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COMMERCIAL AVIATION

Structural Costs Continue to Challenge Legacy Airlines' Financial Performance

Statement of JayEtta Z. Hecker, Director Physical Infrastructure Issues

GAO-05-834T

July 13, 2005

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Structural Costs Continue to Challenge Legacy Airlines' Financial Performance

GAO Highlights

Accountability·Integrity·Reliability

Highlights of GAO-05-834T, a testimony before the Committee on Commerce, Science, and Transportation, Subcommittee on Aviation, U.S. Senate

Why GAO Did This Study

Since 2001, the U.S. airline industry has confronted unprecedented financial losses. Two of the nation's largest airlines—United Airlines and US Airways–went into bankruptcy, terminating their pension plans and passing the unfunded liability to the Pension Benefit Guaranty Corporation (PBGC). PBGC's unfunded liability was $9.6 billion; plan participants lost $5.2 billion in benefits.

Considerable debate has ensued over airlines' use of bankruptcy protection as a means to continue operations, often for years. Many in the industry and elsewhere have maintained that airlines' use of this approach is harmful to the industry, in that it allows inefficient carriers to reduce ticket prices below those of their competitors. This debate has received even sharper focus with pension defaults. Critics argue that by not having to meet their pension obligations, airlines in bankruptcy have an advantage that may encourage other companies to take the same approach.

GAO is completing a report for the Committee due later this year. Today's testimony presents preliminary observations in three areas: (1) the continued financial difficulties faced by legacy airlines, (2) the effect of bankruptcy on the industry and competitors, and (3) the effect of airline pension underfunding on employees, airlines, and the PBGC.

www.gao.gov/cgi-bin/getrpt?GAO-05-834T.

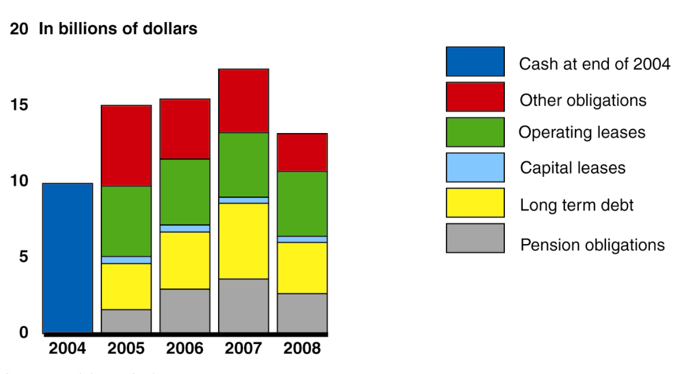
To view the full product, including the scope and methodology, click on the link above. For more information, contact JayEtta Z. Hecker, (202) 512-2834 or heckerj@gao.gov.

What GAO Found

U.S. legacy airlines have not been able to reduce their costs sufficiently to profitably compete with low cost airlines that continue to capture market share. Internal and external challenges have fundamentally changed the nature of the industry and forced legacy airlines to restructure themselves financially. The changing demand for air travel and the growth of low cost airlines has kept fares low, forcing these airlines to reduce their costs. They have struggled to do so, however, especially as the cost of jet fuel has jumped. So far, they have been unable to reduce costs to a level with their low-cost rivals. As a result, legacy airlines have continued to lose money–$28 billion since 2001.

Although some industry observers have asserted that airlines undergoing bankruptcy reorganization contribute to the industry's financial problems, GAO found no clear evidence that historically airlines in bankruptcy have financially harmed competing airlines. Bankruptcy is endemic to the industry; 160 airlines filed for bankruptcy since deregulation in 1978, including 20 since 2000. Most airlines that entered bankruptcy have not survived. Moreover, despite assertions to the contrary, available evidence does not suggest that airlines in bankruptcy contribute to industry overcapacity or that bankrupt airlines harm competitors by reducing fares below what other airlines are charging.

While bankruptcy may not be detrimental to rival airlines, it is detrimental for pension plan participants and the PBGC. The remaining legacy airlines with defined benefit pension plans face over $60 billion in fixed obligations over the next 4 years, including $10.4 billion in pension obligations -- more than some of these airlines may be able to afford given continued losses (see figure). While cash from operations can help fund some of these obligations, continued losses and the size of these obligations put these airlines in a sizable liquidity bind. Moreover, legacy airlines still face considerable restructuring before they become competitive with low cost airlines.



Source: PBGC and SEC filings.

Mr. Chairman and Members of the Subcommittee:

We appreciate the opportunity to participate in today's hearing to discuss the financial condition of the U.S. airline industry—and particularly, the financial problems of legacy airlines.[1] Since 2001, the U. S. airline industry has confronted financial losses of unprecedented proportions. From 2001 through 2004, legacy airlines reported losses of $28 billion, and two of the nation's largest legacy airlines—United Airlines and US Airways—went into bankruptcy,[2] eventually terminating their pension plans and passing the unfunded liability to the Pension Benefit Guaranty Corporation (PBGC).[3] Two other large legacy airlines have announced that they are precariously close to following suit.

In recent years, considerable debate has ensued over legacy airlines' use of Chapter 11 bankruptcy protection as a means to continue operations, often for years. Some in the industry and elsewhere have maintained that legacy airlines' use of this approach is harmful to the airline industry as a whole, in that it allows inefficient carriers to stay in business, exacerbating overcapacity and allowing these airlines to potentially under price their competitors. This debate has received even sharper focus with US Airways' and United's defaults on their pensions. By eliminating their pension obligations, critics argue, US Airways and United enjoy a cost

[1]While there is variation among airlines in regards to the size and financial condition, we adhere to a construct adopted by industry analysts to group large passenger airlines into one of two groups—legacy and low cost. Legacy airlines (Alaska, American, Continental, Delta, Northwest, United, and US Airways) predate airline deregulation of 1978 and have adopted a hub and spoke network model that can be more expensive to operate than a simple point-to-point service model. Low cost airlines (AirTran, America West, ATA, Frontier, JetBlue, Southwest, and Spirit) have generally entered the market since 1978, are smaller, and generally employ a less costly point-to-point service model. The 7 low cost airlines have consistently maintained lower unit costs than the 7 legacy airlines.

[2]Two other smaller carriers—ATA Airlines and Aloha—are also in bankruptcy protection. Hawaiian Airlines just emerged from bankruptcy protection earlier this month.

[3]The Pension Benefit Guaranty Corporation's (PBGC) single-employer insurance program is a federal program that insures certain benefits of the more than 34 million worker, retiree, and separated vested participants of over 29,000 private sector defined benefit pension plans. Defined benefit pension plans promise a benefit that is generally based on an employee's salary and years of service, with the employer being responsible to fund the benefit, invest and manage plan assets, and bear the investment risk. A single-employer plan is one that is established and maintained by only one employer. It may be established unilaterally by the sponsor or through a collective bargaining agreement.

advantage that may encourage other airlines sponsoring defined benefits plans to take the same approach.

