

**Remarks at  
“The Aviation Industry of Tomorrow: Emerging from the Crisis”**

**Jiro Hanyu**  
President  
Japan International Transport Institute

**Greetings**

First, I would like to thank all of you in the audience for coming to our conference on the future of civil aviation. We are also very fortunate to have here three top experts in the aviation field, in experience and knowledge, and so I'd like to thank Jeffrey Shane, Associate Deputy Secretary of the Department of Transportation; Mike Levine, of Yale University; and Toru Nakamura, former President and CEO of the Narita Airport Authority for graciously agreeing to share with us their views on this important topic.

Finally, we are grateful for the full and continuing support of the Japan Foundation, which allows us to pursue our work in international transportation research.

**Overview**

- 1) First let me be clear that my discussion of the aviation industry is a discussion of the worldwide industry. This is after all a global industry, and I do not intend to imply that the problems I will be pointing out are unique to any one country. Nevertheless, because of the far-reaching influence of the United States' aviation industry in the international aviation market, and the gravity of its problems, I would like to present my discussion utilizing certain examples from the industry.
- 2) The first issue I would like to raise concerns the current serious downturn in the aviation industry and its origins. Do we consider September 11 the cause of the world's aviation industry crisis, or a trigger to the accumulation of problems that have plagued the industry over the last ten years?
- 3) I believe it is the latter. There is no question that the terrible tragedy of September 11 caused serious damage to this industry. Yet a similar set of conditions prevailed during the Gulf War, and the industry recovered a year later, on its own, without government subsidy or other assistance. Today, despite both direct and indirect government subsidy to the airlines, the industry's recovery seems very far away. The causes of the current crisis cannot be attributed solely to the events of September 11, but rather are of a more structural nature.
- 4) What, then, are these structural problems? Are they the steep rise in labor costs, particularly pilot compensation? The growing market share of low cost carriers? Or do the problems stem from flaws in the hub and spoke system of the network carriers? While all of these situations hold true, I don't believe they are necessarily the causes but rather a series of phenomenon negatively impacting the viability of the industry.

- 5) I believe instead that the causes of the current crisis in the aviation industry have to do with the following three structural problems:
  - a. The first concerns open skies-type policies. That is, while the international market is liberalized, the domestic market is reserved for domestic carriers. In the end there is only a partial liberalization that has resulted in an arbitrary division of the global market.
  - b. The second problem lies in the preferential allocation of airport slots at congested airports to those carriers with grandfather rights.
  - c. And the third is the weak protection of consumer rights, particularly with respect to the excessive pursuit of profit by network airlines at the expense of their customers.
- 6) Now I would like to explain, briefly, how these three problems act as barriers to fair competition in the market and obstruct consumers from engaging in fair transactions with the airlines.

### **Open Skies-Type Policies**

- 1) The problem of open skies policies isn't just that foreign corporations are denied the opportunity to compete in domestic markets. This is not necessarily an inherent flaw of open skies policies themselves, because all countries participating in the global aviation market engage in such exclusionary practices. The problem is also that domestic network carriers in a vast, profitable domestic market cross subsidize their domestic and international markets, creating for themselves an overwhelming advantage, even in bilateral agreements.
- 2) Consider it from this perspective. When an airline from one country competes in the international market, the easiest way to ensure a highly profitable domestic market is through higher prices for domestic consumers, rather than effective cost-cutting.
- 3) To see if this is correct, let's examine unit revenues and costs for two carriers' domestic and Pacific routes. Looking at second quarter figures for four consecutive years, beginning in 1999, these two carriers consistently had higher unit revenues in their domestic market than in their Pacific market. At the same time, unit operating costs were consistently lower for their Pacific routes compared to their domestic routes. These numbers seem to back up my statement. From a revenue standpoint, the domestic market is more lucrative than the Pacific market. From a cost perspective, however, the Pacific routes are less expensive because the airlines are forced to operate in a more competitive environment, and therefore have to be more careful about costs.

### **Existing Rights at Airports**

The next point I'd like to raise is the problem of preferential existing rights with respect to slots at congested airports in the international market.

- 1) As we are all aware, the slots at airports are public, not private assets. It isn't appropriate, then, that airlines with existing slot rights should receive preferential treatment in the allocation of those slots. Of course I realize that in recent years Japan, the U.S., and Europe have modified this type of regulation and now are requiring a certain number of slots be allocated to new entrants. However, the number of these available slots is extremely limited.

