or scaled back significantly, saving more than $250 million in capital commitments. Those few projects that are going forward are, in most cases, projects that would cost more to cancel or are being funded directly by the airport. We've also cut capital spending in other areas. Since the fourth quarter of 2001, we have deferred the delivery of 40 aircraft, saving over $3 billion. And we've cut spending on aircraft modification projects, information technology and ground equipment. In total, we have deferred more than $4 billion in capital spending from our pre-9/11 plan.

In the Human Resources area, we are aggressively using automation to move paper processes and human-assisted transactions to online self-service. Ultimately, Jetnet, our employee Internet portal, will be a convenient, one-stop resource: "From hire to retire, everything online." Already, our employees can go to Jetnet for benefits enrollment, pension/401k transactions, employee support and payroll services, company communications personalized to each workgroup, real time operations information, policy and technical manuals, and company reference information. In addition, all employee travel is planned and booked online, executed via self-service check-in, and will be completely paperless in 2003.

We are looking at ways to battle skyrocketing health benefit costs, a problem not just for American, but for corporate America as well. We are increasing our focus on preventative healthcare, encouraging the use of generic versus brand drugs, and requiring higher co-payment amounts, resulting in more than $14 million of cost avoidance.

We've made similar automation strides in accounting, with a relentless focus on going paperless. In payroll, disbursements, and revenue accounting, we are moving rapidly to 100 percent electronic. These efforts will produce great savings for us, and greater service for our customers.

Since September 11, American has reduced its management and administrative headcount by 22 percent. In addition, management employees have received no pay increases since 2000, and will not see one in 2003. Company wide, across all labor groups, job reductions to date total about 27,000, and—unfortunately—we're not out of the woods yet. As we adapt to the new and increasingly low cost business model, our company will look very different from what we've known in the past. Our ability to adapt will be critical to our survival.

Many of these cost cutting ideas were submitted by our employees. Our people stepped up to the plate in a big way when I asked for cost-savings ideas. They submitted ideas that ranged from revising our headset policy to limiting the distribution of ticket jackets. To date, thousands of ideas have been received. Of these, hundreds have been implemented and dozens more are under review. When tallied, we estimate that employee ideas have saved the company hundreds of millions of dollars.

So far I've talked about restructuring in seven major areas where we've been actively seeking to reduce costs. In total, these changes will produce $2 billion of annual cost savings when fully implemented. With that being said, I haven't addressed an area equally important to our recovery—that is restructuring our labor costs. Labor is our company's single greatest expense and, with the exception of taxes, our fastest growing expense. In fact, at about 40 percent of our total operating costs, it's more than three times our next biggest expense.

Despite its importance, there's a reason I mention labor costs last. Unlike some of our competitors, we recognized early on that the industry's problems were structural and not simply the result of a typical business cycle. And so, rather than merely cut pay and benefits, we took a different tack in attempting to solve our financial problems. Instead, we first set out to do everything that was under management's control to change how we operate, increase efficiency, eliminate waste, cut expenses and so on—all encompassed in the seven areas that I've just discussed with you.

Throughout that process, we have valued labor's input. And indeed they have certainly borne their share of our common challenge thus far, with the staffing cuts that I've mentioned previously and by working harder and doing more with less. But because our financial task is so great, we must also examine our labor costs—just as we have in every other area—if we are to stem our losses, remain competitive, and return to profitability. That's not an easy thing to do, indeed it can be extraordinarily difficult for everyone, but it must be done.

Toward that end, we've met with our unionized groups, as well as our non-represented employees, all across the company to ask for their help. We've explained our situation clearly and even given them complete access to our financial data so they could make informed decisions. To date, we've asked that everyone forego scheduled wage increases next year—management included. We must go further, however, and we're requesting productivity improvements and increased flexibility from all work groups to lower our labor costs.

Through it all, we've worked hard to build credibility between management and labor. Our goal has been to create a partnership that will allow us to successfully meet the fundamental challenges we face. It's time now for that partnership to produce results, beginning with an acknowledgement of the depth of our problems, a recognition of the changing nature of our true competition and a restructuring of our labor agreements to allow us to effectively compete. We're hopeful we'll be successful in that regard. As I continue to tell employees at our town hall meetings, we have an opportunity to demonstrate to ourselves and to the world that an airline can save itself by working together, cooperatively and creatively.

In a peculiar way, however by emphasizing the positive steps that we are taking and our determined spirit of optimism, I worry that I have understated the magnitude of the crisis and the importance of your role in working with us to solve the problems of our industry.

There are, in fact, two more clouds on the horizon that are very troubling. First is the rapid increase in fuel prices. One of the few things that saved us last year was a substantial drop in year-over-year fuel costs. Those savings are now long gone. Fuel is spiking rapidly and this will add significantly to our cost challenges in the months ahead. This is, perhaps, as much driven by the situation in Venezuela as by the Middle East crisis. But it is a very real problem indeed. Moreover, the predicted colder winter in the Northeast will add further to the problem since jet fuel and home heating fuel are, for the most part, the same commodity and increased demand for either drives up the price for both.

The second cloud is the impending conflict in Iraq. If the history of the Gulf War is any indication, a conflict in Iraq will have very profound and adverse consequences for the airline industry. We are planning for this probability to the best of our ability. But a combination of even higher fuel prices, together with a precipitous drop in demand, will be an extraordinary challenge for us all.

A year ago, this Committee and the leadership of Congress rallied in a time of crisis to provide us a lifeline. I simply can't state strongly enough how important that was. You literally saved our industry. We continue to be grateful beyond words.

As I have indicated in this and previous discussions, we continue to need your help in the areas of security costs and taxes; however, that is not my primary mission today. Rather, my goal is to let you know that we are exhausting every conceivable means of self-help. At American that process is not yet complete. Our dialogue with our employees is intended to build a consensus within our company about a survival strategy. I can assure you there will be sacrifices needed by every single person involved, including, most certainly, both myself and the officers of the company. Indeed, the largest cuts to date have been in management—22 percent are gone permanently. By most corporate standards, we are running a very lean machine. After 9/11 all the officers took pay cuts, bonuses were eliminated, and managers' salaries were frozen.

In summary, that is our situation as of January 9, 2003. We hope it will improve and are doing everything in our power to make that happen. And finally Mr. Chairman and Members of the Committee, we are most grateful for both the reality and the symbolism of the Committee choosing the concerns of the airline industry for one of its first hearings of this Congress. We look forward to continuing this dialogue and working with you throughout the year.

Senator ROCKEFELLER. Thank you, Mr. Carty.

Mr. Anderson, you will be next.

STATEMENT OF RICHARD H. ANDERSON, CHIEF EXECUTIVE OFFICER, NORTHWEST AIRLINES, INC.

Mr. ANDERSON. Thank you, Mr. Chairman, and first, both as CEO of Northwest Airlines and as chairman of the Executive Committee of the Air Transport Association I want to express our thanks to this Committee and the leadership that it has provided. I agree with Mr. Carty in his statement that but for the work of this Committee after 9/11, including the work on the Transportation Security Administration, that has been vital to where we are today in the industry, that without your help and assistance in the post 9/11 environment, I dare say the circumstances we would be discussing here today would actually be far worse, if you could imagine that.

With that said, you really need to understand what the industry faces today in the context of deregulation. Deregulation set about changing dramatically our industry—and I am sure the father of deregulation, sitting down at the end of the table, will have a much better vantage point on this. Deregulation at a macro level has been a great success.

The safety record of the industry is phenomenal. Nominal air fares since deregulation have gone down 50 percent in constant dollars from 1980 to 2001, and we hit nearly 700 million passenger enplanements in the year 2000, so by all measures, air transportation has gone down in cost, safety has gone up, and air transportation has become much more accessible to many more Americans.

With that said—this is the third inflection point in this industry since deregulation. If you will recall, in 1980 with the failure of Braniff Airlines, we had a really significant down cycle in the industry. At the time of the Persian Gulf War, which saw the loss of Pan American World Airways and Eastern Airlines and Midway Airlines, we had another inflection point, and we are actually at the third significant inflection point in the post-deregulation environment, and the changes that are being made that many of the speakers before me, or the two speakers before me have highlighted, are permanent.

And I think the permanence, without going into any other fact, in 2002, the airline industry will have $19 billion in fewer revenues than it did in the year 2000. So, you essentially have businesses that today are operating on the same revenue streams that they had 6 years ago, and those changes are permanent. We can go into a lot of the reasons, the reasons being the impact of the Internet, the impact of new entry into the marketplace, but they are a reality that ultimately we have the responsibility as the leaders of these companies to fix. It is not at its core a government responsibility with respect to private industry righting its ship.

What have we done? Why are we here? We have talked about recession. We have talked about a significant reduction in business travel, the fall-off in travel after 9/11, and the continuing aftermath of the impact of 9/11, and more particularly now the war in Iraq, and the effect that the possible war in Iraq has, particularly on airlines that operate internationally, is very significant.

What have we done about it? It is first and foremost our responsibility, and Senator McCain, you mentioned Northwest eking out an operating profit in the third quarter of this year. It was as the result of some very painful and difficult decisions that we had to take along the way, like laying off 12,000 employees, closing a maintenance base in Atlanta, closing an engine shop, and basically going through our business and eliminating every unnecessary expense, including merit increases for officers of the company, reducing the number of officers at the company, imposing a 20 percent health care premium on our employees, and virtually going after every single expense at the company.

Those efforts have to continue, but in the end, it is our responsibility to get our costs in line with the ability of our airlines to generate revenues.

Now, there have been discussions about the hub-and-spoke system, and I would submit to you that the hub-and-spoke system is first the product of a deregulated market. One of the first significant events after deregulation in a free marketplace was the evolution of hub-and-spoke systems.

Second, airlines did not invent hub systems. They were actually invented by railroads and steamship companies, and it just so happens that most of the large hubs in the United States today happen to be in the same place where railroads built hubs, because it makes logistic sense to gather traffic and cargo and bring them into hubs and then redistribute, and if you look at even the low-cost carriers, several of the low-cost carriers operate hub-and-spoke systems. AirTran has a hub in Atlanta, Frontier has a hub in Denver, America West operates a hub in Phoenix, and Southwest Airlines relies on almost 30 percent of its traffic in hubbing kind of traffic. That is, flow traffic and through traffic. Most particularly, hubs are how small communities are served.

I actually have a slide that I brought (before I knew that Senator Lott would have his new position) that shows our service to Mississippi versus Southwest Airlines service to Mississippi. Southwest Airlines serves one city in Mississippi. Northwest Airlines serves seven cities in Mississippi, and we serve them every day, three times a day. We can take you to Minot, North Dakota, Brainerd, Minnesota, and on one stop put you in Tokyo.

We serve Bangkok, we serve Regina, Saskatoon. Most of the low-fare carriers have one fleet type, and they tend to serve large markets. They do not serve international destinations at all. It is very expensive operating a fleet of 40 747's, but from the standpoint of a global aviation community, and the importance, I know in the communities that I serve, where we have our hubs, our international service is critical to the auto industry in Detroit, and our international service in Minneapolis is critical to the success of 3–M and Target and Cargill, and the large companies that are the backbone of the economy in our communities.

We have ultimately the responsibility to right our ship, and I agree with Don Carty when he says we are not here asking for anything, but it does bear pointing out several issues with respect to the intersection of our business and government.

First, the Transportation Security Administration and the legislation this Committee created was exactly what the industry needed. The TSA has done a great job implementing that legislation, but much of the burden, including the cockpit doors that were intended by this Committee to be covered by the Transportation Security Administration, has not been covered by the Transportation Security Administration. The reality is there are significant financial burdens that remain on the airline industry that were intended by the legislation to be borne by the TSA.

Second, our cargo and mail revenue, a very significant portion of airline operations, has essentially been cut in half post 9/11 because of restrictions in the post-9/11 environment.

Third, market solutions like the Delta-Continental-Northwest alliance should be allowed to work. We are a deregulated industry. The Justice Department has clearly said there are no antitrust issues with respect to our alliance, and we should be allowed to go forward with a marketplace solution.

Fourth, in my testimony, I have put a simple map in, or a simple chart in that shows that on the average round trip ticket in the United States today, the tax is 26 percent. It has gone up; that tax has gone up 145 percent in 10 years.

