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**Speech**

**Remarks of**

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For a lawyer who was told to check his legal credentials at the door upon re-entering government service a few years ago – if the word "policy" is in your title in the bureaucracy, you had better not be caught rendering a *legal* opinion about anything -- it is a rare pleasure to be able to pay even a fleeting visit to the American Bar Association's Annual Meeting. Each year, the ABA wins the prize for conducting the world's most complicated meeting. So many sections, divisions, committees, subcommittees, and forums! You have to have a legal education just to be able to figure out the program. According to my quick estimate, more than a thousand meetings will be conducted during this five-day affair. Apparently there is a lot to talk about. It's reassuring to know that the bar is keeping busy.

To be serious, I am very grateful for Jim Tussing's gracious invitation to speak with you today. I want to talk about the profound changes sweeping through the airline business. For government policy makers, as you can probably imagine, it is a time of great challenge. I also want to talk about what the Bush Administration and Secretary Norm Mineta have been doing to provide leadership for the future of the aviation sector, including some things that haven't received much public notice. I also want to give you my impressions of where the industry is headed. Finally, I hope we can engage in some dialogue; I came to Atlanta as much to hear what practitioners in this sector are seeing and thinking as to offer pronouncements on aviation policy.

**An Industry in Transition**

As you are all well aware, the airline industry is going through a period of profound transformation. A fundamental restructuring is under way, attributable to three simultaneous phenomena: first, the shrinkage of high-end demand for air travel that began in late 2000; second, the emergence of a new cadre of low-cost carriers; and third, the increased transparency of alternative airline offerings and less expensive itineraries made possible by the internet and other technologies.

DOT's analysts believe that the collapse of high-end demand at the end of 2000 was not simply another cyclical change, but rather an important *structural* change driven by a powerful combination of economics and technology. While leisure travelers have always chosen an airline primarily based on price, there is growing evidence that business travelers have become significantly more price sensitive. For many, the change is likely to be permanent. Together, the economic downturn beginning in the latter half of 2000 and 9/11 engendered some major changes in business travel purchasing habits. Because cutting travel budgets became a corporate imperative, businesses embraced lower cost travel alternatives, including low-cost air carriers. Many trips that would have been routine just a few years ago simply weren't taken. Consider how many fewer trips you take today during the course of a major transaction than even a few years ago. That's because your clients are more attentive to such costs and because it is so easy to exchange redlined documents electronically. Businesses in every sector made similar changes in their travel patterns, substituting web conferencing and other technologies for face-to-face meetings.

Second, the new generation of U.S. low-cost carriers – like JetBlue, AirTran, and Frontier – are bigger and better than the previous generation of LCCs, most of whom ultimately failed. Flying on a low-cost carrier generally used to mean infrequent service on aging airplanes across a limited network. No longer. LCCs now offer convenient schedules, state-of-the art aircraft, and amenities that meet or exceed those offered by the "full service" airlines. This competitive challenge has forced pre-deregulation airlines – we now call them "legacy" carriers -- to take a hard look at their business strategies and reduce costs wherever possible.

A third factor underlying the structural changes in the industry is the internet – not as a substitute for travel but as a perfect purveyor of information *about* travel. Carriers everywhere have embraced online ticket sales as a means of reducing distribution costs. Low-cost carriers were often in a better position to take the greatest advantage of internet distribution channels because they were unburdened by the legacy of existing distribution systems and technologies. Travelers now have the wherewithal to compare price and service offerings of all airlines quickly and efficiently, and to act on those comparisons instantly with only a few keystrokes.

**New Realities in Aviation**

The conventional wisdom seems to be that demand for air travel remains soft, that there is too much capacity in the marketplace, and that's why our traditional network carriers are still suffering. The truth is that the only demand that is soft is demand at the high end of the fare structure. The demand for more affordable air travel is extremely healthy. That the carriers earning profits in this market are the ones charging the lowest prices is an important clue to the different kind of structural transformation that is currently under way.

One important difference is that high-end legacy carrier fares have declined not merely on routes served by LCCs, but also on routes where there is no current LCC competition. Very clearly, the fare transparency delivered by the internet and the expansion of LCC services has increased the price-sensitivity of all travelers, even business passengers. The airline seat is rapidly becoming a commodity, and as a result the pressure on legacy carriers to reduce their cost structures has been enormous.

Despite these difficulties, legacy carriers remain an invaluable part of commercial aviation in America. They are – and for the foreseeable future will be – the only airlines that link thousands of city-pair markets across the nation and often the only service available to small communities. Through the legacy carriers' networks and those of their alliance partners, Americans can reach any corner of the globe, often with just one connection. We should not underestimate the continued importance of these networks to our economy and to our nation generally. Nevertheless, it is clear that this time we are witnessing a true watershed in the development of deregulation, and legacy carriers can no longer simply follow each other through the ups and downs of the normal business cycle.

