“The New Aviation Environment”

Remarks before the National Business Travel Association
by
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Good afternoon. Thank you for that kind introduction, Carol. And thanks to all of you for that warm welcome. It is a pleasure to be with you this afternoon, and to be able to participate in the NBTA’s Legislative Day. As Carol mentioned, before I joined the Department of Transportation, I was privileged to work for two years for Secretary Evans at the Department of Commerce on international trade issues. And in my time at Commerce, I always enjoyed and profited from the opportunity to interact with industry leaders and those affected by Commerce Department policies. Since I have been at Transportation, I have found such opportunities to be, if anything, more valuable. Aviation is such a dynamic and multifaceted industry that policymakers certainly need to be in regular contact with stakeholders such as yourselves in order to ensure we remain on the right track.

Today, before fielding your questions, I would like to discuss with you some of the trends that we at the Department believe are taking place in aviation – both domestically and internationally – and touch upon what those trends may mean for the future of business travel.

Fundamental Changes

Let me begin by describing what we believe are fundamental changes in the commercial aviation industry. It's an overused word – fundamental – but in this case it accurately describes what is occurring. And while those fundamental changes are impacting all segments of the industry, they are having a particularly pronounced effect on you and your clients – America's business travelers.

As you know, Congress deregulated the commercial airline industry in 1978, giving carriers the legal right to serve whatever markets they chose with whatever aircraft they wanted – and at whatever price those markets would bear. The purpose was to give consumers more choices and lower fares. And to some extent it worked – consumers did have more choices and lower fares. But, I would submit, not until recently has the true vision of deregulation really started to be fulfilled. And that's because, for the first 25 years of deregulation, <u>demand</u> for scheduled passenger air transportation was driven by the constraints and confines of its providers – principally, the network air carriers. Network carriers were able to avoid cost-side pressures by focusing on revenue-side strategies – largely centered on the high-yield business traveler. That focus led to innovations like sophisticated global distribution systems, revenue management, and frequent flyer programs that helped the airlines segment demand. You are – or were – the linchpin in that strategy, as businesses and other time-sensitive travelers accounted for only 20% of network airline traffic, but for 80% of network airline revenue.

This strategy worked because the business traveler grew accustomed to paying high fares and often did not have an attractive alternative to the high fare, and also because the airlines enjoyed a greater ability to control the number of seats available to discretionary travelers. In short, in the post-deregulation world, travelers – particularly business travelers – did have greater options than before, but, even with the impact of the occasional low-fare carrier, they were often at the mercy of major carriers when it came to price.

In effect, demand for passenger service was driven, even controlled, by the supply that network carriers were willing to deploy in the market.

That situation is coming to an end. As it should in any sector, demand is now beginning to drive supply. Why the change? We attribute it to a number of interrelated factors, among them the decline of high-end demand for air travel toward the latter part of 2000; the emergence of a new breed of low-cost carriers; and the price transparency that the Internet has created for all types of passengers. These developments have seriously compromised the ability of legacy carriers to charge higher prices to travelers on routes where they overlap with low-cost carriers.

First, at the end of 2000, as you know, demand for business class and other high-end product fell dramatically, as corporate travel managers became more cost-conscious and carriers came to the end of a seven-year string of profits. Second, low-cost carriers have proliferated and now offer real, lasting competition to their network rivals. This generation of low-cost carriers has newer fleets, a better in-flight product, and better on-time performance and completion factors than the first wave of post-deregulation start-ups. Finally, the fare transparency delivered by the Internet and the expansion of low-cost carrier services have increased the price-sensitivity even of business passengers. The airline seat is rapidly becoming a commodity. The Department's deregulation of computer reservation systems set to take effect this summer will likely bring even more marketplace changes to airline distribution.

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

I hasten to add that we are not sounding the death knell of the network carriers. They have put in place serious cost-control measures. In most cases, they have rationalized their fleets and fare structures or will soon do so. They have utilized regional jets across their systems, seeking to persuade passengers to pay a premium for frequency and other network advantages while, at the same time, avoiding the need to carry traffic at the lower end of the demand curve. And, of course, through their broad-based international networks, network carriers still offer the only on-line service to many cities in our country and around the world.

Nonetheless, there is little doubt that the low-cost carriers will continue to expand. They are departing from some of the time-honored assumptions about the kind of services low-fare carriers provide. Their business models and fleets are increasingly diverse. They no longer limit themselves to dense, short-haul markets. Several low-fare carriers serve a growing number of smaller communities and city-pair markets of all distances.

Increasing numbers of business travelers use low-fare airlines as a matter of corporate travel policy. And low-cost carriers – both foreign and domestic – are poised to expand into what was once the preserve of their network rivals – international service.