Next, the CRS rules—the Department of Transportation has proposed rescinding the computerized reservation system display rules, and we endorse that effort on the part of the Department of

Transportation. One of the very real significant costs that we have as legacy airlines is the cost of distribution, and the distribution costs are really driven by the CRS rules, which are a legacy of regulation, and those rules need to be repealed.

And lastly, I would leave with you that we absolutely and completely support our government in its efforts in the Middle East. Many of our pilots are flying there. Many of our mechanics are working on those airplanes, and our airlines have the responsibility, and the Civil Reserve Air Force, to provide full support.

With that said, the impact of what is going on in the Middle East is very significant now. The price of a barrel of oil has been hovering from $30 to $32 a barrel. That number should be down, in a free market sense, in the $22 to $25 a barrel, and we know from our experience in the Persian Gulf War that in the event there are hostilities, that number will jump up to over $40 a barrel. Fuel represents, after labor, the second-largest item of cost on our statement of operations.

Once again, thank you for the opportunity. I am sorry the red light went on, but we do appreciate the opportunity to be here today, and look forward to your probing questions.

[The prepared statement of Mr. Anderson follows:]

PREPARED STATEMENT OF RICHARD H. ANDERSON, CHIEF EXECUTIVE OFFICER, NORTHWEST AIRLINES, INC.

Mr. Chairman, Members of the Committee, my name is Richard Anderson, and I am CEO of Northwest Airlines. Mr. Chairman and Senator Hollings, thank you and the Committee for all of the support you have given this industry, particularly in the last year. Unfortunately, the financial viability of the industry continues to deteriorate and we are confronting new economic challenges. I appreciate your holding this hearing to discuss the struggles we face.

I would like to begin today by stating three general principles that I believe are a necessary starting point for any analysis of the current state of the airline industry or any discussion of possible prescriptions for curing the severe problems it currently faces:

First, a viable and convenient air transportation system is an indispensable component of a well-functioning U.S. economy and has developed into a critical element in the quality of life enjoyed and expected by most Americans. Our air transportation system is the best in the world, as deregulation has been a tremendous success. Aviation safety has dramatically improved since 1978; the average fare has steadily decreased as more and more Americans have had access to the air transportation system at affordable prices.

Second, network airlines, with their hub and spoke systems, have viable business models and will continue to be the most efficient means to provide high frequency, convenient air transportation service domestically and internationally, to the vast majority of Americans, particularly to those located outside the major metropolitan areas.

Third, the U.S. airline system, in general, and the network airlines in particular, are currently facing their most significant challenges since deregulation. The industry is facing permanent changes to the revenue model that has fueled the tremendous growth and success of commercial aviation in the two decades since deregulation. What is this permanent change and how has it manifested itself? Put simply, passenger and cargo revenues have declined sharply for the whole industry. Beginning in February 2001, we saw a precipitous drop in overall airline industry revenue. Then September 11th occurred and devastated the industry. We had hoped for passenger traffic and yield recovery in the second half of 2002. That recovery did not occur. (Attachment 1 illustrates the revenue shortfall). U.S. carriers are projected to lose more than $7 billion in 2002, and could lose another $3 billion in 2003 before reapproaching profitability in 2004.

Two statistical comparisons will bring home the dramatic nature of the challenge we are confronting in the airline industry.

- Northwest in 2002 operated an airline about the same size as we did in 1996. And we will be lucky to have about the same revenues in 2002 as we had in 1996. But to run the same size airline, our costs will be over $1 billion higher in 2002 than they were in 1996.
- At Northwest, comparing August 2002 to August 2000, our actual passenger revenue declined 20 percent, on 9 percent less capacity, and 500,000 fewer enplaned passengers, an 8 percent decline. During the same time period, Northwest's total operating expenses declined 11 percent.

What are the reasons for this precipitous drop in revenues? First, is the economic recession. We at Northwest recognized early on the impact on our business of the recession and immediately took action to begin reducing our costs. But the recession turned out to be even deeper than we, or most others, thought it would be. And, perhaps more importantly, the recession has had a much larger impact on business travel than anyone could have anticipated based on past experience. Business passenger revenues for the industry are down 21 percent for the first 11 months of 2002 as compared with the same period in 2001 and they were down 36 percent as compared with the same period in 2000. As you can see from those numbers, the revenue problem is severe.

A second, and undeniably substantial, contribution to the industry's financial difficulties was the September 11 attack, which caused the entire system to be shut down and passengers to be stranded, sometimes for days. The overall effect of September 11th and its aftermath have produced an even greater dampening effect on demand for air transportation service. And here again, the impact has been disproportionately on business travel, by making the product less convenient and hence less valuable, further reducing the willingness of business travelers to pay a premium price.

Third, there has been a fundamental change in passenger buying habits. Business passengers (and their employers) have become much more price conscious—and more willing to trade inconvenience for a lower price (a phenomenon that is not unique to airlines).

These factors that have produced the current state of affairs, I would submit, have been not only dramatic and fundamental, but to a large degree, have become permanent, irreversible features of the industry landscape. Plainly stated, passengers are accustomed to paying lower fares, especially for business travel, than they were willing to pay just a few years ago. This is not to say that the economy won't recover; but we will not see again soon, if ever, the level of economic activity during the bubble years of 1999/2000, and we will certainly not see the willingness to pay significantly higher premium fares for domestic business travel. Moreover, the sustained growth of low cost carriers means that consumers will continue to have ever-increasing opportunities to make travel choices based on price. Added to this, the Internet is a powerful and ubiquitously available enabler of individual consumer choice. It thus will continue to be a mechanism for driving the widespread availability of low fares.

How should airlines address these challenges? On behalf of Northwest, here is what we are doing. First, one thing has not changed in the way we conduct our business. Our first priority has been, and will continue to be, the provision of a safe, reliable transportation system that provides convenient service to our customers. While we have not departed from our fundamental business mission, we recognize that because we have a cost structure that is higher than our revenue generating capability, we must match our costs to the revenue generating capacity of our network.

Northwest is often identified as being in relatively better financial condition than many of the other major carriers. One reason for this is that we recognized the need, and had the will, to take early action to cut costs as the drop-off in demand began to materialize in 2001. Beginning early that year, we implemented two rounds of cost cutting *before* September 11th. And we've implemented additional rounds of cuts since then.

During 2001 and 2002, Northwest substantially cut flying, and with that the staffing levels and fuel expenses that went with those flights. Those flying-related cost reductions total $1.2 billion per year. More importantly, we've implemented an additional $1.2 billion per year in permanent cost reductions in 5 rounds of actions, before, during, and after September 2001. We've cut distribution costs. We've cut management headcount by 24 percent (1,350 positions). We have also eliminated 24 percent of our contract employee workforce—that's 11,980 positions eliminated. We've eliminated some major facilities entirely. We've accelerated the use of technology.

Throughout this crisis, we have met regularly with the leaders of our employees. We have three union representatives on our board and our employee leaders have been kept fully up to speed on Northwest's financial outlook and the challenges we face together. Frankly, we, as with most other U.S. carriers, have collective bargaining agreements whose foundations were built in the era of regulation and which were negotiated in the context of a business model that is dated.

While each airline must be responsible for solving its own problems, actions by the Federal Government have sometimes added to, and complicated, this task.

First, we fully support and commend the Congress and DOT for the work on security. But, much of the burden and costs of implementing security safeguards mandated by the Federal Government has been placed on the industry. Airline tickets already bear a September 11th security fee. To that is being added extra charges in the form of un-funded mandates on airports and airlines, requiring them to bear the costs of various federal security functions: the provision of TSA office space at airports; security at airport perimeters; additional local law enforcement officers at airports to meet new TSA requirements; airport screening of caterers and other service employees; the funding of much of the build-out of airports needed to deal with new TSA requirements; and the payment of the costs of the permanent cockpit door modifications, much of which remain un-reimbursed. Congress rightly made all of these functions federal responsibilities in the Aviation and Transportation Security Act. And they ought to be funded accordingly. Second, we have had to bear the loss of revenue from prohibitions on carrying significant amounts of mail and cargo.

Third, consistent with Congress' intent in deregulating the industry, the government should allow carriers to innovate and compete to the same degree as firms in other unregulated industries. One of the major initiatives we have taken in aid of our recovery is to propose expansion of our existing, and highly successful, code sharing alliance with Continental to include Delta Air Lines. Northwest, Continental, and Delta last August submitted the proposed marketing agreement to DOT. It involves the same features as our current alliance with Continental and as the United/US Airways agreement that DOT cleared after a brief review. Like these other alliances, our marketing agreement preserves the competitive independence of the carriers, as well as their incentives to compete. There is no antitrust immunity being requested, so the carriers remain fully subject to the antitrust laws. Like the other two alliances, the marketing agreement promises substantial consumer benefits in terms of broader network offerings, new online routes, improved service on existing routes and expanded frequent flyer and lounge program benefits. These service enhancements will stimulate consumer demand and thereby allow each of the carriers to earn critical incremental revenues.

The Justice Department completed its review of the marketing agreement last October, based on our agreement to conditions that we understand to be identical to those required of United/US Airways. Nearly three months later (and more than five months since we submitted the agreement), the Department of Transportation remains enmeshed in its review of a proposal that does not present any issues that were not equally presented by the United/US Airways agreement, which DOT cleared after a review period of a little over two months. We are not asking for special treatment; only that the Federal Government provide equitable treatment, particularly in view of the extreme importance of the marketing agreement as part of our recovery plan.

Fourth, the airline industry is overtaxed. In 1972, shortly after the Aviation Trust Fund was established to support airport and airway development and ticket taxes were imposed, 7 percent of an average ticket went to ticket taxes and fees. By 1992 that figure had increased to 10.5 percent. Today the taxes amount to 26 percent of the average ticket, counting ticket taxes, security fees, and PFC's authorized by the Federal Government. (Attachment 2 illustrates the tax burden on a typical ticket). In the case of the most deeply discounted tickets, over 40 percent of the ticket price can be accounted for by government-imposed ticket taxes.

These taxes and fees are simply too high and they cannot be passed on to passengers in the form of higher ticket prices. This means that they are an added cost at a time when we are already under tremendous pressure to cut costs throughout our system.

Fifth, despite steps we have taken, distribution costs remain one of our highest cost categories. In particular, U.S. airlines pay over $2 billion per year in Computer Reservation System fees, fees that the Departments of Justice and Transportation have long found to be excessive. We are not asking for any extraordinary relief here, only the chance to bargain for better fees, just as we bargain over the price of any other goods or services we buy. The Department of Transportation has recently proposed changes to the CRS rules that would create the possibility that we could bargain with the CRSs for more reasonable fees. This is a modest but necessary step in our ability to get these excessive costs under control, and I commend the Department for their proposal. It would in fact be one of the few ways we could reduce costs without either reducing amounts paid to employees or air service to communities.

Sixth, the overhang of war in the Middle East and its impact on fuel prices and demand is one of the biggest risks facing the airline industry right now. A war with Iraq would raise fuel costs, lead to a drop in passenger traffic and increase security measures at airports and airlines as further security precautions become necessary. In addition, carriers would have to bear an extra cost for rerouting their flights around air space in the Middle East. War would delay any recovery in the industry that is still under severe strain from the effects of the terrorist attacks of September 11th.

I want to thank the Committee again for its interest in these issues of critical importance not only to the industry, but also to the traveling public. Notwithstanding the huge challenges we face, I am optimistic that we will find a way to navigate through this storm. The airline industry is an indispensable component of our national economy. With responsible action by the Federal Government, airlines and their employees will rightly be held responsible for their own successes or their failures. We at Northwest intend to succeed. I would be happy to take any questions the Committee may have.