Last year, we reported on the industry's poor financial condition, the reasons for it, and the necessity of legacy airlines to reduce their costs if they are to survive.[4] At the request of the Congress, we have continued to assess the financial condition of the airline industry and, in particular, the problems of bankruptcy and pension terminations. Our work in this area is still under way.[5] Nonetheless, we can offer some preliminary observations about what we are finding. Our statement today describes our preliminary observations in three areas: (1) the continued financial difficulty faced by legacy airlines, (2) the effect of bankruptcy on the industry and competitors, and (3) the effect of airline pension underfunding on employees, retirees, airlines, and the PBGC. Our final report, which we expect to issue in September, will offer additional evidence and insights on these questions.

In summary:

- U.S. legacy airlines have not been able to reduce their costs sufficiently to profitably compete with low cost airlines that continue to capture industry market share. Challenges that are internal and external to the industry have fundamentally changed the nature of the industry and forced legacy airlines to restructure themselves financially. The changing demand for air travel and growth of low cost airlines has kept fares low, forcing legacy airlines to reduce their costs. However, legacy airlines have struggled to do so, and have been unable to achieve unit cost comparability with their low-cost rivals. As a result, legacy airlines have continued to lose money—$28 billion since 2001—and are expected to lose another $5 billion in 2005. Additionally, airlines' costs have been hurt by rising fuel prices – especially legacy airlines that did not have fuel hedging in place.

- Bankruptcies are endemic to the airline industry, the result of long-standing structural issues within the industry, but there is no clear

[4]U.S. Government Accountability Office, *COMMERCIAL AVIATION: Legacy Airlines Must Further Reduce Costs to Restore Profitability* (GAO-04-836) August, 2004.

[5]We found all relevant data for assessing the financial condition of the airline industry, analyses of the effects of bankruptcy on the industry as a whole and six case studies of hub markets affected by airline bankruptcy or service withdrawals, interviews with industry and subject area experts, and analyses of SEC and PBGC data to be sufficiently reliable for our purposes.

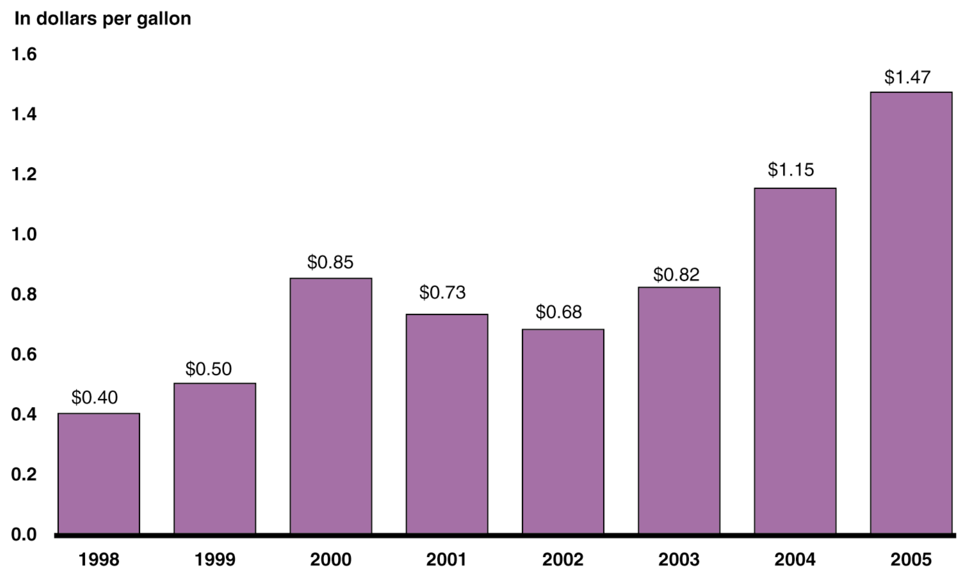
evidence that bankruptcy itself has harmed the industry or its competitors. Since deregulation in 1978, there have been 160 airline bankruptcy filings, 20 of which have occurred in the last 5 years. Airlines fail at a higher rate than most other types of companies, and the airline industry historically has the worst financial performance of any sector. This inherent instability that leads to so many bankruptcies can be traced to the structure of the industry and its economics, including the highly cyclical demand for air travel, high fixed costs, and few barriers to entry. The available evidence does not suggest that airlines in bankruptcy contribute to industry overcapacity or that bankrupt airlines harm competitors by reducing fares below what other airlines are charging. The history of the industry since deregulation indicates that past liquidations or consolidations have not slowed the overall growth of capacity in the industry. Studies conducted by others do not show evidence that airlines operating in bankruptcy harmed other competitors. Finally, while bankruptcy may appear to be a useful business strategy for companies in financial distress, available analysis suggests it provides no panacea for airlines. Few airlines that have filed for bankruptcy protection are still in business today. Bankruptcy involves many costs, and given the poor track record, companies are likely to use it only as a last resort.

- While bankruptcy may not harm the financial health of the airline industry, it has become a considerable concern for the federal government and airline employees and retirees because of the recent terminations of pensions by US Airways and United Airlines. These terminations resulted in claims on PBGC's single –employer program of $9.6 billion and plan participants (i.e., employees, retirees, and beneficiaries) are estimated to have lost more than $5 billion in benefits that were either not covered by PBGC or exceeded the statutory limits. At termination in May 2005, United's pension plans promised $16.8 billion in benefits backed by only $7 billion in assets (i.e., it was underfunded by $9.8 billion). PBGC guaranteed $13.6 billion of the promised benefits, resulting in a claim on the agency of $6.6 billion and an estimated $3.2 billion loss to participants. The defined benefit pension plans of the remaining legacy airlines with active plans are underfunded by $13.7 billion (based on data from the U.S. Securities and Exchange Commission, or SEC), raising the potential of additional sizeable losses to PBGC and plan participants. These airlines face $10.4 billion in pension contributions over the next 4 years, significantly more than some of them may be able to afford given continued losses and their other fixed obligations. Spreading these contributions over more years, as some of these airlines have proposed, would relieve some of this liquidity pressure but would not necessarily keep them out of bankruptcy because it does not fully address the fundamental cost structure problems faced by legacy airlines.

Legacy Airlines Must Reduce Costs to Restore Profitability

Since 2000, legacy airlines have faced unprecedented internal and external challenges. Internally, the impact of the Internet on how tickets are sold and consumers search for fares and the growth of low cost airlines as a market force accessible to almost every consumer has hurt legacy airline revenues by placing downward pressure on airfares. More recently, airlines' costs have been hurt by rising fuel prices (see figure 1).[6] This is especially true of airlines that did not have fuel hedging in place. Externally, a series of largely unforeseen events—among them the September 11th terrorist attacks in 2001 and associated security concerns; war in Iraq; the SARS crisis; economic recession beginning in 2001; and a steep decline in business travel—seriously disrupted the demand for air travel during 2001 and 2002.