- 2) As the system now stands, airlines holding grandfather rights to specific slots have priority in acquiring their preferred slots. Under typical IATA-based rules regarding grandfather rights, if an airline utilizes a specific slot during the one season, it maintains existing rights to that slot for the next equivalent season. This type of rule can also lead to inefficient use of these scarce operating privileges. In one extreme case, a large international carrier used a Cessna on a 4,000 meter runway at a highly congested airport so that it wouldn't have to give up that slot to a competitor.
- 3) The restrictions of this type of system where grandfathered rights allow preferential allocation make it extremely difficult for small carriers to compete in a commercially viable manner at congested airports. In Japan, both Haneda and Narita fall under this category.
- 4) I think the situation in the U.S. has improved. Due to more recent legislation, the slot constraints at the high density airports will eventually be lifted and all airlines will takeoff and land on a first-come-first-served basis. On the other hand, even at those hub airports without slot constraints, where one or two major network carriers dominate the airport through terminals and gates, significant entry by new or small incumbents is economically unfeasible.
- 5) The global practice of preferential existing rights very effectively hinders competition between the hub-and-spoke network carriers and others such as new entrants and small market share carriers. The current system of slot allocation at congested airports should be dismantled, but since that isn't feasible in the markets outside the U.S., at least in the medium-term, I think one way to address the inequities would be to shift the preferential allocation of slots to small carriers.

### **Consumer Protection Policies**

Finally, I will very briefly touch on consumer protection policies.

- 1) The position of the individual airline passenger is a very weak one when conducting a transaction with an airline company. Consumer protection policies therefore have the purpose of protecting consumers in such a position, so that they can engage in relatively fair transactions with the airline companies. On the other hand, anti-monopoly policies and regulations monitor the scale advantages among and across companies to ensure fair competition. While these policies and regulations have some overlap, they should not be confused with each other.
- 2) Consumer protection policies can be broken into three general categories:
  - a. Access to information about the products and service of any given corporation
  - b. The establishment of responsibility for the manufacture or provision of those products and services.
  - c. Regulation of extreme profit-taking by corporations that unduly ignores or harms consumers
- 3) I am very impressed with the progress the U.S. has made in the first two areas. Nonetheless, because of a reluctance to interfere with the workings of the market, something common to the major industrialized countries, there is a significant weakness in the third area of consumer protection.
- 4) In the aviation market, I believe there is a serious need for improved consumer protection because: a.) the hub and spoke system makes it easy for the network carriers

to maintain oligopolies in large sections of consumer and geographic markets; b.) preferential slot allocation at congested airports creates economic barriers to entrance into those markets, and c.) code-sharing allows an extensive amount of alliance-building between the majors. Nonetheless, network carriers in particular are freely allowed to continue to increase their market share, charge higher yields to certain groups of consumers, through hubs reduce the choices of direct flights, and even engage in predatory pricing (although this is as yet almost impossible to prove) to prevent new entrants. I can't help but think that this type of behavior is driving consumers away from the major network carriers around the world.

## **Conclusion**

In looking at the structure of the aviation industry, I am reminded of an industry formed in the environment of 19<sup>th</sup> century capitalism. Its outdated practices and policies have invited poor service, high prices and barriers to new entrants, and I can conclude only that they have in turn all caused consumers to avoid travel via the network carriers.

Therefore, in order to move beyond this crisis and revitalize the industry, the entire market must be opened up, the system of preferential treatment of slot holders with existing rights must be abolished, and improved consumer protection policies must be introduced. These measures could even be phased in and be successful, but all three problem areas must be addressed simultaneously. Ideally, these changes would be made not in just one country, but throughout the worldwide aviation market.

Lastly, let's consider that this type of change is indeed possible, and not just theoretically. These types of changes should be implemented now, while the industry is in severe crisis. The trend, unfortunately, is in the opposite direction. The reality is, we have a European market that is becoming regionalized, and we see the world's largest carriers continue to seek subsidies in times of crisis. A future where this type of behavior persists cannot bode well for air travel consumers demanding fair transactions or for carriers trying to engage in fair competition.

That concludes my remarks. Thank you.