Attachment 1

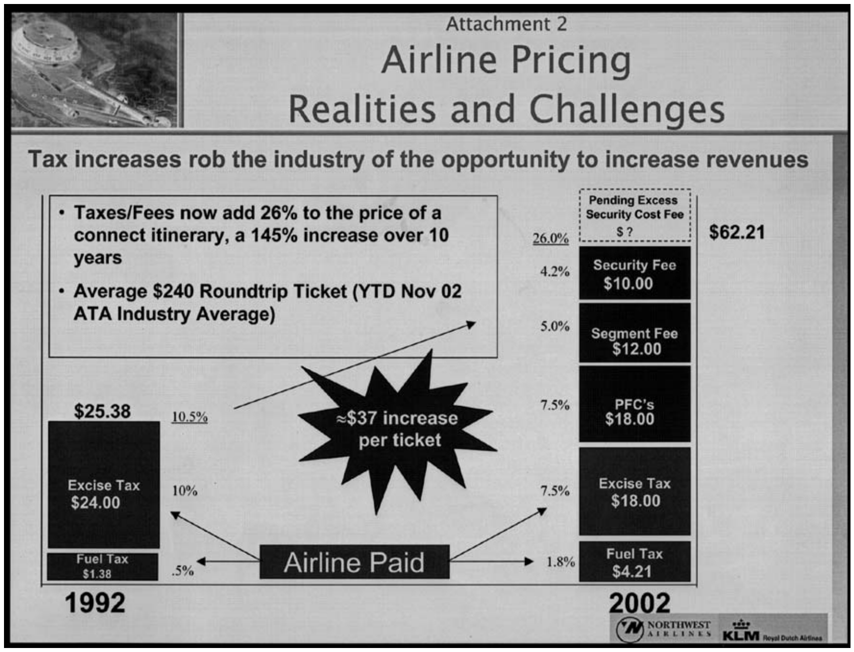
Industry Revenue Trends

Domestic Industry Revenue Trends

NORTHWEST AIRLINES

- Although Industry passenger revenues have grown on average 4.5% annually from 1990-2000, revenues have significantly deteriorated since 2000
  - In fact, year 2000 should be considered as a "bubble" year with a growth rate of 10.5% vs. 1999
- Industry revenues in 2002 have deteriorated an estimated $19 billion or 25% when compared to 2002 projected revenues based on 1990-2000 actual regression

Data Source:
Form 41 (1990-Q2 2002); Actual Air Transport Association data adjusted for non-ATA carriers (Q3 2002); Estimate based on historical Q3-Q4 relationship (Q4 2002)



Senator DORGAN. (presiding) Senator Rockefeller will return momentarily.

Next to testify is Duane Woerth, president of the Air Line Pilots Association. Mr. Woerth, why don't you proceed.

STATEMENT OF CAPTAIN DUANE E. WOERTH, PRESIDENT, AIR LINE PILOTS ASSOCIATION, INTERNATIONAL

Mr. WOERTH. Thank you, Senator. Thanks to all the Members of the Committee. Thanks particularly Senator McCain and Senator Hollings for the invitation to testify. I am president of the Air Line Pilots Association, which represents 66,000 airline pilots who fly for 42 airlines. I am also a vice president of the AFL–CIO's Transportation Trades Department. We represent in that body the mechanics and the flight attendants and the customer service agents, and certainly even those on the manufacturing side which have been impacted by this. This is affecting Boeing. This is affecting all the manufacturers. This is affecting all the avionics people.

Basically, about 150,000 people in the aerospace business have lost their jobs since September 11. I think what we have to focus on, what is different about this recession? We are deregulated. We live with the ups and downs of the economy. Every time there has been a recession—I have been in this business 25 years—people get laid off, and people take pay cuts. That happens every time. When we recover, we try to get pay raises and make our life a little better, but what is different this time is the war on terrorism, and we need to focus on that distinction.

We are a global industry. We buy our airplanes from the same two manufacturers. We buy our fuel in a global market. We even use the same capital markets. Half our loans are from Japanese or German banks. It is a global industry, but the industry is not in trouble globally. It is only in a crisis in the United States of America, and the only thing that is different between Lufthansa and KLM and the Japanese carriers, and even Canada and Mexico, who are making money, is we are fighting a war on terrorism, and we have extraordinary costs. It has affected our consumers, and it has affected them in a dramatic way.

I think the most important debate that was started before you all adjourned at the end of the last session was over homeland security. That is probably the most important thing in front of this country, along with fixing our economy.

So, the debate centers on this for our industry. What is the appropriate amount of cost to be borne by the airlines and its passengers or cargo shippers, and what is an appropriate cost of homeland defense? We are not just defending airplanes. We are defending citizens in the cities. We learned that in New York City. It could be true in Chicago, in Los Angeles, any place in this country.

Homeland security is defending the Nation, not just the airline industry. So I think we need to have a full and fair debate on what is the appropriate cost for the airlines and their passengers to bear, and how much of this security—should be borne by the TSA and the Homeland Security Department.

I would also think Congress would like to review the intention of the Air Stabilization Act and how it was applied. Certainly—and I really appreciate all your efforts. ALPA worked with all of you, in the rapid response that this Congress displayed—30 days after September 11, you had passed legislation in both bodies, and I am very much grateful for that effort. But none of us probably knew or suspected at that time how bad the industry was going to get, how long it would take to recover. The $5 billion in grants, as Secretary Shane has stated, has pretty much been granted, but two-thirds of that package was $10 billion in loan guarantees, and I am wondering, did Congress intend that that money not be actually used, or was it to stabilize the industry?

The result is, we do not have a stabilized industry, and most of that $10 billion in loan guarantees was never used, and I think we deserve, and I think you deserve an explanation from those in the Administration administrating that program. Is that what you intended, that none of this money would be loaned out? I think that was a mistake.

The third thing I would like to address is that we have another disaster coming down the road. It is the time bomb of the problem in the airline business, and that is with pensions. Because of pension law, the crisis has been deferred. The law allows many months, 18 months, 24 months before you have to catch up with your pension obligations. Well, that time is upon us, and certainly at places like US Airways, we are at a crisis point.

I think you are probably aware both Senator Specter and Senator Santorum will be offering some legislation that would help the PBGC stabilize the pension system so we can amortize them over a longer period of time and not force these things into distress terminations and cause a great burden to the PBGC and also harm the workers.

Lastly, I must say that I think it is a poor workman who quarrels with his tools, and I am referring to trying to amend the Railway Labor Act to protect us from ourselves. The Railway Labor Act produces contracts 99 percent of the time. Only about once every 10 years do we have a strike in this business, but in spite of dozens and dozens and dozens of airlines—I represent 43 airlines, 42 airlines now after some mergers, and only every 10 years do we have a strike, so if any law produces 99 percent success, how are we calling that a failure, and why should I blame, or ask Congress for an arbitration—a compulsory arbitration—instead of solving the problems ourselves, and not have any buy-in from the workers or management?

I do not think removing the collective bargaining rights—and that is what this does—if anybody would make compulsory arbitration, collective bargaining would be over. I do not think any of these executives who might be pushing this would accept this in any other part of their business. Would you accept arbitration of your fuel bills? Would you accept arbitration of the price of your airplanes? For the price of your jetway? Of anything? Free enterprise, free markets, collective bargaining is a part of that, and we should not willy-nilly eliminate those rights.

I believe that as a union president—it is my responsibility to get it right with bargaining, to work with the National Mediation Board and get it done with management cooperatively. I think it is too big, and a risky and unnecessary step to try to make compulsory arbitration. It is provided voluntarily in the act now, and the president has a way to protect the public with a presidential emergency board. I think this is a solution in search of a problem.

Thank you.

[The prepared statement of Mr. Woerth follows:]

PREPARED STATEMENT OF CAPTAIN DUANE E. WOERTH, PRESIDENT, AIR LINE PILOTS ASSOCIATION, INTERNATIONAL

My name is Duane Woerth, and I am the President of the Air Line Pilots Association, International. ALPA represents 66,000 airline pilots who fly for 42 U.S. and Canadian airlines. I also appear as a vice president for the Transportation Trades Department, AFL–CIO, whose 35 member unions represent several million transportation workers including the vast majority of the nation's airline employees.

We sincerely thank you Chairman McCain for inviting ALPA to present our views on the state of the airline industry and our recommendations for solving some of the industry's problems while protecting the interests and jobs of America's aviation workers.

The State of the Airline Industry

The New Year opens with the airline industry experiencing problems of catastrophic proportions. Revenue losses are considerable: industry analysts estimate that losses for 2002 will total $7.4 billion compared to a 2001 loss of $6.2 billion. The industry experienced a net loss of $1.6 billion, and stock values plummeted—dropping 54 percent for the major airlines just for the third quarter.

The Airline Index as of January 3, 2003 is shown below as *Figure 1*.

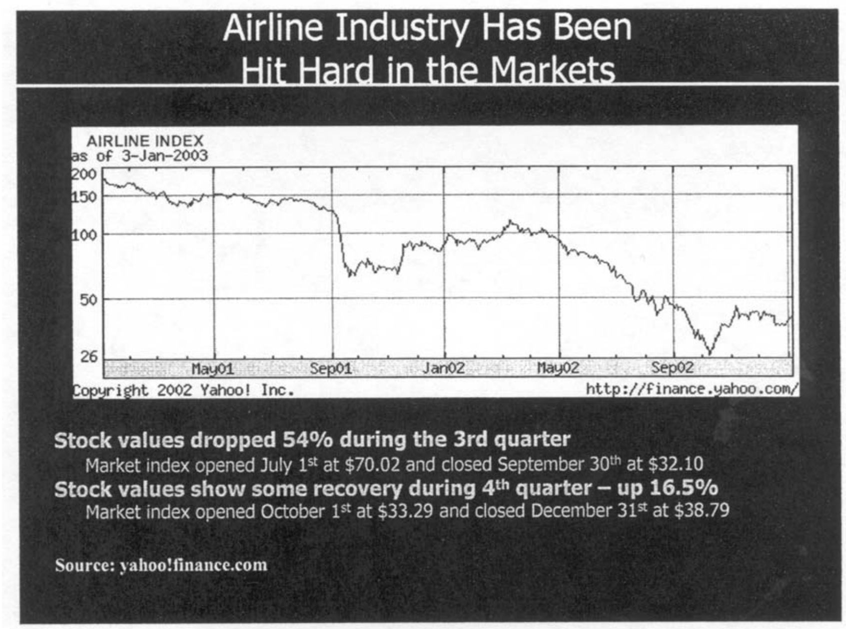


Figure 1

Two major airlines are in bankruptcy.

In addition, general industry forecasts are difficult to determine due to a number of events. The combination of an unstable economy, the continued threat of terrorism, and possible war all factor into the possibility for recovery or the potential for further erosion of industry income. Analysts have been revising their forecasts downward throughout the year. It is projected that the industry will experience a $3–4 billion net loss for 2003. (*Figure 2*)

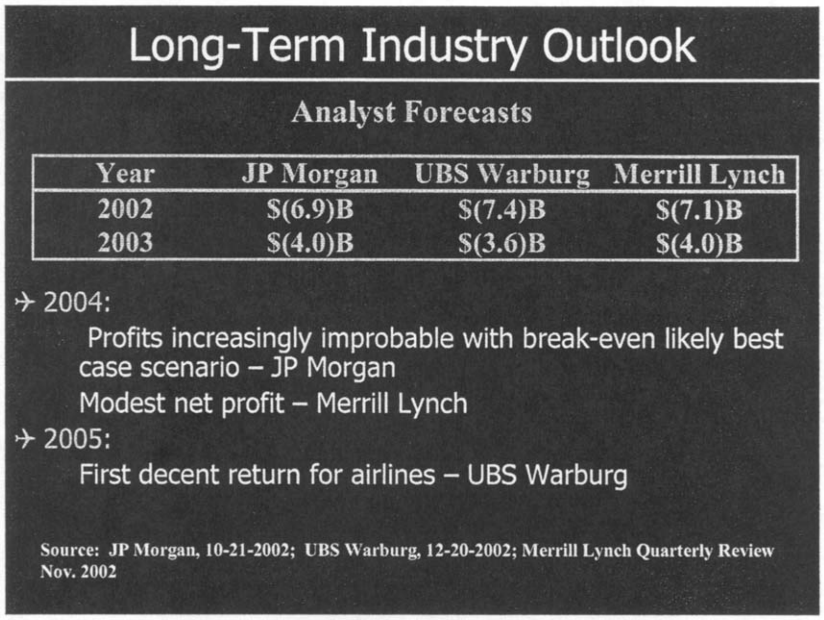


Figure 2

Other factors are contributing to this bleak forecast. We are seeing a second round of global furloughs for airline employees. For bankrupt carriers US Airways and United this will mean more employee cuts. Revenue levels continue to deteriorate with estimates for 2002 at 25 percent below 2000 levels. (*Figure 3*).