Figure 1: Average Annual Spot Price for Gulf Coast Jet Fuel, 1998-2005



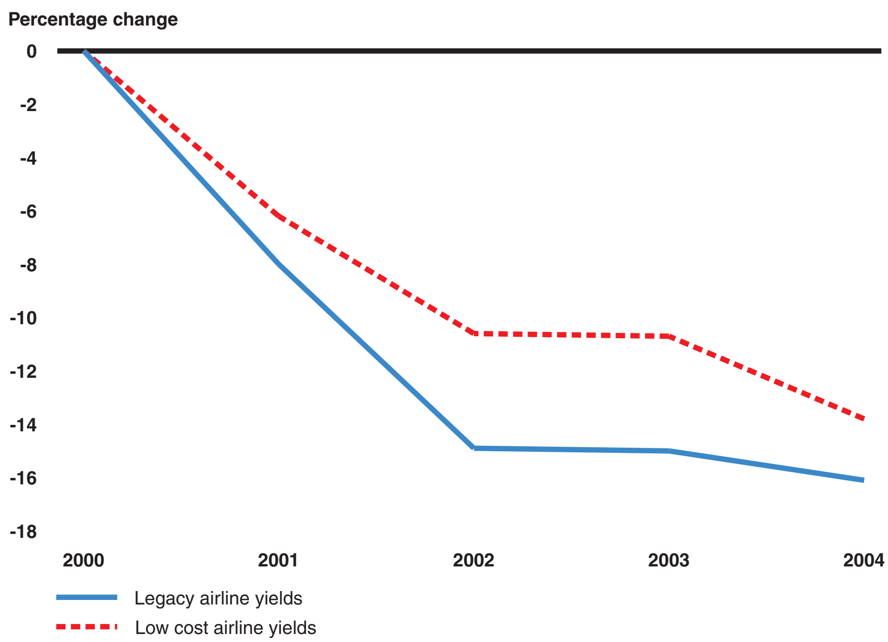
Source: GAO analysis of Department of Energy's Energy Information Administration data.

Note: 2005 prices reflect average through June 7.

[6] Legacy airlines' fuel costs as a percentage of total operating costs doubled from 11.5 percent during the 4th quarter of 1998 to 22.9 percent during the 4th quarter of 2004. Fuel costs for these airlines were $5 billion higher in 2004 than in 2003 – an amount roughly equal to their net operating losses.

Low fares have constrained revenues for both legacy and low cost airlines. Yields, the amount of revenue airlines collect for every mile a passenger travels, fell for both low cost and legacy airlines from 2000 through 2004 (see figure 2). However, the decline has been greater for legacy airlines than for low cost airlines. During the first quarter of 2005, average yields among both legacy and low cost airlines rose somewhat, although those for legacy airlines still trailed what they were able to earn during the same period in 2004.

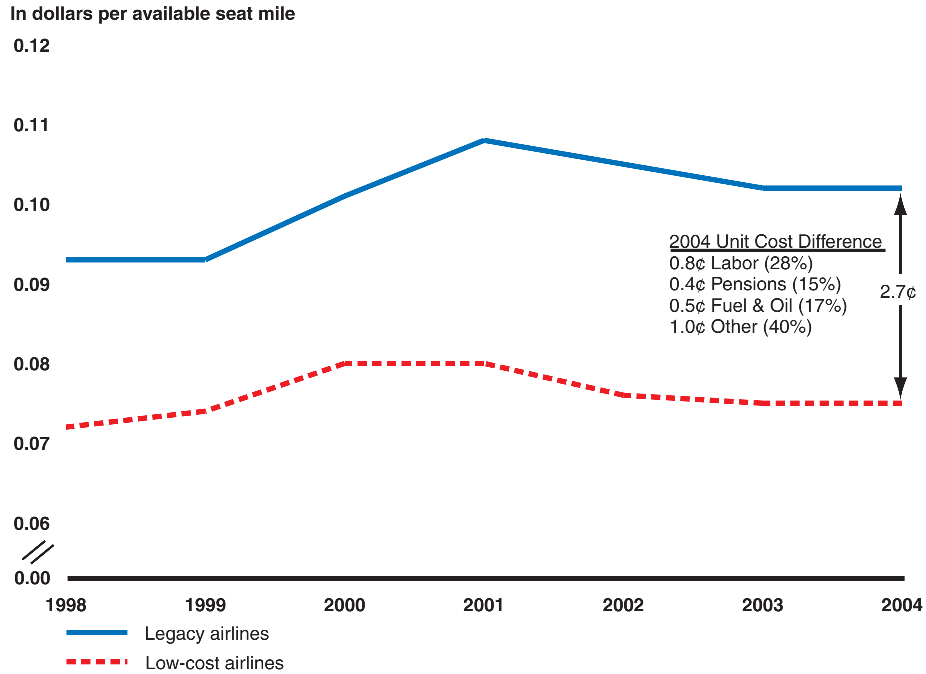
Figure 2: Percentage Change in Passenger Yields Since 2000



Source: GAO analysis of Department of Transportaion (DOT) Form 41 data.

Legacy airlines, as a group, have been unsuccessful in reducing their costs to become more competitive with low cost airlines. Unit cost competitiveness is key to profitability for airlines because of declining yields. While legacy airlines have been able to reduce their overall costs since 2001, these were largely achieved through capacity reductions and without an improvement in their unit costs. Meanwhile, low cost airlines have been able to maintain low unit costs, primarily by continuing to grow. As a result, low cost airlines have been able to sustain a unit cost advantage as compared to their legacy rivals (see figure 3). In 2004, low cost airlines maintained a 2.7 cent per available seat mile advantage over legacy airlines. This advantage is attributable to lower overall costs and greater labor and asset productivity. During the first quarter of 2005, both legacy and low cost airlines continued to struggle to reduce costs, in part because of the increase in fuel costs.