The architects of deregulation predicted that new airlines, unburdened by higher costs, would enter the market and exert pressure on pre-deregulation carriers either to compete on cost or fail. The first 25 years of deregulation did not follow this script, largely because of the unexpected economies of scale and scope on the revenue side that enabled carriers to pursue a strategy focused on higher unit revenues rather than on lower unit costs. For years, our large network carriers were able to avoid cost-side pressures by focusing on a revenue-side strategy largely centered on high-yield business traveler. The strategy generally worked because the business traveler, who grew accustomed to paying high fares, had no attractive alternatives. The airlines also kept tight control over the number of seats available to discretionary travelers. In a market now characterized by declining high-end demand and widespread availability of attractive low-fare options, legacy carriers no longer have the ability to do that. As a result, revenue-side strategies are no longer sustainable. While the architects of deregulation were accurate in predicting how the market would change, they were way off in guessing how long it would take that change to materialize.

What does all this mean for the future? The "delta" between the legacy carriers and the LCCs in cost per available seat mile remains very high, even for carriers that have gone through a round of restructuring. It will be a continuing challenge for the legacy carriers to further shrink that gap in the current environment, particularly because low-cost carriers continue to make improvements and drive costs down still further.

It also seems likely that today's group of savvy, well-equipped, low-cost carriers will continue to expand. They are pushing the limits of the traditional low-cost carrier business model, in which low-fare carriers only operated successfully in dense, short-haul, point-to-point markets. ATA, AirTran, and Frontier all operate hub-and-spoke systems to destinations from coast-to-coast. Furthermore, LCCs are now rapidly expanding into transcontinental markets and some even into international markets as well. In fact, ATA, based in Indianapolis, has announced trans-Atlantic service between Chicago and Cologne/Bonn beginning in May 2005.

**International Developments**

What is also remarkable about the transformation of this industry are the striking similarities between the U.S. market and what is happening in Europe today. Common to both sides is a rapidly changing, dynamic marketplace, with a demand for affordable air travel that is increasingly robust. In fact, global passenger growth is exceeding IATA's expectations, registering a 20 percent jump for the first six months of 2004.

Although deregulation of the airline industry within the European Union was not completed until 1997, there has been a rapid convergence of airline business models on both sides of the Atlantic. The European airline industry, like our own in the U.S., is characterized by a combination of legacy network carriers and LCCs. Consumers and our respective economies need both types of service. Low-cost carriers now account for nearly a 30 percent market share in the U.S. and close to 20 percent in Europe. Like Southwest and JetBlue in the U.S., Ryanair and EasyJet are reshaping the nature of air travel in Europe. There is, perhaps, one important difference – European low-cost carriers face very real additional competition from Europe's expanding high-speed rail network.

Legacy carriers on both sides of the Atlantic are responding to mounting low-cost carrier competition in similar ways. Some, like America West and Aer Lingus, are transforming themselves into LCCs. Others, like United and SAS have formed low-fare airline brands. Most legacy carriers on both sides of the Atlantic are seizing the opportunity to strengthen their trans-Atlantic alliances to reduce costs, increase revenues, and respond to changes in the marketplace.

The government's role in this process is clear: to do all we can to encourage continued innovation and dynamism within this remarkable and essential industry.

That is why we were disappointed at the European Council of Ministers' recent refusal to take the first important step toward a new comprehensive air services agreement with the U.S. that would have taken aviation liberalization to an entirely new level. Among a number of important innovations in that accord was an agreement by the United States to treat EU airlines not as national carriers allowed to fly to the U.S. only from their individual home countries, but rather as "EU carriers" eligible to originate flights anywhere in EU territory to any point in the U.S. and beyond. That single concession would open the door to a likely rationalization of the European airline industry, with important dividends for U.S. carriers and their alliances as well. It is a badly overdue first step, and the U.S. announced its commitment to take that step at the very outset of the negotiations. I am surprised that our European friends didn't attach more value to that commitment.

We have not, of course, let the EU's refusal to take this first step towards a fully liberalized market stop us from pushing forward elsewhere. We recently concluded bilateral agreements with China and Indonesia, expanding liberalized air service and a more open aviation market to another 1.6 billion people. The number of commercial and cargo flights between the U.S. and China will increase successively through 2010 by nearly 200 weekly departures, bringing huge economic benefits to both countries. Indeed, we estimate that a single new daily 777 roundtrip between the U.S. and China will produce a total annual benefit of about $158 million to the U.S. economy.

**Implications for Competition Policy**

It is reasonable to expect the expanding liberalization of aviation markets – including eventually the trans-Atlantic market -- to facilitate further changes in the industry's structure. In a liberalized environment, the industry can look forward at last to managing itself in keeping with commercial exigencies, not political ones.