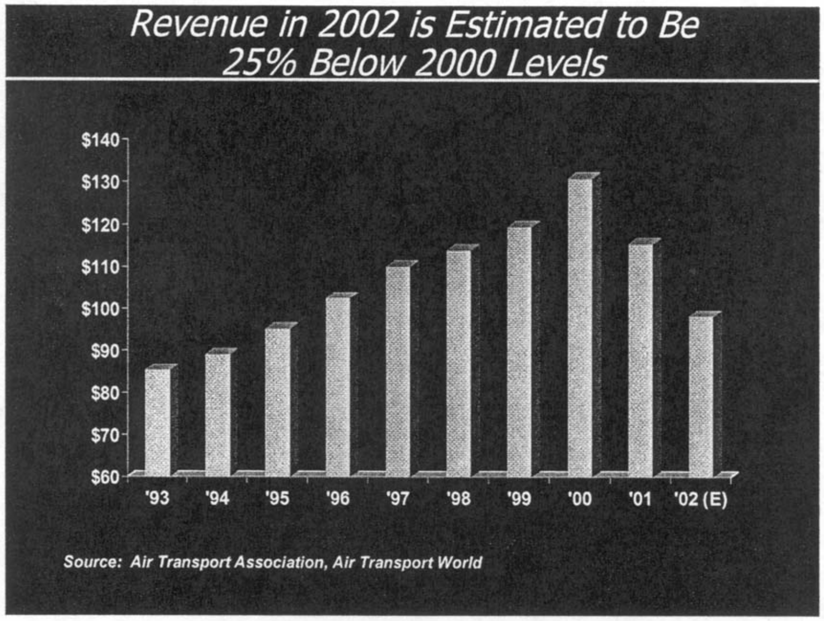


Figure 3

The current environment continues to challenge the industry. Customer behavior changes have been seen by the weak passenger mix, as the business passenger has sought lower fares. The airlines' inability to raise fares in a time when the airlines have little pricing power is having a very negative effect on profitability. Below find *Figures 4 and 5*, which show the decline in Domestic and International, fares.

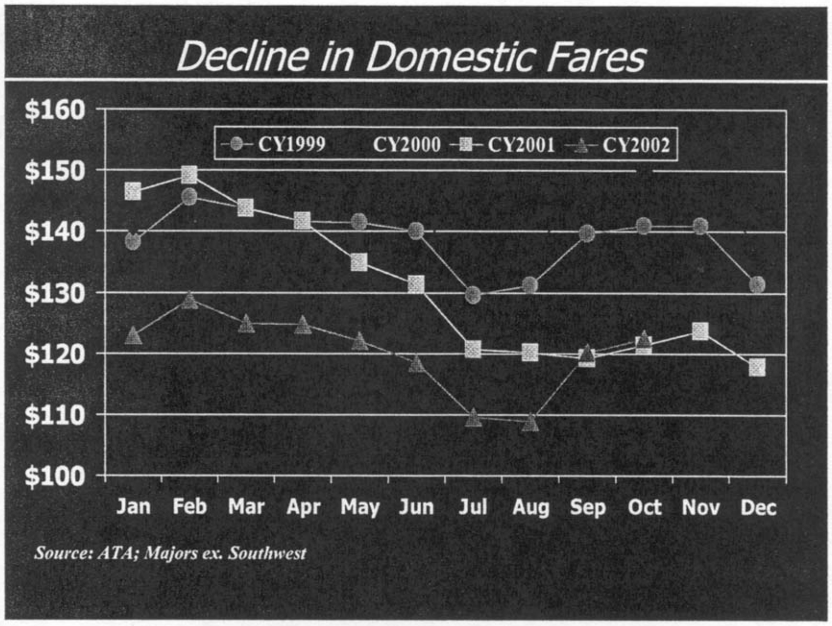


Figure 4

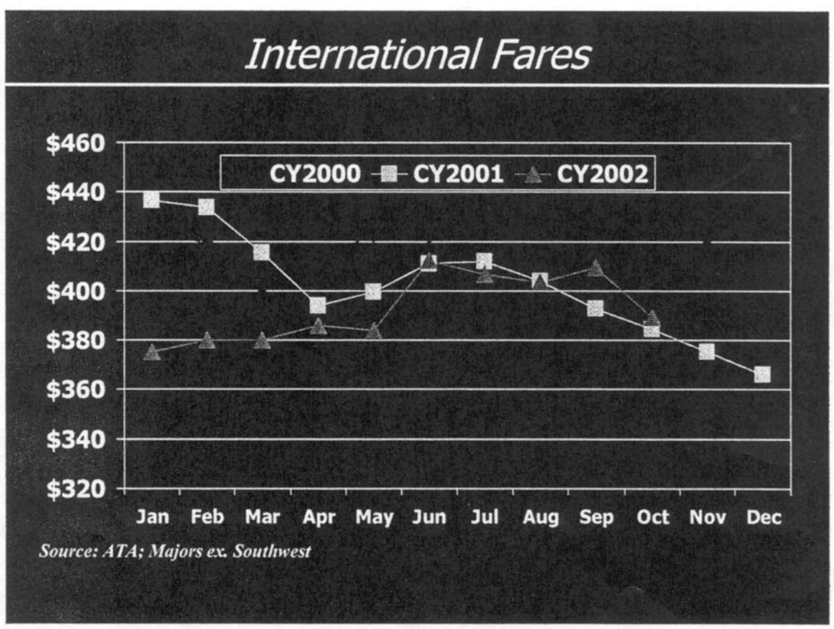


Figure 5

Fuel prices remain volatile and the debate looms regarding the potential impact the industry will face if the U.S. goes to war in Iraq (*Figure 6*).

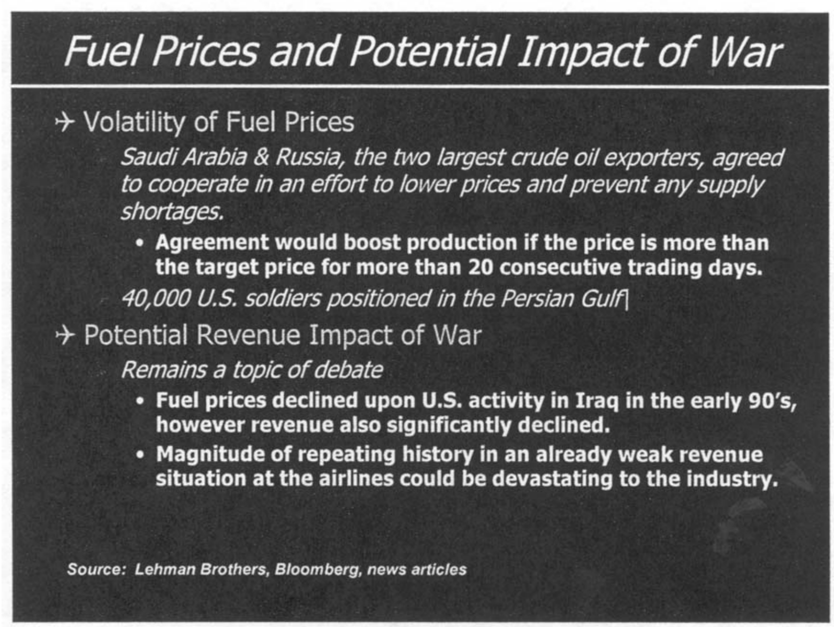


Figure 6

Travelers continue to be deterred from air travel due to the "hassle factor" and are using alternate forms of travel. Single day business trips are now being conducted by conference calls.

Indeed, the state of the industry was characterized as being in an "economic meltdown" in a recent speech by Carol Hallett, Air Transport Association President and CEO.

For airline workers, the consequences have been devastating. More than 150,000 airline and aerospace employees are now laid-off and thousands more brace for layoff as air carriers struggle to emerge from or avoid bankruptcy and aircraft purchases continue to sag. And I remind the Committee that those workers were among the first to experience the dire economic consequences of 9/11 as thousands have exhausted their unemployment benefits and health care coverage.

To date, nearly 7,000 ALPA pilots are out of work, with more furloughs predicted. Within the next two months, we could see this number grow to nearly 8,000 very qualified and experienced pilots out of work. In an effort to help their airlines reduce costs, pilots have made major concessions, agreeing to significant pay cuts and other benefit reductions. What is the result of these concessions? Well Mr. Chairman, US Airways pilots took a $465 million cut effective last year with an additional $101.3 million, excluding pension savings, for a total of $566.3 million average per year. These average annual pilot cost savings are effective through December 31, 2008. United Airlines pilots, just yesterday, ratified a 29 percent wage cut package.

These concessions are just those made by the pilots. They do not include the concessions made by all the other employee groups.

In addition, we are seeing degradation and, in some cases, total elimination of long-held airline employee retirement and insurance benefits. These benefits were bargained in good faith, in lieu of direct compensation, with the expressed purpose of protecting pilots and their families before and after their employment years ceased. In a cruel twist of fate, pilots have made meaningful concessions to protect these benefits and then seen a confluence of negative events, beyond labor's control, conspire to further jeopardize their retirement security. These ongoing events include an extremely negative stock market performance and a historically low interest rate environment that mandates additional retirement funding charges, at a point in time when air carriers can least afford to pay.

The consequences of this meltdown are so grave that in that same speech, Ms. Hallett stated that, to save the industry it may, and I quote, "necessitate nationalization of the industry."

ALPA Recommendations

I think we all agree that nationalization is *not* a solution to this crisis. I'm not sure that some form of re-regulation might not be required, however, that is a discussion for another day.

There are other solutions that can be implemented right now that can turn this industry around. However, everyone must do their part and take immediate action to implement these solutions.

ALPA pilots are committed to ensuring the survivability of the industry. They are doing their part and will continue to work with management, federal agencies and other industry organizations to return the industry to viability. They are working with management to reduce costs and help establish financial stability through reductions in pay and benefits and increased productivity.

Airlines are working to find ways to reduce costs, and Congress has enacted legislation and established an oversight Board to help the airline industry. While we applaud these efforts, though, they are not enough and to this day, despite bipartisan support for action following 9/11, Congress and the President have failed to provide relief to the staggering number of jobless aviation industry employees who, through no fault of their own, are out of work and have no reasonable expectation of becoming re-employed in the foreseeable future.

We must make a concerted effort together to turn the industry around.

First, the Air Transportation Stabilization Board needs a course correction. Congress charged the ATSB with providing airlines with loan guarantees to help ailing airlines weather the effects of 9/11. But to date, it has failed to carry out this charge. It has turned its back on several airlines—two of which are in bankruptcy, and one that is out of business because they didn't get help. The Board must be held accountable. Either change the law so that the Board must carry out its mandate, or replace it with a more responsive and responsible entity.

Next, we must provide major tax relief for the airline industry. Taxes are choking the industry to death. Airlines face a myriad of charges on passengers, fuel, cargo, and security. They are able to keep far less of a percentage of their revenue generated from passenger ticket price and cargo fees than carriers from many other countries.

Currently, airline travel is the highest taxed good or service available *(Figure 7)*. Airline passengers who buy a single-connection roundtrip ticket for $200 can expect 25.6 percent of their ticket charge to go to the Federal Government in taxes and fees (Figure 8). In 1972 and 1992 the taxes represented 7 percent and 15 percent, respectively, of the total ticket fare. A comparable trip for $100 gets taxed a massive 44.2 percent! *(Figure 9)* (PFC in Figure 8 and 9 is the passenger facility charge.) The airline industry's tax burden must be reduced.