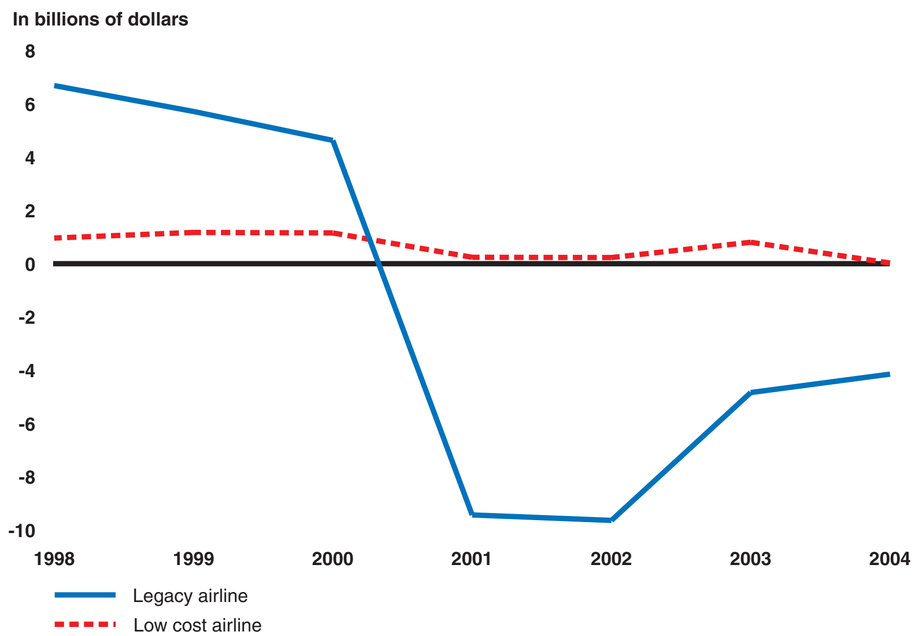
Figure 3: Legacy vs. Low Cost Airline Unit Cost Differential, 1998 2004



Source: GAO analysis of DOT Form 41 data.

Weak revenues and the inability to realize greater unit cost-savings have combined to produce unprecedented losses for legacy airlines. At the same time, low cost airlines have been able to continue producing modest profits as a result of lower unit costs (see figure 4). Legacy airlines have lost a cumulative $28 billion since 2001 and are predicted to lose another $5 billion in 2005, according to industry analysts. First quarter 2005 operating losses (based on data reported to DOT) approached $1.45 billion for legacy airlines. Low cost airlines also reported net operating losses of almost $0.2 billion, driven primarily by ATA's losses.

Figure 4: Airline Operating Profits and Losses, 1998-2004



Source: GAO analysis of DOT Form 41 data.

Since 2000, as the financial condition of legacy airlines deteriorated, they built cash balances not through operations but by borrowing. Legacy airlines have lost cash from operations and compensated for operating losses by taking on additional debt, relying on creditors for more of their capital needs than in the past. In the process of doing so, several legacy airlines have used all, or nearly all, of their assets as collateral, potentially limiting their future access to capital markets.

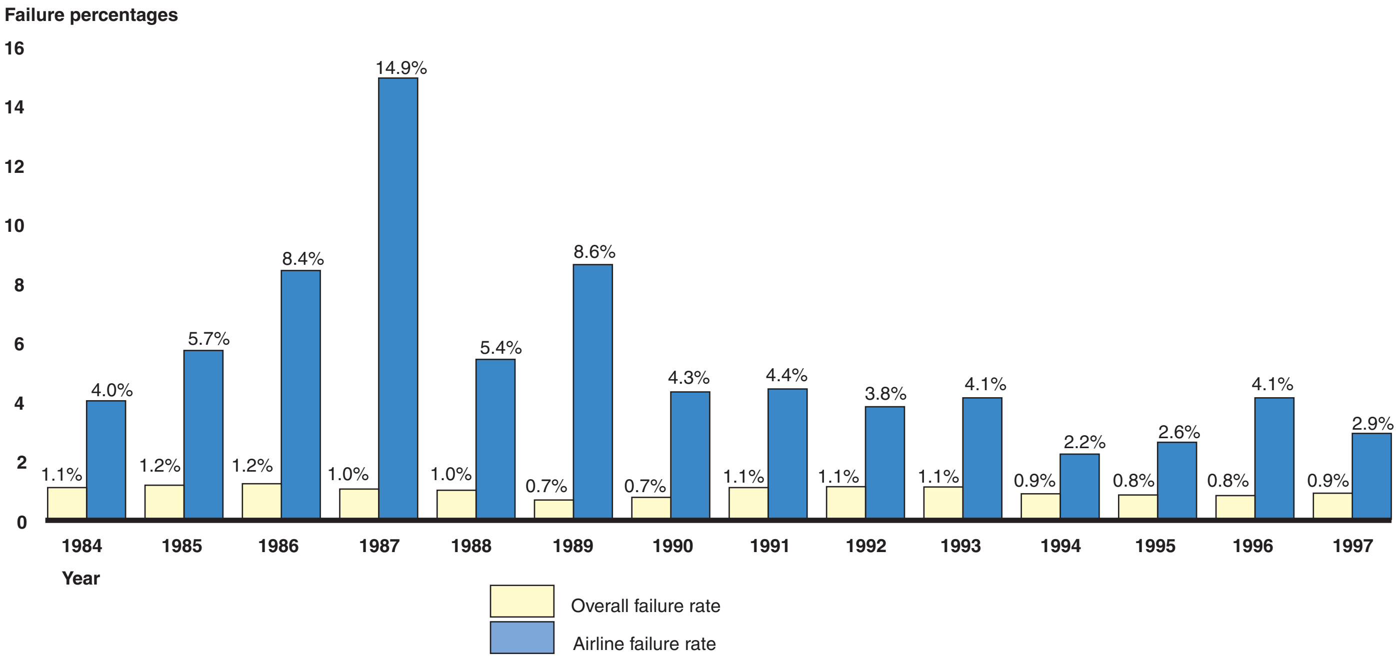
In sum, airlines are capital and labor intensive firms subject to highly cyclical demand and intense competition. Aircraft are very expensive and require large amounts of debt financing to acquire, resulting in high fixed costs for the industry. Labor is largely unionized and highly specialized, making it expensive and hard to reduce during downturns. Competition in the industry is frequently intense owing to periods of excess capacity, relatively open entry, and the willingness of lenders to provide financing. Finally, demand for air travel is highly cyclical, closely tied to the business cycle. Over the past decade, these structural problems have been exacerbated by the growth in low cost airlines and increasing consumer sensitivity to differences in airfares based on their use of the Internet to purchase tickets. More recently airlines have had to deal with persistently high fuel prices—operating profitability, excluding fuel costs, is as high as it has ever been for the industry.

Bankruptcy is Common in the Airline Industry, but There is No Evidence that it is Harmful to the Industry or Competitors

Airlines seek bankruptcy protection for such reasons as severe liquidity pressures, an inability to obtain relief from employees and creditors, and an inability to obtain new financing, according to airline officials and bankruptcy experts. As a result of the structural problems and external shocks previously discussed, there have been 160 total airline bankruptcy filings since deregulation in 1978, including 20 since 2000, according to the Air Transport Association.[7] Some airlines have failed more than once but most filings were by smaller carriers. However, the size of airlines that have been declaring bankruptcy has been increasing. Of the 20 bankruptcy filings since 2000, half of these have been for airlines with more than $100 million in assets, about the same number of filings as in the previous 22 years. Compared to the average failure rate for all types of businesses, airlines have failed more often than other businesses. As figure 5 shows, in some years, airline failures were several times more common than for businesses overall.