How these changes will shake out is not entirely clear, and it will depend, to some extent, on how business travel evolves. For instance, will business travelers become even more price-sensitive than they have been in recent years? Will benefits such as frequent flyer programs allow network carriers to maintain at least a modicum of loyalty from business travelers? And, perhaps most importantly, what new business plans will emerge to respond to consumer demand?

Whatever the answers to these questions, we view the industry's current dynamism as an enormously positive development, one that accords with the Administration's broader commitment to free trade. Carriers may encounter difficult times, certain business models may rise and then falter, but these things will occur within the context of a marketplace that is providing the best, most varied passenger service since deregulation took effect 25 years ago. That is the promise of deregulation fulfilled.

International Aviation Liberalization

I would also like to say a few words regarding the international passenger market, and the agenda that we have for it. Here, in contrast with the domestic market, we confront a patchwork of markets, some open, some heavily regulated, some that fall somewhere in between. The possibility of opening up these markets, of deregulating what has traditionally been a heavily regulated field, is a tremendous opportunity.

I mentioned just a moment ago the Administration's commitment to free trade. Having served at the Commerce Department, I can tell you that this commitment is real and comes from the President's belief that markets work best when governments resist the temptation to meddle in them. In the international aviation context, that has meant a clear Administration policy of pursuing Open Skies agreements around the world.

As many of you know, the Open Skies agreement allows carriers flying internationally to do what deregulation, broadly speaking, allowed them to do domestically – namely, to fly from any city in the U.S. to any city in an Open Skies country whenever they want, using whatever aircraft they choose, and charging whatever price they believe the market will bear. We believe that this model has been to the benefit of U.S. and foreign consumers alike. It has exposed U.S. and foreign airlines to rigorous competition – it has forced them to rationalize their international operations and has resulted in lower prices, and new and better service options.

But the problem – and it's the most significant problem that consumers of international air transportation face today – is that still too many of our international markets – and, in particular, too many of our largest international aviation markets – remain distorted by governmental regulation. Notwithstanding the achievement of negotiating more than 60 Open Skies agreements, we continue to lack liberalized aviation regimes with some of our most important trading partners.

Therefore, with Secretary Mineta's leadership and in partnership with our colleagues at the State Department and in industry, we are working to change that.   In the past six months, we have launched bilateral negotiations with China, India, Japan, and the newly-expanded European Union with its 25 member states. Through these negotiations, we are seeking further liberalization – further opportunities for carriers, communities, and consumers – in markets that represent over 47% of the world's population, nearly 40% of the global economy, and 16 of the nation's 50 largest trading partners. The successful conclusion of <u>any</u> of these negotiations – and let me be clear, there remain significant issues to be worked out in all of them – would yield enormous economic dividends and be a significant diplomatic achievement with an important global partner.

Nor do we intend to stop there. We will also seek to engage our significant trading partners in North America, Latin America and the Middle East. In all these negotiations we are seeking to liberalize the bilateral aviation relationships. Where our foreign partner is willing, we seek Open Skies. Where it is not willing, we will consider pursuing incremental or phased-in liberalization. The goal is to keep our air services relationships moving forward to keep pace with – or preferably to outpace – the trade relationships that international aviation should facilitate and foster.

Let me say a brief word about one set of negotiations in particular – those with the European Union. The negotiations launched by the President last June could remove governmental constraints on one of the most important international markets and create a new template for international air services. The fifth round of negotiations concluded in Washington, D.C. last week, with negotiators from both sides working very hard to try to reach an agreement. I remain no less enthusiastic than I was last September, when I came to the Department, about what could <u>potentially</u> result from such an agreement.

An agreement along the lines that the United States has offered would promise substantial, tangible benefits to both sides. It would create the conditions for transatlantic Open Skies with all 25 EU member states. In so doing, it would afford U.S. carriers and communities unfettered access to the ten European countries that are currently constrained by restrictions on where and how carriers may operate. These countries include Great Britain, and together they represent 47% of the total U.S.-EU passenger market.

Although the two sides have made a great deal of progress, there are some issues related to Europe's access to the internal U.S. market that thus far have prevented a deal. We believe that the EU side must put these issues aside and embrace the proposal we have offered. A near-term agreement that achieves the benefits I've just described could help spur international carrier activity at a critically important period in the industry's development. It could help to broaden and deepen international carrier alliances at a time when those alliances themselves are going through substantial change. And it would reinforce and stimulate the United States' broader economic relationship with our European partners. Most importantly, such an agreement would put passengers – not governments – in the driver's seat about when, where, and for how much we can all travel between the U.S. and the 25 nations of the EU.

And that, ultimately, is what we all seek, the ability to move people, goods, and services around the world, as efficiently as possible. That is the point behind the President’s and Secretary Mineta’s vision of an aviation system that – both domestically and internationally – lives up to the open, free-trading economy it so indispensably supports.

Thank you for your attention.