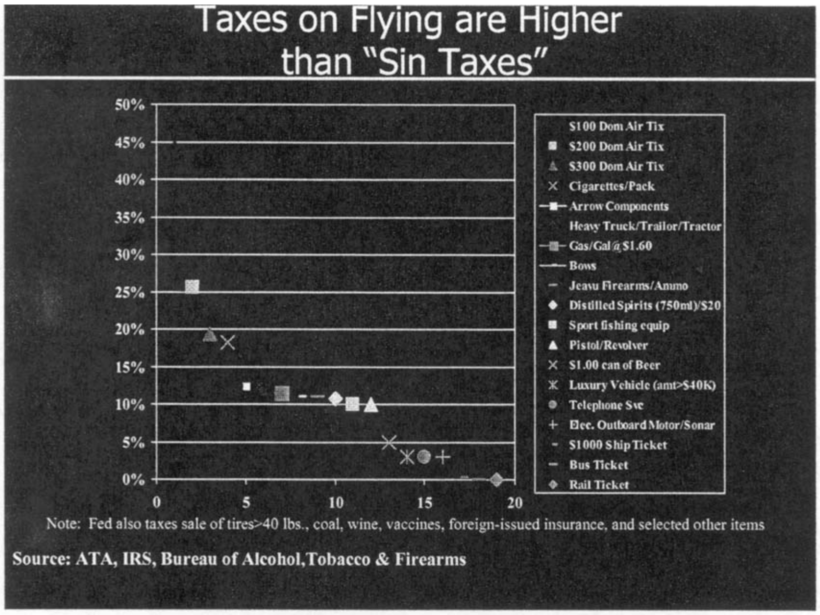


Figure 7

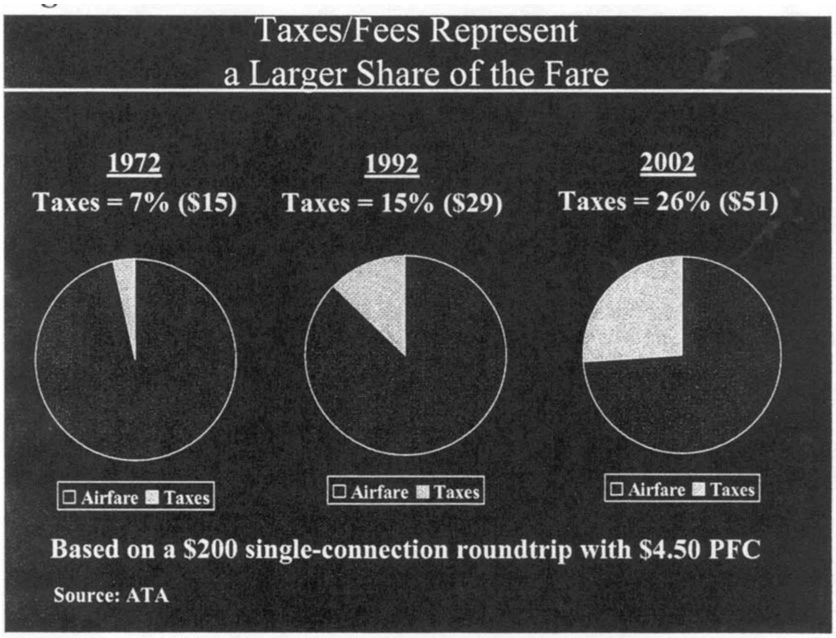


Figure 8

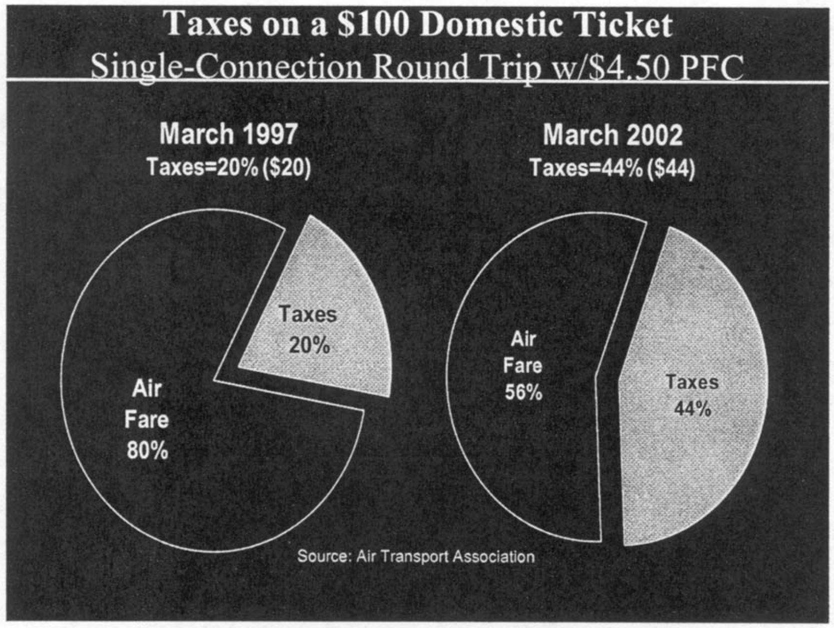


Figure 9

Third, Congress must take action to ensure employee pensions are protected. If the Pension Benefit Guaranty Corporation is unwilling to use its broad mandate to take action necessary to preserve pensions such as those at US Airways, Congress must act. ALPA and US Airways seek to amortize the payments necessary to fund the pension plans over a thirty year period consistent with their business plan as a basis to secure the ATSB loan guarantee and emerge from bankruptcy.

Fourth, Congress must provide extended jobless assistance to the laid-off workers in this industry who unfortunately were the first to face the devastating economic effects of 9/11 and to this day struggle to provide for their families as this industry's downward spiral shows no signs of reversal.

Finally, we must shift the burden of security costs to the Federal Government. The airlines, and their customers are now bearing additional security-related costs exceeding $4 billion annually.

The bill to approve creation of the Department of Homeland Security does not include appropriations to pay for all the security programs that Congress and the Administration have created—programs that ALPA members strongly support. The Federal Government must assume responsibility for these costs, as they do for national defense, while at the same time ensuring that all security measures are in place and enforced.

As I said earlier, our pilots are ready and willing to work together with management and the government to solve the problems of the airline industry. This is not a time to impart blame. Labor-bashing, as we have seen within certain elements of the airline industry, won't turn this industry around.

Remember, it was our pilots and the other airline workers who returned to flying during the dark days immediately after September 11th. It is our pilots that have worked with this Committee, as well as the Transportation Security Administration and other organizations to make flying safer and more secure. It was our pilots who continue to develop and offer additional security measures to enhance air safety. It was our pilots and their cabin crew partners who flew nearly 600 million passengers safely, without a single fatality this past year.

And, let's not forget that many of our pilots are getting ready to go off to war again in support of the government's actions against another threat to our national security. This problem is not our fault and it's not any employee groups' fault. The sooner everybody—pilots, management, other employee groups and Congress—starts working together as part of the solution, I guarantee the sooner that solution will come.

ALPA thanks you again for the opportunity to appear before you today to make our views known to the Committee. I would be pleased to respond to any questions you may have.

Senator ROCKEFELLER. (presiding) Thank you, Captain Woerth. Professor Kahn.

STATEMENT OF ALFRED KAHN, ROBERT JULIUS THORNE PROFESSOR OF POLITICAL ECONOMY EMERITUS, CORNELL UNIVERSITY

Mr. KAHN. Thank you. I am honored by your invitation. I hope it is not presumptuous of me to congratulate the Committee. I think these hearings are terribly important.

I would only add, because I am afraid you would not otherwise have enough work to do, that you ought to have a similar look at telecommunications. That is to say, we have here two fundamental huge industries, both of which have been affected by, in the one case, complete deregulation, in the other something that goes under the guise of deregulation, but is obviously neither one nor the other, and I think this look is just terribly important. It was a challenge to me to look at the industry again in its present abysmal condition.

I think I do—without in any way imposing on you by rearguing the case for deregulation, I want only to say peremptorily, and I regret it is in the absence of your present Chairman, that deregulation in the airlines has been an outstanding success, that the savings to travelers have been estimated now at $20 billion a year by the most authoritative studies we know, and, of course, the growth of hub-and-spoke, which, as one of our witnesses pointed out, could not possibly have occurred under a regulated industry, has permitted a great increase in the number of origins and destinations available from all origins across the country, and that history of regulation demonstrates could not possibly have happened as long as every change in a company's route alignment or structure had to be subject to judicial, quasi-judicial determination by a Civil Aeronautics Board that was determined to take the place of private enterprise in deciding what would be profitable and what would not be profitable, and whether it would be injurious to competitors or not, which is, of course, in a sense the essence of competition.

Now, just one other sentence on that, in a sense self-justification. Of course those sharp reductions of fares and the great savings to travelers have been accompanied by a great increase in congestion, a clear deterioration in the quality of service, but I suggest that was a success of deregulation, not a failure.

When the average load factor on your planes is only 50 percent, or 52, as it was in the decade before deregulation, and it has been in the 70 percent range in the 5 years before the present downturn, of course you are going to have more congestion. That is, however, what makes possible the offer of lower fares, and the problem with the previous system was that it offered people good service at uniformly noncompetitive high fares, and a competitive market offers people options, including the option of crowded service, long lines, uncomfortable service, but at very, very low prices, and I am proud of that. That was our intention, and incidentally, in contrast, or in support of the argument I made to the heads of the AFL–CIO back in 1978, in fact, we have not had an increase in unemployment. On the contrary, employment in the industry has doubled during this period.

Now, the fact remains that the industry is in a financial crisis, and that inevitably raises the question of whether we need any fundamental changes. The thing to remember is that the airline industry has always been unusually sensitive to changes in the state of the economy generally, both before and after deregulation, and we have to concede that, by unleashing price competition, deregulation has permitted the economy-wide recessions to be aggravated by competitive price-cutting. But that is always going to happen in a competitive industry which has very, very heavy fixed costs, you are going to have a great deal of price competition.

Now, remember that in the 1990 to 1993 period the industry lost some $13 billion, more, it is said, than it earned in its entire history since the Wright Brothers first flew. At that time, there were cries for renewed regulation and government assistance, but we argued that it was a normal, cyclical phenomenon. Demand would recover. The industry would learn from its previous mistakes, and in point of fact, of course, the industry's profits were highly satisfactory—by no means characterized as monopolistic, but nevertheless highly satisfactory—in the 5- or 6-year period in the late 1990s.

Now, the fact remains also, however, that the industry is in a much more catastrophically bad financial situation now than it was even in the early 1990s, and, of course, as you all recognize, this has been greatly exacerbated by September 11, and in the circumstances, I have had no hesitation in agreeing whenever I was asked, that temporary assistance, large-scale assistance to such an important industry with these huge, in effect quasi-military costs imposed on it, was not in my belief in any way incompatible with the philosophy of deregulation.

Of course, I also argued that the offers should indeed be made—contingent offers of government assistance—on major give-backs of extraordinarily inflated wage costs that were achieved by powerful unions, and point out only briefly that, to my pride, I argued for exactly the same thing in 1978, when we gave a multi-hundred-million-dollar loan guarantee to Chrysler at the very time when the UAW had signed a contract giving them over 13 percent raises per year over a 3-year period, and Senator Proxmire called the bill back and demanded concessions from dealers, from parts suppliers, and from the unions, and I do not see anything wrong with that process now.

The real problem before us now, however, is, there seems to be, as I think all the witnesses have stated, a secular change that is also taking place in the industry. One of the major successes of deregulation was the spread of hub-and-spoke, which made it possible to serve small communities via strategically placed hubs, and even to sparsely settled areas, but those, I should point out those advantages of the hub system never translated into enormous profitability, but the fact is that the serious fact of which we have become increasingly aware is that giving that kind of ubiquitous service, or almost ubiquitous service—and by the way I supported the essential air community, or air service bill as well—that that involves very, very heavy fixed costs. It is not just serving a lot of destinations that would not otherwise be possible, but having convenient scheduling, and when you have an industry that has extremely heavy fixed costs, it is not surprising—it is a phenomenon in the economy in general—that the industry developed really brilliantly what they call yield management.

Now, I know a lot of people hate yield management. They think it is discriminatory. The fact is, as economists have known for 100 years, that industries with very heavy fixed costs have to develop differentiated price structures in which, in the case of the airlines, you fill the planes by offering very low, as low rates as are necessary to fill the empty seats and still get some contribution, while at the same time charging the people to whom the convenience of the hub-and-spoke system and the convenience of the scheduling are particularly valuable, and that has, in fact, occurred, and it has been necessary, and there is nothing immoral in it.

Senator ROCKEFELLER. Professor Kahn, with great respect, you understand that the red light is on.

Mr. KAHN. I will be very brief, or—I promise, and I will talk fast.