[7]Airlines may file for two types of bankruptcy. Chapter 7 of the bankruptcy code governs the liquidation of the debtor's estate by appointed trustees of the court. Chapter 11 of the code governs business reorganizations and allows, among other things, companies to reject collective bargaining agreements and renegotiate contracts and leases with creditors with the approval of the court. Companies may also convert from a Chapter 11 reorganization into a Chapter 7 liquidation or may liquidate within Chapter 11.

Figure 5: Comparison of Airline and Overall Business Failure Rates, 1984-1997



Source: GAO analysis of DOT and Dun & Bradstreet data.

Note: Dun & Bradstreet data were only available through 1997.

With very few exceptions, airlines that enter bankruptcy do not emerge from it. Of the 146 airline Chapter 11 reorganization filings since 1979, in only 16 cases are the airlines still in business. Many of the advantages of bankruptcy stem from legal protection afforded the debtor airline from its creditors, but this protection comes at a high cost in loss of control over airline operations and damaged relations with employees, investors, and suppliers, according to airline officials and bankruptcy experts.

Contrary to some assertions that bankruptcy protection has led to overcapacity and under pricing that have harmed healthy airlines, we found no evidence that this has occurred either in individual markets or to the industry overall. Such claims have been made for more than a decade. In 1993, for example, a national commission to study airline industry problems cited bankruptcy protection as a cause for the industry's overcapacity and weakened revenues.[8] More recently, airline executives

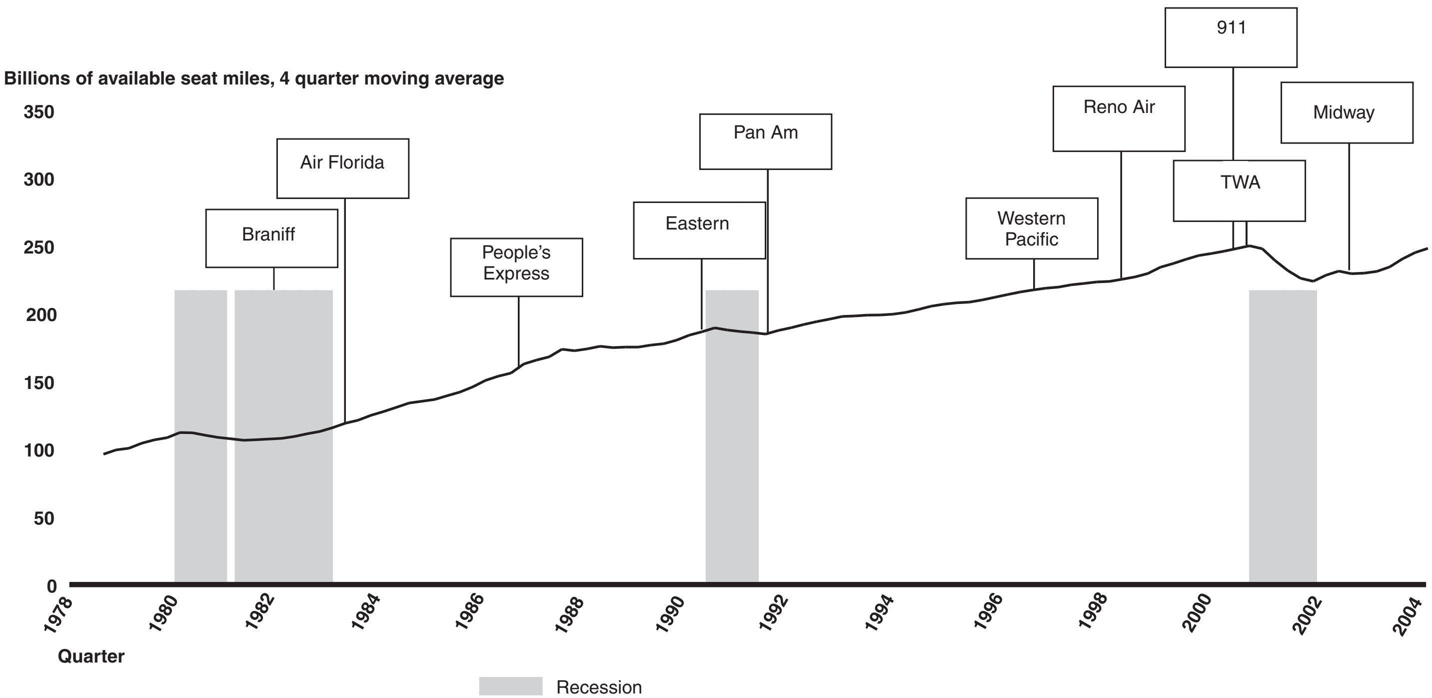
[8]The National Commission to Ensure a Strong Competitive Airline Industry, *Change, Challenge, and Competition*, A Report to the President and Congress, August 1993.

have cited bankruptcy protection as a reason for industry over capacity and low fares. However, we found no evidence that this had occurred and some evidence to the contrary.

First, as illustrated by Figure 6, airline liquidations do not appear to affect the continued growth in total industry capacity. If bankruptcy protection leads to overcapacity as some contend, then liquidation should take capacity out of the market. However, the historical growth of airline industry capacity (as measured by available seat miles, or ASMs) has continued unaffected by major liquidations. Only recessions, which curtail demand for air travel, and the September 11th attack, appear to have caused the airline industry to trim capacity. This trend indicates that other airlines quickly replenish capacity to meet demand. In part, this can be attributed to the fungibility of aircraft and the availability of capital to finance airlines.[9]

[9]Conversely, consolidation within the industry may help remove some capacity. The pending merger between America West and US Airways contemplates an airline with approximately 10 percent less total capacity than what the two carriers now operate independently. The U.S. federal government will own a significant stake in the merged company: the Air Transportation Stabilization Board will own 11.2 percent of the company, and the PBGC will own at least 5 percent.

Figure 6: Growth of Airline Industry Capacity and Major Airline Liquidations Billions of ASMs, Moving Quarterly Average, 1978-2003



Source: Bankruptcy filings, media reports, and DOT Form 41 data.

Note: Figure does not show liquidations of smaller airlines.

Similarly, our research does not indicate that the departure or liquidation of a carrier from an individual market necessarily leads to a permanent decline in traffic for that market. We contracted with Intervistas/GA2, an aviation consultant, to examine the cases of six hub cities that experienced the departure or significant withdrawal of service of an airline over the last decade (see table 1). In four of the cases, both local origin-and-destination (i.e., passenger traffic to or from, but not connecting through, the local hub) and total passenger traffic (i.e., local and connecting) increased or changed little because the other airlines expanded their traffic in response. In all but one case, fares either decreased or rose less than 6 percent.