Airline strategies in this environment are increasingly predicated on an array of joint ventures and alliances. Internationally, these alliances serve as a surrogate for genuine consolidation, which is artificially impeded today by national laws everywhere governing the ownership and control of airlines – another relic of the past that we undertook to revisit with the Congress as part of a new agreement with the EU. Those strategies appear to be moving in the direction of more consolidation in this industry, particularly among the legacy carriers. It appears to be taking two forms. The first involves airlines joining forces under a holding company structure to deal with the longstanding restrictions on foreign ownership. This approach was followed by Air France and KLM and appears to be the strategy of Virgin Express and SN Brussels. The second form is the further development of the international alliance model. This could take the form of consolidation of alliances or through the deepening of cooperation within alliances. European carriers and their U.S. partners in the major global alliances (e.g., Star, Oneworld, SkyTeam) increasingly see these alliances as a major component of their business.

Perhaps one of the greatest policy challenges going forward will be for governments to deal effectively with new consolidation proposals. Changes in international alliances will have a direct impact on domestic competition, as current developments already make clear. The Department of Transportation will actively follow these dynamics, and will consider carefully their impact on the industry and consumers. While the marketplace, not the government, will determine which carriers succeed, the government does have a role in protecting competition by barring anticompetitive behavior.

**Providing Capacity to Facilitate Growth**

In addition to the various responsibilities governments have in supporting competition and ensuring safety and security, we also must provide adequate aviation infrastructure so that the industry can continue to serve as an engine of economic growth and prosperity. Passengers are returning to the system in a big way as demand returns to pre-9/11 levels, and as a result we are facing significant delays at some of our most congested airports. While increasing capacity will typically be our preferred response, there will be some situations where we will have to take action to alleviate delays, at least on a temporary basis.

One such example is the current situation we face at O'Hare International Airport in Chicago. Over the last two days, the FAA has been meeting with the carriers that serve O'Hare, where a substantial increase in operations over the last few years has strained the airport's capacity and caused record delays. We hope ultimately to achieve schedule reductions from the carriers on a voluntary basis, but have made it clear that we will take unilateral action if we must to ensure that passengers at O'Hare do not continue to suffer through intolerable delays. In doing so, however, we will leave room for some limited new entry and keep a close eye on the competitive environment at O'Hare going forward. In the interim, we will also be working closely with the City of Chicago on their proposals for modernizing and ultimately expanding O'Hare.

Other airports, like New York's LaGuardia, are a different challenge in that there is little room for additional capacity. As they did for O'Hare in 2002, Congress has eliminated the limit on operations at LaGuardia as of January 1, 2007. We are working closely to explore options available to us to better manage demand there, including market-based mechanisms. Just last week, I chaired a discussion with our airport and airline stakeholders to discuss the pros and cons of such market-based mechanisms. It was a very open and productive dialogue – one that we plan to continue in the months ahead.

These efforts, of course, are not a comprehensive or long-term solution to the growing demand for air travel. We need to take a hard look at what we expect of the entire system in the longer term. To that end, Secretary Mineta has announced an historic new initiative that will take our aviation system to a wholly different level of efficiency and capacity. No matter what the future market for air transportation will look like, we know we will have to handle a great many more aircraft operations than we do today. Secretary Mineta therefore has called for a tripling of system capacity over the next two decades. As part of his *Next Generation Air Transportation System Initiative* we have established a new Joint Planning and Development Office within the FAA that is staffed by representatives of a number of participating agencies, including NASA and the Departments of Defense, Homeland Security, and Commerce. The program is being guided by a Senior Policy Committee chaired by Secretary Mineta, with high-level participation from each of the participating agencies. That committee has met twice now, and is well on its way to developing the first edition of a National Plan that will lay out the long-term plan for ensuring the continued vitality of our air transportation system, and ensuring its wherewithal to accommodate whatever increases in demand our growing and robust economy places on it..

**Conclusion**

I've been talking about our policy toward the economics of the airline business – it's largely "hands-off" – as well as our efforts to instill greater competition in international aviation markets, to preserve competition in the face of a growing pressure to consolidate, and to grow the capacity of our aviation system so that it continues to support America's economic growth. I hope I have left you in no doubt that I am bullish on this industry. There is an abundance of creativity in the airline business here and abroad and none of us can predict with any confidence what the next important innovation will be.

But my bullishness is predicated in turn on my optimism about the direction of government policy. It is critically important that government continue to place its trust in market forces to the greatest possible extent and to address impediments to competition – both here and abroad -- in a way that ensures healthy competition but that does not unreasonably impede the continued evolution of the industry. Finally, it is government's job to ensure that the aviation system has the wherewithal to accommodate whatever the market may deliver in the future.

I am pleased to tell you that the Bush Administration has understood all this. Secretary Mineta and the DOT/FAA team have addressed these issues and many others – safety, security, war risk insurance, compensation for 9/11-related losses, liability for accidents on international flights, the Cape Town Convention on interests in mobile assets – in an aggressive and clear-eyed way.

Regardless of the particular prism through which you look at the aviation industry, it is endlessly fascinating. I don't think you need to be concerned about your practices drying up any time soon.

Thank you for allowing me to share these thoughts with you this afternoon.

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