The problem then that the Committee, I think, has to confront is what kind of government policy is appropriate in the situation in which the industry is going through, not just a temporary emergency, but as Don Carty pointed out, a structural change in the direction and the diminution of supportability of hub-and-spoke operations. It is not surprising in these circumstances that members of the industry have turned to mergers and have turned to alliances.

I do hope that you will look carefully at the proposed alliance of Delta, Northwest, and Continental. As everybody has pointed out, alliances are an extension of hub-and-spoke. They have permitted the advantage of those to go to more origins and destinations with a single fare, a unified fare, which in itself, I point out in my statement, is very, very valuable, and the evidence shows it is lower.

At the same time, and I am not suggesting an opinion, I simply think it is necessary to be more certain than I am that the negotiations on one carrier A saying we will put my travelers, my customers on your planes, and you will put your customers on my planes, is simply—and this is truly an expression of ignorance—I do not quite see how you do that without agreeing in some way to curtail your scheduling, I will curtail my scheduling and put mine on yours.

The only other thing I want to call to your attention is—and that was a question. The other is the combining of frequent flyer programs. Frequent flyer programs are a brilliant competitive tactic—and developed, I think, initially by American Airlines, but they also operate by, in effect, giving exclusive patronage discounts.

The value of these credits gets higher and higher as you stick to one carrier. Therefore, it has also been brilliantly successful with the hub-dominating carriers, and I am worried that the—at least I want to know the answer to the question of whether putting together these three carriers, (1) in any way threatens horizontal competition between them on the routes on which they are likely to be the only or the major carriers, that is, between their respective spokes, and second, can we be certain that putting the frequent flyer programs together does not exclude smaller competitors from a fair opportunity to compete on the basis of their efficiency.

This is not an argument, per se, against alliances, because alliances are an extension of hub-and-spoke, and hub-and-spoke has been successful. The regulation is not the way to help the industry solve its problems. They are going to have to work it out themselves. To what extent that does require alliances and to what extent that can truly be done without suppressing competition is an open question in my mind.

Thank you very much.

Senator ROCKEFELLER. Thank you, Professor Kahn.

Mr. MITCHELL.

STATEMENT OF KEVIN P. MITCHELL, CHAIRMAN, BUSINESS TRAVEL COALITION

Mr. MITCHELL. Mr. Chairman and Members of the Committee, thank you for inviting the Business Travel Coalition to this important hearing. The airline industry is in crisis and in need of reform, as is abundantly evident. A brief story underscores the need for this reform, and reform in the broadest sense.

I was on the phone recently with a journalist in Syracuse, New York, who had to go to Phoenix, Arizona. The problem was that the fare was $1,800, so he went onto the Internet, which gives transparency not only to the major network carriers' fare structures but also to low-fare carrier offerings and alternative airports. He ended up finding a fare, and he drove to Buffalo and connected through Pittsburgh for $268.

I shared that with a number of airline executives at an industry gathering recently, and they said, Kevin, you just do not get it. When that guy realizes the value of his time, he will be back, and I said, in all due respect, you may get him back at $368 or $468, or maybe even $568, but the days of $1,800 are clearly over.

There is a backlash among business travelers and senior managers who oversee corporate travel budgets, and the backlash is against major airlines' policies and the overall travel experience. Specifically, sky-high business air fares, eroding customer service levels, and aviation system gridlock converged during the late 1990's to greatly deepen and lengthen the fall-off on business travel demand that the airlines are currently facing. However, BTC is optimistic. Over the next 18 or so months, it is very likely that these three issues, pricing, service, and aviation system reliability, will be largely addressed by an industry restructuring.

Driving factors that are forcing major network airlines to restructure include recognition, as late as it might be, that the fall-off in business traveler demand is not 100 percent tied to the economy, and the business traveler now has an unprecedented range of alternatives to a seat on a major airline. These alternatives, the automobile, train, bus, charter jet, fractional jet, videoconferencing, webcasting, in effect combine to form a powerful disciplining force on major airline pricing. In effect, they represent a proxy for the market contestability theory upon which deregulation was premised.

Of all the alternatives, though, it is the low-fare airline product that is disciplining the major airlines the most. Low-fare airlines as a segment have nearly doubled their national market share since the last industry cyclical downturn in the early 1990's. They now have seasoned management teams, more and newer aircraft, expanded route systems, and an air fare structure that consumers can understand and embrace.

Of particular importance to this hearing is that when low-fare competition and the consumer were threatened in the late 1990's by artificial barriers to market entry, and in some cases alleged predatory competitive behaviors, this Committee's work was critical in drawing national attention to the problem and helping preserve competition.

Importantly, were it not for a resurgent low-fare airline segment, it is doubtful that major airline executives and airline union leaders would be taking the restructuring so seriously right now. As optimistic as I am, however, there are three serious threats to low-fare competition and to successful major airline restructurings.

Number 1, Federal taxes, taxes that are now baked into the airline ticket can exceed a third of the ticket price. This burden is threatening the continued democratization of air travel enabled by deregulation, particularly as it disproportionally impacts low-fare carriers. As important, these taxes weaken an industry which represents a powerful economic engine and fulcrum across the U.S. economy. This issue deserves new and serious review.

Number 2, national security costs. The airline industry should, in BTC's view, be provided some permanent relief from the post 9/11 security-related costs. We do not support the $4 billion in Federal Government support the airlines are requesting. However, it is clear that the airline industry and its customers are shouldering a disproportionate burden in what is in part a national security budget.

Importantly, once a baseline financial responsibility were established for airlines for security, it should be codified in legislation that future increases in security fees will be paid for by U.S. citizens through the Federal Government. We all benefit from this kind of national security program, and a security tax is too easy a target for increased funds.

Number 3, and finally, industry consolidation. The proposed marketing lines between Continental, Northwest, and Delta that would comprise close to 40 percent of the marketplace is bad for low-fare competition and would be harmful to consumers and the corporations that fund business travel activities. The premise of this proposal, the United Airlines-US Airways alliance, is obsolete, given their bankruptcies.

More importantly, the opportunity to abuse the privilege to coordinate marketing opportunities is enormous, and I quote from a 1999 GAO study. It is difficult to determine when the partners in the alliance will continue to compete, or whether the alliance will encourage them to act in a manner that may reduce competition.

With that as a backdrop, one BTC member wrote me this week, and this member is a very large buyer of air transportation services, and I quote: "Northwest, Continental, and Delta currently say if you, the buyer, tell us it is okay to work a deal via a percentage discount off published fares with all three of us acting as one, then it is okay. It is legal." To continue the quote, "what these three airlines are saying is that just say the word, and we will work as one airline, and we can talk and will talk about discounts among all three of us for you. This makes me very nervous," end quote.

This kind of anticompetitive activity would eliminate two competitors from the marketplace, and would enable this alliance to force customers in a local market who want to maintain some level of hub discount to shift business in a distant market, including international markets, to these alliance partners. This would harm competition and artificially increase business air fare levels.

And if a Fortune 500 corporation with its purchasing volumes is nervous, the other 9 million U.S. business should be, too.

Thank you for the opportunity to speak to you today.

[The prepared statement of Mr. Mitchell follows:]

PREPARED STATEMENT OF KEVIN P. MITCHELL, CHAIRMAN, BUSINESS TRAVEL COALITION

Mr. Chairman, and Members of the Committee, thank you for inviting the Business Travel Coalition to this important hearing, and for your interest in the views of the customer of the commercial air transportation system.

The airline industry is in crisis. Major network airlines will transform themselves or go out of business. The process will be painful for employees, their families and the communities in which they live and work. However, major network airlines have the prospect of coming out at the other end of this crucible more competitive and responsive to customers and better able to solve their own problems.

There is a backlash among many business travelers and corporate senior managements regarding major airlines' policies and the overall travel experience. Sky-high business airfares, eroding customer service levels and aviation system gridlock converged during the late 1990s to help deepen the falloff in business travel demand airlines are facing today.

However, BTC is very optimistic about the future. Over the next eighteen or so months it is very likely that these three issues—pricing, service and aviation system reliability—will be largely addressed. A driving factor forcing the major network airlines to restructure is the recognition, as late as it might be, that the business traveler now has an unprecedented range of alternatives to a seat on a major airline. These alternatives—the automobile, train, bus, charter jet, fractional jet, video conferencing, web casting—to name just a sampling, combine to form an effective proxy for the market contestability theory.

Of all the alternatives, though, it is the low-fare airline product that is disciplining the major airlines the most. Low-fare airlines, as a segment, have nearly doubled their national market share since the last airline cyclical downturn in the early 1990s. They have great management teams, more and newer aircraft, expanded route systems and an airfare structure that all consumers can understand and embrace.

When low-fare competition and the consumer were threatened in the late 1990s by artificial barriers to entry and, in some cases predation, this Committee was critical in drawing national attention to the problem and helping preserve competition. Were it not for a resurgent low-fare airline segment, it is doubtful that major airline managements and airline union leaders would be taking restructuring so seriously. Competition and the consumer will benefit greatly from successful major airline reforms.

There has been much industry discussion about whether there is room for the low-fare, point-to-point business model and the hub and spoke model embraced by major network airlines. BTC agrees with those whose determination it is that both models can coexist in a similar manner as the U.S. automakers coexist with low-cost foreign competitors.

The question is how fast can the major airlines reconfigure their cost and productivity platforms to stem threatening financial losses and market share losses to the low-fare airline segment. Every day major airlines operate with relatively high cost and low asset utilization levels they cede ever more share to low-fare competitors. This competitive reality is encouraging pro-customer reforms such as America

West's new air fare structure, or American Airlines' fare structure reduction and simplification experiment—now in several hundred markets.

As optimistic as I am, however, there are three serious threats to low-fare competition, and to successful major airline restructurings, that BTC hope this Committee will seek to better understand and influence through future hearings.

1—The proposed marketing alliance among Continental, Northwest and Delta—comprising close to 40 percent of the marketplace—is bad for low-fare competition and would be harmful to consumers and the corporations that fund business travel activities.

2—The taxes that are now baked into the price of an airline ticket can exceed a third of the price. This burden is threatening the continued democratization of air travel enabled by deregulation and the health of an industry that represents a powerful economic engine for the national economy.

3—The airline industry should be provided some permanent relief from post 9/11 security and insurance-related costs. Moreover, once a baseline financial responsibility was established for the airline industry for security, it should be codified that any future increases in security fees should be born by the taxpayer.

I thank you again for the opportunity to speak here today.

Senator ROCKEFELLER. Thank you, gentlemen, all very much for your statements, and we will begin the questioning with Chairman-to-be McCain.

Senator MCCAIN. Thank you, Senator Rockefeller.

Professor Kahn, given the differing financial fortunes of the low-fare airlines and the major carriers since the economic downturns, are the major carriers' business models flawed?

Mr. KAHN. No, I don't think that it will prove in the end that those models are simply obsolete. What I am saying is that nobody can predict what the ultimate balance is going to be.

Senator MCCAIN. What do they need to do?

Mr. KAHN. Well, clearly, I think the gentlemen at my left all pointed out, the necessity of getting cost under control. That is just terribly——

Senator MCCAIN. Are their major costs, labor costs?

Mr. KAHN. I think that is the major cost, right, but they may have to search more about which operations they can continue and which they cannot. Bankruptcy is regarded as unfair, and in a sense it is unfair to the firms that do not have the advantage of going into receivership, but that is another way that we will get restructuring in the courts.

I am certainly not competent to say what the ideal structure would be. The only thing I insist is that neither could the Civil Aeronautics Board, or anything like the Civil Aeronautics Board.

Senator MCCAIN. What is the biggest single thing the airlines can do to get back on their feet?

Mr. KAHN. The biggest single thing they can do to——

Senator MCCAIN. To get back to viability.

Mr. KAHN. I would have to defer to the people at my left. I think what they are doing, the number of things, one, reexamining whether some routes are really contributing anything to the recovery of their incremental costs, putting in lower low-cost affiliates, making fuller use of regional jets, which are terribly important from the point of view of cost, and beyond that, if they do not survive in the competitive market, that is too bad. I will have to go to a business school and see if anybody has any wisdom to impart. It would be presumptuous of me to tell these people how to run their businesses.