Table 1: Case Examples of Markets' Response to Airline Withdrawals

Market	Year	Airline	Effect on passenger traffic	Change in fares
Nashville, TN	1995	American Airlines eliminated hub	Other airlines' traffic increased. Origin and destination traffic increased.	-10.2%
Greensboro, NC	1995	Continental Lite eliminated hub	Other airlines' traffic increased. Origin and destination traffic decreased.	+5.5%
Colorado Springs, CO	1997	Western Pacific moved operations to Denver	Other airlines' traffic decreased Origin and destination traffic decreased.	+43.6%
St. Louis, MO	2001	TWA acquired by American Airlines	Other airlines' traffic decreased. Little change in origin and destination traffic.	+5.4%
Kansas City, MO	2002	Vanguard Airlines suspended service	Little change in other airlines' traffic. Little change in origin and destination traffic.	+4.2%
Columbus, OH	2003	America West eliminated hub	Other airlines' traffic increased. Little change in origin and destination traffic.	+3.6%

Source: Intervistas/GA^2.

Note: Little change in traffic means that traffic increased or decreased less than 5 percent and that origin and destination traffic increased or decreased less than 10 percent. Changes in passenger traffic and fares are measured from 4 quarters prior to the airline departure to 8 quarters after.

We also reviewed numerous other bankruptcy and airline industry studies and spoke to industry analysts to determine what evidence existed with regard to the impact of bankruptcy on the industry. We found two major academic studies that provided empirical data on this issue. Both studies found that airlines under bankruptcy protection did not lower their fares or hurt competitor airlines, as some have contended. A 1995 study found that an airline typically reduced its fares somewhat before entering bankruptcy. However, the study found that other airlines did not lower their fares in response and, more importantly, did not lose passenger traffic to their bankrupt rival and therefore were not harmed by the bankrupt airline.[10] Another study came to a similar conclusion in 2000, this time examining the operating performance of 51 bankrupt firms, including

[10] *Do Airlines In Chapter 11 Harm Their Rivals?: Bankruptcy and Pricing Behavior in U.S. Airline Markets*, National Bureau of Economic Research Working Paper 5047, Severin Borenstein and Nancy L. Rose, February 1995.

5 airlines, and their competitors.[11] Rather than examine fares as did the 1995 study, this study examined the operating performance of bankrupt firms and their rivals. This study found that bankrupt firms' performance deteriorated prior to filing for bankruptcy and that their rivals' profits also declined during this period. However, once a firm entered bankruptcy, its rivals' profits recovered.

Legacy Airlines Face Significant Near-term Liquidity Pressures, including $10.4 Billion in Pensions Contributions over the Next 4 Years

Under current law, legacy airlines' pension funding requirements are estimated to be a minimum of $10.4 billion from 2005 through 2008.[12] These estimates assume the expiration of the Pension Funding Equity Act (PFEA) at the end of this year.[13] The PFEA permitted airlines to defer the majority of their deficit reduction contributions in 2004 and 2005; if this legislation is allowed to expire it would mean that payments due from legacy airlines will significantly increase in 2006. According to PBGC data, legacy airlines are estimated to owe a minimum of $1.5 billion this year, rising to nearly $2.9billion in 2006, $3.5 billion in 2007, and $2.6 billion in 2008. In contrast, low cost airlines have eschewed defined benefit pension plans and instead use defined contribution (401k-type) plans.

However, pension funding obligations are only part of the sizeable amount of debt that carriers face over the near term. The size of legacy airlines' future fixed obligations, including pensions, relative to their financial position suggests they will have trouble meeting their various financial obligations. Fixed airline obligations (including pensions, long term debt, and capital and operating leases) in each year from 2005 through 2008 are substantial. Legacy airlines carried cash balances of just under $10 billion going into 2005 (see figure 7) and have used cash to fund their operational losses. These airlines fixed obligations are estimated to be over $15 billion in both 2005 and 2006, over $17 billion in 2007, and about $13 billion in 2008. While cash from operations can help fund some of these obligations, continued losses and the size of these obligations put these airlines in a

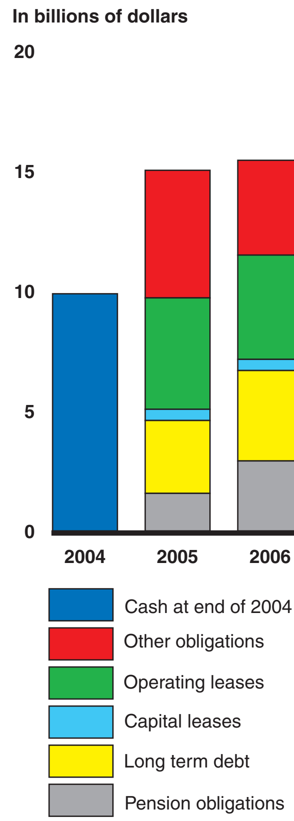
[11] *The Effect of Bankruptcy Filings on Rivals' Operating Performance: Evidence From 51 Large Bankruptcies*, Robert E. Kennedy, International Journal of the Economics of Business; Feb. 2000; pp. 5-25.

[12] These estimates include only legacy airlines that continue to sponsor defined benefit pension plans and reported their estimated pension obligations to PBGC. Pension law provisions prohibit publicly identifying the airlines that have reported this information.

[13] Pension Funding Equity Act of 2004 (P.L. 108-218, April 10, 2004). The PFEA also changed the interest rate used to calculate future liability from the 30-year Treasury bond to a corporate bond rate, which effectively reduces future liabilities.

sizable liquidity bind. Fixed obligations in 2008 and beyond will likely increase as payments due in 2006 and 2007 may be pushed out and new obligations are assumed.

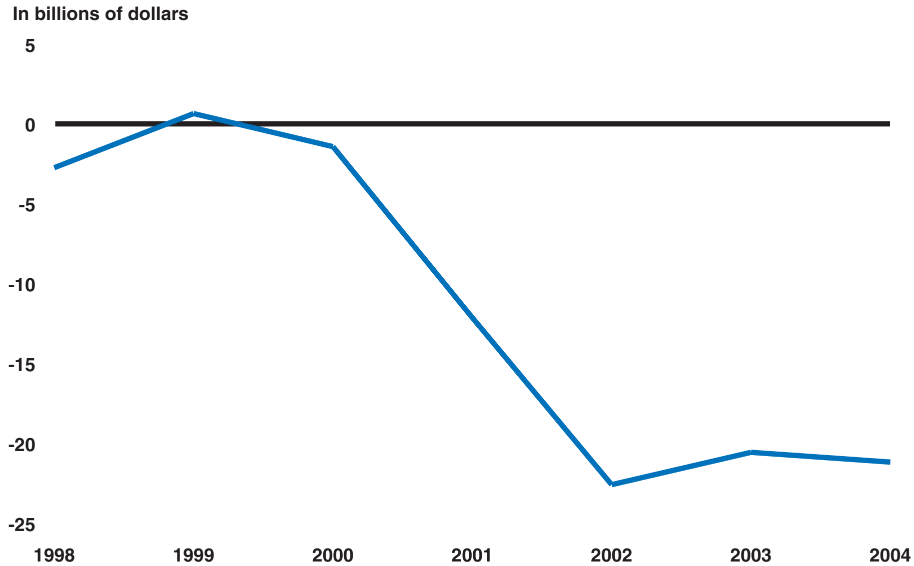
Figure 7: Comparison of Legacy Airline Year-end 2004 Cash Balances with Fixed Obligations, 2005-2008



Source: PBGC and SEC filings.

The enormity of legacy airlines' future pension funding requirements is attributable to the size of the pension shortfall that has developed since 2000. As recently as 1999, airline pensions were overfunded by $700 million based on Security and Exchange Commission (SEC) filings; by the end of 2004 legacy airlines reported a deficit of $21 billion (see figure 8), despite the termination of the US Airways pilots plan in 2003. Since these filings, the total underfunding has declined to approximately $13.7 billion, due in part to the termination of the United Airline plans and the remaining US Airways plans.[14]

Figure 8: Funded Status of Legacy Airline Defined Benefit Plans, 1998-2004



Source: GAO analysis of SEC filings.

Note: The termination of the United Airlines and remaining US Airways defined benefit pension plans in 2005 reduced the total shortfall to approximately $13.7 billion, based on 2004 year-end data.

The extent of underfunding varies significantly by airline. At the end of 2004, prior to terminating its pension plans, United reported underfunding of $6.4 billion, which represented over 40 percent of United's total operating revenues in 2004. In contrast, Alaska reported pension underfunding of $303 million at the end of 2004, or 13.5 percent of its operating revenues. Since United terminated its pensions, Delta and Northwest now appear to have the most significant pension funding

[14]SEC data and PBGC data on the funded status of plans can differ because they serve different purposes and provide different information. The PBGC report focuses, in part, on the funding needs of each pension plan. In contrast, corporate financial statements show the aggregate effect of all of a company's pension plans on its overall financial position and performance. The two sources may also differ in the rates assumed for investment returns on pension assets and in how these rates are used. As a result, the information available from the two sources can appear to be inconsistent. PBGC data also are not timely. For more information, see GAO, *Private Pensions: Publicly Available Reports Provide Useful but Limited Information on Plans' Financial Condition* (GAO-04-395) March 31, 2004.

deficits—over $5 billion and nearly $4 billion respectively—which represent about 35 percent of 2004 operating revenues at each airline.

The growth of pension underfunding is attributable to 3 factors.

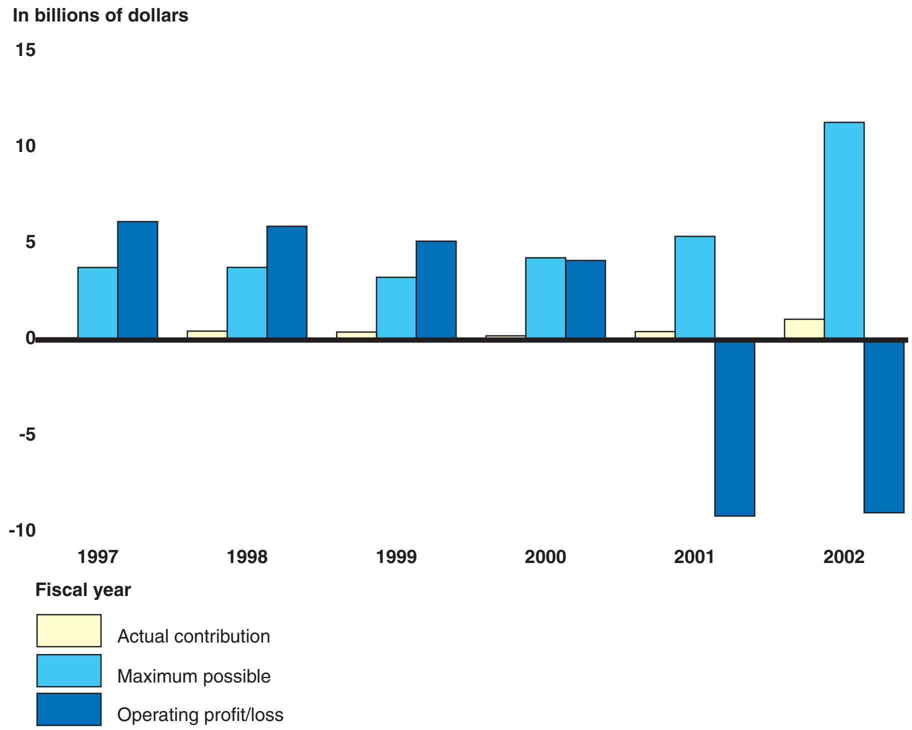
- Assets losses and low interest rates. Airline pension asset values dropped nearly 20 percent from 2001 through 2004 along with the decline in the stock market, while future obligations have steadily increased due to declines in the interest rates used to calculate the liabilities of plans.

- Management and labor union decisions. Pension plans have been funded far less than they could have on a tax deductible basis. PBGC examined 101 cases of airline pension contributions from 1997 through 2002, and found that while the maximum deductible contribution was made in 10 cases, no cash contributions were made in 49 cases where they could have contributed.[15] When airlines did make tax deductible contributions, it was often far less than the maximum permitted. For example, the airlines examined could have contributed a total of $4.2 billion on a tax deductible basis in 2000 alone, but only contributed about $136 million despite recording profits of $4.1 billion (see figure 9).[16] In addition, management and labor have sometimes agreed to salary and benefit increases beyond what could reasonably be afforded. For example, in the spring of 2002, United's management and mechanics reached a new labor agreement that increased the mechanics' pension benefit by 45 percent, but the airline declared bankruptcy the following December.

[15]These 101 cases covered 18 pension plans sponsored by 5 airlines.

[16]Pension funding rules permit sponsors to choose the interest rate used to determine the maximum deductible pension contribution permitted from an interest rate "corridor" – a limited range of interest rates. In calculating the maximum deductible contribution, a higher interest rate produces a lower deductible contribution limit. The maximum deductible contributions referred to in this paragraph and figure 9 are calculated using the lowest interest rate permissible from the interest rate corridor.

Figure 9: Comparison of Legacy Airline Pension Maximum and Actual Contributions and Operating Profits, 1997-2002



Source: PBGC and DOT.