Senator MCCAIN. Mr. Woerth, the *New York Times* urged that Congress lift limits on foreign investment in the airlines. Do you still oppose that, lifting these limits?

Mr. WOERTH. Senator, we, the Airline Pilots Association, have always believed that the real question is control. I do believe that—the act talks about foreign ownership and control, and we have always been interested in keeping, as I think the intention of the Congress has always been the control of the airlines in U.S. hands, and I think that the Defense Department, with the Civil Reserve Air Fleet, are also concerned about it.

I have never believed there is anything magic about 25 percent. You could probably control an operation, depending on the corporate structure, with less than that, but if we are going to move to higher limits, say something like 49 percent, I would certainly like to have in any bill, caveats that certainly met control tests, and remedies that the Department of Transportation could impose if they failed those tests and, indeed, a carrier had shifted to foreign control.

Senator MCCAIN. Mr. Carty, last August you were quoted as telling your employees that the then-current business fare war with Northwest was, quote, "true madness", unquote, that even the low-fare carriers were complaining about the discounting that was going on. There is anecdote after anecdote of major airlines pricing below cost to gain market share.

Why does an industry that is losing billions of dollars insist on price wars that, while they may be good for the consumer, are in your words true madness, and I would be interested in hearing Mr. Anderson's comments on that.

Mr. CARTY. Senator, I guess I would start off by agreeing with something the professor said, and that is that industries like the airline industry that have very high fixed cost have a tendency to lend themselves to this kind of incremental pricing.

Now, that being said, when I talk about some amount of pricing activity being true madness, I am talking about situations that go beyond that, where I believe airlines, for whatever reason, or people within the airlines' pricing department for whatever reason take actions that make not only no economic sense to them in the short-term, but no economic sense in the long-term. These things sometimes spiral out of control, and I think if I have a criticism of ourselves as managers of these industries, it is the senior management of the company not bringing more discipline to competitive response, because I think we leave a lot of money on the table in the most extreme of these cases.

Now, that being said, we are going to see incremental pricing in our industry, because of the fixed-cost nature of it.

Senator MCCAIN. Mr. Anderson.

Mr. ANDERSON. Our analysis shows that Northwest has been pegged as the spoiler. Since I took over we have not matched the system-wide increase either on the discount side, the leisure side, or on the business side, and it is really just based on the evidence of what fare increases have produced with respect to yield, and the elasticity of those increases.

The bottom line is, every fare is elastic, and if you look at the period 1999 through 2001, walk-up business fares went up 30 percent and yields went down 5 percent, so there was not a relationship between your yield increasing. And, in a time when the economy is weak, business travelers are moving away, and our fare structure is very elongated between the walk-up business fare and the discount fare, it was our best judgment that the revenue-maximizing strategy for Northwest was to not match fare increases to the walk-up business fare. But in fact, to take steps to deal with the elongation of the fare structure between leisure fares and business fares.

Senator MCCAIN. Mr. Chairman, if I could just ask one more question.

Mr. Anderson, in this envisioned alliance, would that mean you would be doing joint scheduling so that passengers could have more and better access and less delay?

Mr. ANDERSON. No, sir, there is no joint scheduling, and that is the misnomer between all the critics of our alliance. In fact, the most vociferous critic of our pricing policies or pricing practices have been our alliance partners at Continental. Very simply put, we operate as completely independent entities, and that is why the Justice Department has signed off from an antitrust perspective on the Northwest-Continental alliance and the United-US Air alliance, so no, we do not coordinate schedules or coordinate pricing in any way.

Senator MCCAIN. Well, I thank you, and I would like to repeat, as I said at the beginning of the hearing, this is a most critical part of America's economy and America's life, and we will continue to explore with you ways that we can keep a healthy, robust, and competitive airline industry in America. I think you have given us some very important and valuable information today, and there will be more hearings, and perhaps legislative remedies to be of assistance without doing harm.

I thank you, Mr. Chairman. I thank the witnesses.

Senator ROCKEFELLER. Thank you.

The same question, but I will ask it in two parts to Mr. Carty, Mr. Anderson, and then Mr. Woerth. The cost of labor obviously looms large, and that is because there are a lot of employees, and they are paid, and you need them to fly, service, and do all the rest of the things you do for your airlines.

Now, in the case of American and Northwest, you are perfectly aware, of course, that some of your competitors are cutting their costs by reducing their costs, by negotiating wage, and by benefit cuts, and my question to you, and then I will go right to a question of Captain Woerth, is in response to that, you are going to probably have to do the same thing, in fact you indicated such, and have indicated some success on such. What do you anticipate in the way of a response on the part of employees to what it is that you ask, or how they respond to the negotiations that you are all in together?

Then to Captain Woerth, I would say that you have indicated that there is one strike every 10 years. It seems to get awfully close to being more than that, but you may be correct on that. However, you do understand that in order to cut costs, airlines have to negotiate on all fronts, including labor, and in that binding arbitration, which I do not start out favoring, and letting the system work. It then becomes extremely important as to not only how management reacts and feels, but also how labor and not just ALPA feels and reacts, if we are to keep the Nation's economy working. It is my view that if the airlines get into too bad a position, this country is devastated economically. So I would be interested in all three of your questions, and any interaction that might ensue therefrom.

Mr. CARTY. Let me take a crack at trying to be responsive to a number of your comments. In the first instance, when we talk about labor costs being our largest single cost component, it is true, but there are several aspects to what drives labor costs. One, obviously, is the contractual relationship we might or might not have with a particular union. The other is how we, as management, organize work and use automation, and use technology to be labor-efficient, and the efforts we have had underway at American to date to restructure the company, which began long before 9/11 because we saw these trends developing, involved attacking the issues that management can control, bringing automation to the workplace, whether it is at the airports or the res offices, our maintenance operations, rescheduling our airline in ways that will present work to our employees in a way that they can be more productive, and so we have been grappling with all those things.

You know, Senator, because I know you pay attention to these issues, that technology has enhanced the productivity of labor across America. I think, in fact, the airline industry in the 1990's lagged, and I think we have got some catching up to do, and an awful lot of that is our job.

There is a second piece of that, and it has to do with our existing labor contracts. Now, United and US Air and other carriers that ended up filing for bankruptcy are certainly going to influence the outcome of what our relationships with our employees look like. That is inevitable.

United is our biggest single competitor and has been for 60 years, and we cannot ignore our major competitor, but we have premised our strategic plan on having to develop a financial formula, not to deal with United, but to be responsive to the advent of this new business model, the low-cost carrier, and that is where the $4 billion objective for American came from. It did not come from United.

Now, as it turns out, it is starting to get validated by what is happening in the bankruptcy court. We attacked that $4 billion. We have identified over $2 billion. We are not finished. We are going to try to identify more, and what we have now done is said to the folks that represent our employees, and I might add our unrepresented employees, we need to all get in the room and reexamine the history of our contracts in a way that helps us finish the job of getting to $4 billion.

Now, that is something I hope we will do. It will not be an easy task, because it obviously is going to mean changes, and some of those changes will not be changes that our employees will necessarily embrace. At the same time, we do not necessarily embrace all of them, too. You know, one of our objectives is to create uniquely good outcomes for all three of our constituencies, including our employees, so we do not feel that the airline ills need to be visited solely on the back of our employees.

Those contracts need to be reexamined and restructured. We have invited that process. We hope in the next 30 to 60 days, that process will be well underway. As a matter of fact, with our pilots, since we are in section 6 negotiations in any case, that is going forward.

Now, as to the longer-term issue, and I consider it a longer-term issue, as to whether we need revisions to the Railway Labor Act, they are not going to get us through this crisis whether they happen or not happen, because they would only bear on contracts that were officially in negotiation. We have contracts that run several years from now. I know Richard does as well, so that is more of a long-term consideration.

And the question of, once we get the airline industry healthy, do we need such changes to keep the industry healthy, and I know there are varying views about it, and we are not going to resolve that question this morning. In fact, I would rather not engage in the debate this morning, but we believe that there have been problems with the old model that have not only affected the companies, but have affected our employees unfavorably and affected our customers unfavorably, and therefore we think, as Senator McCain challenged both us and organized labor to do a year ago, we need to reexamine that labor code, and I think it needs to be reexamined.

The exact form of whatever changes might come up I think have to be determined, but we do think it needs to be changed for the long-term health of the industry.

Senator ROCKEFELLER. Thank you, Mr. Carty.

Mr. Anderson, in answering the same question, Mr. Carty was generic in his answer. I understand that, given this being a public hearing, but has there been progress? Has there been an understanding on, in this case the two sides? Well, there is organized, unorganized employees, and there is management. Has there been a change of nuance, a change of the sense of what is at stake as these matters have progressed, as you see it?

Mr. ANDERSON. I absolutely believe that there is that comprehension. We are a bit unusual at Northwest. In fact, Duane Woerth used to be on my board of directors, because Northwest once before faced this challenge in 1992, shortly after the Persian Gulf War, and at that time, we did a successful ESOP with our employees, and in fact today have three labor directors and a Northwest 747 captain on our board of directors, and so we are very close.

Our labor leaders have every piece of information about what goes on in our company because they sit on our board of directors, and we are very engaged, and they are very—it is difficult. It is very hard to do things that affect people's lives, the worst being when you have to lay an employee off or impose, in our case, premiums for health insurance, which we did for the first time this year, but the reality has set in, and our leaders, our labor leaders are very pragmatic. It is evidenced by the fact that one of them is sitting two chairs down from me and has served on our board, and we have shown in the past that we have been able to weather these difficult times, and I think the reality has set in and we are in regular discussions with all of our labor leaders.

We have something called the Labor Advisory Committee at Northwest that meets now every 2 weeks, which is the senior leadership of all of our labor unions, and we think we first have an obligation to be certain we are doing everything else in our business to restructure the business, whether it is forming an alliance with Delta Airlines, whether it is enhancing our KLM alliance, whether it is taking other steps to reduce non-labor costs across the company.

We are doing all of those things, but ultimately we have to be in a position where the cost of operating the airlines fit the revenue and capital regeneration that is necessary to keep the business viable. We have been in business since 1926 operating as Northwest Airways, and it is every intention, I believe, of our labor leaders and management of the company just as we did when we faced this crisis before in 1990, after the Persian Gulf War, to do it successfully again in 2002, and 2003 and beyond.

Senator ROCKEFELLER. Thank you, sir. Captain Woerth.

Mr. WOERTH. My belief is that I think we should do a quick review again of the very proactive way labor has responded to this crisis right now. The United pilots, for example, had the first economic plan renegotiated with management a year ago. Then, when that was not enough, they did a second one, economic recovery plan 2, and most recently voluntarily under collective bargaining, of their free will, no bankruptcy court judge order, just signed a 29 percent pay cut, by far larger than any other employee group, and took a leadership position.

US Airways pilots have done the same thing. They did not wait to get into bankruptcy. They were negotiating, collaborating with their company for a joint survival plan in the free market with collective bargaining. That happened, and it has been our track record, and certainly the track records of the principals in the transportation trade as well, that we are—if we are approached with a legitimate business plan for our survival, we will engage in a negotiation.

I cannot predict the outcome of that, mostly because the circumstances are very different. I want to make this clear, it is not an automatic assumption, because United Airlines or US Airways for various competitive problems, different leasing arrangements where the cost structure was not the same, that does not transpose the same contract from US Airways or United that is going to end up at United or Northwest or anyplace else. We will see what collective bargaining produces.

But if allowed to remain in that market, and when workers always feel they have the right to determine their own destiny and have a stake in that destiny, I think the history of the recessions in the 1970's and the 1980's and the 1990's, shows we have always responded responsibly and sought the recovery of those airlines. Airline employees have no illusions. You do not just go from door to door and end up a captain in an airplane. You start over from the bottom. That is true of the mechanics, that is true of the flight attendants, so we feel all of our employees are extremely committed to the success of that airline, because their seniority and their pensions are not transportable, so I believe events will transpire.

I think the biggest open question is, and I am sure Mr. Carty and Mr. Anderson will agree their biggest concern right now, what is going to be the pricing policies of some of these carriers that are in bankruptcy or may approach bankruptcy? You know, there is the cost side of the equation, there is the revenue side of the business, and how that affects their revenue is probably the thing they wake up losing as much sleep at night over besides their labor cost. What is the revenue going to look like in this industry as we proceed over the next few critical months?

Senator ROCKEFELLER. Thank you, Captain Woerth.

Senator Fitzgerald, the last question is yours, sir.

Senator FITZGERALD. Thank you, Mr. Chairman, and thank all of you for being with us. It has been a long morning. You have all been patient.

Mr. ANDERSON AND MR. Carty, thank you both. I think both of you have been doing good jobs with your respective carriers in very difficult times, and I want to compliment both of you on the friendliness of your employees. I was up in Minnesota recently and the Northwest employees are hardworking and friendly, as they are at American every time I go through O'Hare, Mr. Carty, and you should be very proud of the hard work of the people on the lines there in your company. I do have some questions.

Mr. Carty, I thought you showed great creativity in de-peaking your schedule at O'Hare, and that turned out to be a way to try and lower your costs in your hub system, and we were running into a real problem at O'Hare a few years ago.

Both the *Chicago Tribune* and the *Sun-Times* had exposes about how the airlines marketing departments were going out to find out what time people want to fly, and they would find that 8:45 in the morning was a very popular time to fly, and so they were scheduling all of their flights for 8:45 in the morning. In fact, there would sometimes be 25 or more flights scheduled to take off at 8:45 in the morning out of O'Hare.

Well, the airport only has capacity for three planes to take off every minute, so this was resulting in long delays, and I think that the spreading out, the de-peaking that American has done, has done a lot to alleviate delays, but the obvious question that I would want to ask you, Mr. Carty, is, isn't de-peaking a lot cheaper than building more runways, and wouldn't that be a wiser course for you and United to take at O'Hare than incurring humongous, massive, gargantuan amounts of debt to tear up and rebuild O'Hare Airport at this time?

Mr. CARTY. Well, Senator, I think I certainly know your views on the expansion of O'Hare. I think you know mine. I would only say this, that O'Hare Airport has over the years—and I think you touched on this—been a chronic problem in terms of dependability and reliability, and that is, as Dr. Kahn suggested, the consequence of the great success of deregulation and the amount of activity there.

You made the point that there was a little bit of a decline in traffic at O'Hare last year, but in fact, O'Hare was one of the few airports in the country that actually saw growth in activity again in 2002, in spite of this downturn.

My own view is over time—and Jeff Shane referred to this—we need to address the infrastructure problem, and that O'Hare is a huge, huge piece of the infrastructure problem. The current plan for runway expansion takes a very, very long time to complete, and I do not think we should be confused about some modest de-peaking by American or United, or the current economic downturn as solving the woes of O'Hare.

I think the demand for O'Hare is there. O'Hare is a very important connecting airport. It is one of the busiest airports—it is the busiest airport in terms of activity in the world, and I think the demand for that activity is just going to increase, and so I think having a long-term plan for O'Hare—the exact timing and the form of the financing probably needs further debate, but we need capacity at O'Hare, and even the plan that the city has advanced does not get us much incremental capacity for quite a long time to come, but if we do not get started we will never get to the end.

Senator FITZGERALD. Now, once it kicks in, though, and they issue those bonds, by the figures I have seen, it would raise your debt service costs or your operating costs. By virtue of your landing fees. It would add about $200 million a year at least of debt service to both you and United, and you still feel prepared to assume that added debt service?

Mr. CARTY. We are not terribly excited about any cost increase. You quite rightly pointed out that—and this sort of bears on the government loan program, by the way. Very few airlines need more debt. Whether it is government-guaranteed or not, that is not our problem.

So, further obligations are a challenge to us. Nonetheless, the future of our business and the future of the profitability of Chicago as a hub to us is dependent on the ability for us to continue to participate in the growth in this aviation market, and it is going to grow. We have got a current crisis, but it is going to grow, and I think it would be a terrible mistake for Chicago not to have a long-term expansion plan for O'Hare.

Senator FITZGERALD. Professor Kahn, you had some interesting statistics on, the benefits of deregulation saved consumers some $20 billion a year, and I have heard other statistics that aviation passenger travel has gone up some 400 percent since deregulation.

Mr. KAHN. That sounds reasonable.

Senator FITZGERALD. But is it not true that at the same time—and you mentioned we have developed some problems like congestion, and I suppose that is what the O'Hare issue is about, but have you noticed we have not really built any airports except Denver in this country, big airports? What do you think about that?

In the case of Chicago, United and American have opposed a new airport in Chicago, which the FAA strongly encouraged. Back in 1984, they pretty much ordered Chicago to build another airport. O'Hare reached capacity in 1969. The old Mayor Daley tried to build a third airport and it was opposed. I gather United and American, they have most of the capacity, about 87 percent of O'Hare. They do not want new entrants coming in to compete with them. What are we going to do about that problem? Don't you think we need to build more capacity, and if all the hub carriers are just trying to keep other entrants out of their market, how do we break that logjam?

Mr. KAHN. You are asking me a political question.

[Laughter.]

Mr. KAHN. I have the wonderful situation of having tenure at Cornell, but I think that there has got to be some institutional device that does not depend simply upon the consent of the carriers for the government or whatever agency it is to increase infrastructure.

Senator FITZGERALD. But since they pay for the airports, they do have a say, right?

Mr. KAHN. Well, one of the problems, of course, is that they—having financed the original construction of the airports, or previous expansion—are in a position to, in effect restrict competition, but I do not see, from what Mr. Carty has said, that that is the obstacle. They seem to recognize that it will be necessary to incur the additional costs, and that the other side of it, of course, is that they will be able to handle more traffic. They have run up against it. So I do not have any knowledge that it is the opposition of the incumbent carriers that is preventing the construction.

I do not know what the—I mean, I know that there are political obstacles, but I am not going to instruct you on them.

[Laughter.]

Senator FITZGERALD. Okay. One final question and I will be done.

Mr. Carty, American and the other legacy carriers, they do have unfunded pension liabilities. What is your unfunded pension liability?

Mr. CARTY. I cannot give you that number off the top of my head, Senator. I will get back to you on it, but it is significant. The problem——

Senator FITZGERALD. In the billions?

Mr. CARTY. In the hundreds of millions.

Senator FITZGERALD. It is not over a billion?

Mr. CARTY. I think depending upon whether you calculate it actuarially or otherwise, it is a big number.

Senator FITZGERALD. You are in better shape than United, though, on that.

Mr. CARTY. We have historically been one of the better-funded pension plans. This weakness in the stock market has obviously impacted us, as it has impacted everybody, and the recovery period that Captain Woerth referred to is probably an important thing for us to debate as a country, because it affects so many industries.

Senator FITZGERALD. Well, I would just encourage you to think about—I think funding those pensions is very important. I would congratulate you if you are, to the extent you are better-funded than the other carriers. I think that is something we have got to fight for for the employees of the airlines, and Mr. Woerth, I will look forward to working with you.

Mr. Chairman, it is great to have another aviation hearing, and thank you all for being here.

Senator ROCKEFELLER. Gentlemen, thank you. I would just conclude by saying we could not have a hearing with Senator Fitzgerald present without getting into runways at O'Hare, and that is the way life should be.

[Laughter.]

Senator ROCKEFELLER. I want to congratulate each of our witnesses for your patience on this monumentally important subject. Thank you, and the hearing is adjourned.

[Whereupon, at 12:20 p.m., the Committee adjourned.]

APPENDIX

PREPARED STATEMENT OF HON. GEORGE ALLEN, U.S. SENATOR FROM VIRGINIA

Mr. Chairman, I apologize that I am unable to attend today's hearing on the future of the airline industry. I am currently accompanying the President to a constituent company in Northern Virginia to review his economic growth and jobs program. I very much wish I could be at the Committee hearing to discuss the severe challenges facing so many of our American based airlines. Our airlines are such an integral component of our national economic strength and security.

Efficient U.S. air transportation is a tremendous national asset, carrying more than 600 million passengers per year, providing more than 11 million American jobs, and generating $900 billion in U.S. economic activity. Obviously, both the growth of our country's job market and Gross Domestic Product are directly related to an efficient and growing air transportation system. Therefore, as the economic health of America's airlines has declined in recent years, large numbers of Americans have lost their jobs and our national economy has suffered.

Serving as the headquarters to US Airways and containing hubs for some of the nation's largest airlines, Virginia is especially sensitive to the current state of the airline industry. For instance, as airlines such as US Airways and United Airlines have worked to emerge from bankruptcy protection, Virginia jobs have been lost, entire routes have been cancelled, local airports have suffered, and businesses have been disrupted. Clearly, the continued prosperity of Virginia and the nation is directly related to the future success of these airlines. I know that the leaders of US Airways' labor and management are working diligently to keep operating. This type of cooperative efforts will be needed for the older airlines to survive.

As noted in the Walker Commission report, to ensure such future success, government and industry must work together to address the problems plaguing the airline industry. For example, in an industry where time equals money, security procedures must be expedited to mitigate delays and waiting periods while maintaining the highest level of safety possible. Furthermore, cutting edge technologies must be utilized to better coordinate and direct flight patterns, thereby creating an air traffic management system that can accommodate a greater and more flexible schedule. In addition, the Federal Aviation Administration must confront issues of runway development, expediting airport expansion projects without neglecting existing environmental standards. And, in a larger sense, for our nation's competitiveness and security, we must remain committed to Aeronautic Research and Development efforts. Senator Dodd and I intend to introduce again our Aeronautics Research and Development Revitalization Act to secure the funds needed to ensure that the United States retains its leadership position in aeronautics and aviation—both in commercial market share and military air superiority. Through such efforts, I am confident that our country's airline industry will continue to serve as a great source for American jobs and a cornerstone of our country's economy. Thank you, Mr. Chairman.

PREPARED STATEMENT OF HON. JOHN F. KERRY, U.S. SENATOR FROM MASSACHUSETTS

Mr. Chairman, I would like to thank you for holding this hearing and thank the witnesses for testifying before the Committee. We're here today to discuss the financial state of the airline industry, a key sector of our economy that facilitates the flow of commerce and provides employment for many thousands of Americans. Over the past year, two of the six major air carriers have declared bankruptcy, tens of thousands of workers have lost their jobs, and the industry as a whole has lost over $9 billion. It does not help matters that economic growth has been sluggish, and that the overall forecast for 2003 remains gloomy. Had the Congress not acted in the aftermath of the terrorist attacks and passed a relief package, it is probable that more airlines would have gone into bankruptcy last year, and more jobs would have been lost.

These are dire times indeed for the airline industry, and it is my hope that a consensus can be reached on what role the government should play to help spur its recovery, and what changes the airlines can make to develop more efficient business models and return to profitability. Many of the major airlines have indicated that high operating costs, mainly labor and security costs, are hampering full financial recovery.

While labor costs represent a significant portion of any airline's operating budget, it is flat out wrong to argue that containing labor costs will solve this industry's problems. Much of the industry decline was, and still is, the result of a sagging economy resulting in lower ticket demand and business travel, flawed business practices such as the very costly hub and spoke system, overcapacity of planes and routes, and extreme ticket fare discrepancies between coach, business, and first class seats that has alienated customers. Indeed, airline workers should not be made the scapegoat for the industry's current financial crisis, and labor costs should not be used to scare policy makers into revising existing labor law. At a time of high-security alert, it is imperative that the industry retain a highly-skilled, competitively-paid workforce and that any relief package introduced in the Congress acknowledge worker's collective bargaining rights.

Further, though the airlines have also incurred higher security costs in the aftermath of the terrorist attacks including those mandated by the Aviation and Transportation Security Act, the industry was losing money long before the tragedy of September 11, 2001. I am pleased that we were able to extend the war risk insurance plan as part of the Homeland Security Act—which will save the airlines a considerable amount to insure their planes—and I am optimistic that the government and the industry will work out a security scheme that is factored in to any recovery initiative and which is fair to both parties.

No one with any vested interest in this industry wants more bankruptcies and more job cuts. When airline workers lose their jobs they lose much more than their paycheck, they lose their seniority, their pensions and their benefits, none of which they get to take with them to another airline. At a time when the industry is looking to cut costs and restructure, it is imperative that the Congress approach aiding the industry with a focus on helping the airline's retain a well-trained competitive workforce and restore sound business practices. I look forward to working with industry leaders and my colleagues to help get this vital sector of our economy back on track.