- Pension funding rules are flawed. Existing laws and regulations governing pension funding and premiums have also contributed to the underfunding of defined benefit pension plans. As a result, financially weak plan sponsors, acting within the law, have not only been able to avoid contributions to their plans, but also increase plan liabilities that are at least partially insured by PBGC. Under current law, reported measures of plan funding have likely overstated the funding levels of pension plans, thereby reducing minimum contribution thresholds for plan sponsors. And when plan sponsors were required to make additional contributions, they often substituted "account credits" for cash contributions, even as the market value of plan assets may have been in decline. Furthermore, the funding rule mechanisms that were designed to improve the condition of poorly funded plans were ineffective.[17] Other lawful plan provisions and

[17]For further information, see U.S. Government Accountability Office, *PRIVATE PENSIONS: Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules*, GAO-05-294, (Washington, D.C.: May 31, 2005).

amendments, such as lump sum distributions and unfunded benefit increases may also have contributed to deterioration in the funding of certain plans. Finally, the premium structure in PBGC's single-employer pension insurance program does not encourage better plan funding.

The cost to PBGC and participants of defined benefit pension terminations has grown in recent years as the level of pension underfunding has deepened. When Eastern Airlines defaulted on its pension obligations of nearly $1.7 billion in 1991, for example, claims against the insurance program totaled $530 million in underfunded pensions and participants lost $112 million. By comparison, the US Airways and United pension terminations cost PBGC $9.6 billion in combined claims against the insurance program and reduced participants' benefits by $5.2 billion (see table 2).

Table 2: Airline Pension Termination Information (in millions of dollars)

Airline	Fiscal year of plan terminations	Benefit liability	PBGC liability	Net claim on PBGC	Estimated participant losses
Eastern	1991	1,686	1,574	530	112
PanAm	1991, 1992	1,267	1,212	753	55
TWA	2001	1,729	1,684	668	45
US Airways	2003, 2005	7,900	5,926	3,026	1,974
United	2005	16,800	13,600	6,600	3,200

Source: PBGC.

Note: "Benefit liability" is the value of the benefits promised to participants and their beneficiaries immediately prior to plan termination. "PBGC liability" is the amount that PBGC pays after statutory guarantee limits are imposed. "Net claim on PBGC" is the difference between the PBGC liability and the assets PBGC obtains from the plan. "Estimated participant losses," the difference between the Benefit Liability and the PBGC liability, equals the value of the benefits that plan participants and their beneficiaries lose when PBGC takes over a plan.

In recent pension terminations, because of statutory limits active and high salaried employees generally lost more of their promised benefits compared to retirees and low salaried employees. For example, PBGC generally does not guarantee benefits above a certain amount, currently $45,614 annually per participant at age 65. [18] For participants who retire

[18]This guarantee level applies to plans that terminate in 2005. The amount guaranteed is adjusted (1) actuarially for the participant's age when PBGC first begins paying benefits and (2) if benefits are not paid as a single-life annuity. Because of the way the Employee Retirement and Income Security Act of 1974 (ERISA), as amended, allocates plan assets to participants, certain participants can receive more than the PBGC guaranteed amount.

before 65 the benefits guaranteed are even less; participants that retire at age 60 are currently limited to $29,649. Commercial pilots often end up with substantial benefit cuts when their plans are terminated because they generally have high benefit amounts and are also required by FAA to retire at age 60. Far fewer nonpilot retirees are affected by the maximum payout limits. For example, at US Airways fewer than 5 percent of retired mechanics and attendants faced benefit cuts as a result of the pension termination. Tables 3 and 4 summarize the expected cuts in benefits for different groups of United's active and retired employees.

Table 3: United Airlines Active Employee Pension Termination Benefit Cuts

			Extent of benefit cut		
Plan	**Active employees in plan**	**Actives employees with benefits cuts**	**1% to ≤25%**	**≥25% to ≤50%**	**≥50%**
Management, Administrative, and Public Contact Employees	20,784	19,231	1,696	15,885	1,650
Ground Employees	16,062	16,062	11,448	3,441	1,173
Flight Attendants	15,024	11,109	1,305	7,067	2,737
Pilots	7,360	7,270	3,927	2,039	1,304

Source: PBGC.

Note: Calculation estimates made with 1/1/2005 seriatim data

Table 4: United Airlines Retiree Pension Termination Benefit Cuts

			Extent of benefit cut		
Plan	**Retirees in plan**	**Retirees with benefits cuts**	**≥1% to <25%**	**≥25% to <50%**	**≥50%**
Management, Administrative, and Public Contact Employees	11,360	2,996	2,816	104	76
Ground Employees	12,676	4,961	4,810	121	30
Flight Attendants	5,108	29	27	1	1
Pilots	6,087	3,041	1,902	975	164

Source: PBGC.

Note: Calculation estimates made with 1/1/2005 seriatim data

It is important to emphasize that relieving legacy airlines of their defined benefit funding costs will help alleviate immediate liquidity pressures, but does not fix their underlying cost structure problems, which are much greater. Pension costs, while substantial, are only a small portion of legacy airlines' overall costs. As noted previously in figure 3, the cost of legacy airlines' defined benefit plans accounted for a 0.4 cent, or 15 percent difference between legacy and low cost airline unit costs. The remaining 85 percent of the unit cost differential between legacy and low cost carriers is attributable to factors other than defined benefits pension plans. Moreover, even if legacy airlines terminated their defined benefit plans it would not fully eliminate this portion of the unit cost differential because, according to labor officials we interviewed, other plans would replace them.

Concluding Observations

While the airline industry was deregulated 27 years ago, the full effect on the airline industry's structure is only now becoming evident. Dramatic changes in the level and nature of demand for air travel combined with an equally dramatic evolution in how airlines meet that demand have forced a drastic restructuring in the competitive structure of the industry. Excess capacity in the airline industry since 2000 has greatly diminished airlines' pricing power. Profitability, therefore, depends on which airlines can most effectively compete on cost. This development has allowed inroads for low cost airlines and forced wrenching change upon legacy airlines that had long competed based on a high-cost business model.

The historically high number of airline bankruptcies and liquidations is a reflection of the industry's inherent instability. However, this should not be confused with causing the industry's instability. There is no clear evidence that bankruptcy has contributed to the industry's economic ills, including overcapacity and underpricing, and there is some evidence to the contrary. Equally telling is how few airlines that have filed for bankruptcy protection are still doing business. Clearly, bankruptcy has not afforded these companies a special advantage.

Bankruptcy has become a means by which some legacy airlines are seeking to shed their costs and become more competitive. However, the termination of pension obligations by United Airlines and US Airways has had substantial and wide-spread effects on the PBGC and thousands of airline employees, retirees, and other beneficiaries. Liquidity problems, including $10.4 billion in near term pension contributions, may force additional legacy airlines to follow suit. Some airlines are seeking legislation to allow more time to fund their pensions. If their plans are frozen so that future liabilities do not continue to grow, allowing an extended payback period may reduce the likelihood that these airlines will file for bankruptcy and terminate their pensions in the coming year. However, unless these airlines can reform their overall cost structures and become more competitive with low cost competition; this will be only a temporary reprieve.

This concludes my statement. I would be pleased to respond to any questions that you or other Members of the Subcommittee may have at this time.

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