LINDA LINGLE
GOVERNOR

BRENNON T. MORIOKA
DIRECTOR

Deputy Directors
MICHAEL D. FORMBY
FRANCIS PAUL KEENO
BRIAN H. SEKIGUCHI
JIRO A. SUMADA

IN REPLY REFER TO:

STATE OF HAWAII
DEPARTMENT OF TRANSPORTATION
869 PUNCHBOWL STREET
HONOLULU, HAWAII 96813-5097

February 2, 2009

TESTIMONY OF THE DEPARTMENT OF TRANSPORTATION

COMMITTEE ON TRANSPORTATION

HOUSE BILL NO. 526

We oppose this bill, which establishes a statutory scheme for State regulation of inter-island air carriers. The Department of Transportation (DOT) believes that regulating carriers is not in the best interest of either the airlines or the traveling public.

The federal Airline Deregulation Act of 1978 prohibits states from regulating the routes, rates, or services of airlines operating in interstate commerce. Under this Act, Hawaii is prohibited from regulating its inter-island carriers. In addition, the DOT does not believe that regulation will ensure affordable airfare in the inter-island market. In fact, before 1978, air travel was a luxury and prices steadily increased with regulation. It was competition within the airline industry that resulted in low inter-island airfares.

The bill will create a new state bureaucracy whose sole purpose will be to constantly examine the business and financial affairs of the airlines to see if the fares charged are reasonable to support their activities. Another level of bureaucracy means another level of decision-making and this may lead to more delays in providing essential services and improvement to our airport system.

This measure will have a negative impact on both existing carriers and airlines interested in establishing service in Hawaii. An existing airline carrier would need to obtain permission from the proposed commission every time the airline wanted to add new aircraft to upgrade its fleet, before retiring older planes. This requirement would make it difficult for airlines to expand operations in a timely, efficient manner. Also, carriers interested in starting service in Hawaii would be required to first obtain a certificate of public convenience and necessity. This could limit entry into the Hawaii market and less competition often leads to higher than average ticket prices.

The bill provides that the commission give prior approval before any person shall acquire control of any Hawaii air carrier. We believe this discretionary authority could be perceived as discriminatory, which is not permissible under federal regulations.

Finally, the bill requires the commission's approval for an air carrier to enter into leases of more than five years and limits lease terms to three years if the commission determines a longer-term lease may have an adverse effect on the carrier. This could result in the DOT being at odds with the commission because it is likely to be in the Department's interest to establish longer-term leases. Airlines are more likely to engage in capital investment when under long-term leases. It should be noted that the Federal Aviation Administration, U.S. Department of Transportation in a letter to the Department of Transportation, State of Hawaii, strongly objected to the implementation of this bill, since it will restrict, prevent or impede air carrier access to the Hawaii State airports and hinder airline competition, depriving the public the full benefit of competition in air services. Additionally, if the provisions of this bill are implemented, such an action would conflict with Federal law, namely the Airline Deregulation Action of 1978 and moreover, it would cause the State of Hawaii to breach its federal grant agreement obligations.

For these reasons, we strongly recommend that this measure be held in Committee without further action.

TESTIMONY OF KEONI WAGNER ON BEHALF OF HAWAIIAN AIRLINES REGARDING H.B. NO. 526, RELATING TO HAWAII AIR CARRIERS

February 2, 2009

To: Chairman Joseph Souki and Members of the House Committee on Transportation:

My name is Keoni Wagner and I am the Vice President of Public Affairs for Hawaiian Airlines presenting this testimony on behalf of Hawaiian Airlines regarding H.B. No. 526.

Especially given the loss of Aloha Airlines in 2008, we understand and appreciate the intent of this measure and its precursor, HB 2250, HD1, which was passed by override last session, which we believe is to support and protect Hawaii's vital interisland air service. However, we want to reiterate our concern presented last year at the hearing on HB 2250, HD 1, which is that we believe creating new layers of bureaucracy and regulation will impose added costs on a system already beset with extremely high operating costs and myriad regulations. This would lead to one of two outcomes: higher fares for the consumer or financial instability for the airlines – both of which would be counterproductive to the aims of this bill.

In addition, we believe that regulating routes, services and fares would eliminate free market conditions that foster competition and the benefits that flow from it, such as cost efficiency, innovation and customer service – ultimately leading to a degradation in the quality of service to the public.

For these reasons, we respectfully oppose HB 526 and thank you for the opportunity to present our views on this measure.

awana3-Elenoa

From: mailinglist@capitol.hawaii.gov
Sent: Thursday, January 29, 2009 6:18 PM
To: TRNtestimony
Cc: r2bumgarner@mac.com
Subject: Testimony for HB526 on 2/2/2009 9:00:00 AM
Attachments: Executive Summary v3.5.pdf

Testimony for TRN 2/2/2009 9:00:00 AM HB526

Conference room: 309
Testifier position: support
Testifier will be present: Yes
Submitted by: Capt. Robert Bumgarner
Organization: Individual
Address: 91-1044 Kai Kala St. HI
Phone: (808) 228-2012
E-mail: r2bumgarner@mac.com
Submitted on: 1/29/2009

Comments:
Aloha Chairman Souki:

Peter Forman and I will testify in favor of HB526, Relating to Hawaii Air Carriers.

We have attached the Executive Summary from a white paper we produced following the failure of Aloha Airlines. In it, we conclude that the law passed in 2008 that aims at establishing State regulation of interisland air carriers (HB2250) would so restrict the ability of local airlines to compete that they would lose access to needed capital and might be driven from the market. We also believe that Congress is not likely to grant Hawaii the right to regulate intrastate air commerce if the State intends to implement the level of economic regulation described by the present law.

In the alternative, the amendments proposed by HB526 would eliminate most economic regulation but would retain market entry controls that would enable the State to prevent unfair or cutthroat competition such as that that drove Aloha from the market. They also would create a proactive role for the State in encouraging healthy competition and in initiating discussions with airlines if service levels become either inadequate or excessive.

The language in HB526 is modeled on existing federal laws that govern the regulation of air carriers that operate in international markets. We believe this approach will be more appropriate in the current market and more likely to garner the support of Congress.

Groundwork on the Re-Regulation of Hawaii Intrastate Air Transportation

Robert R. Bumgarner
Peter N. Forman

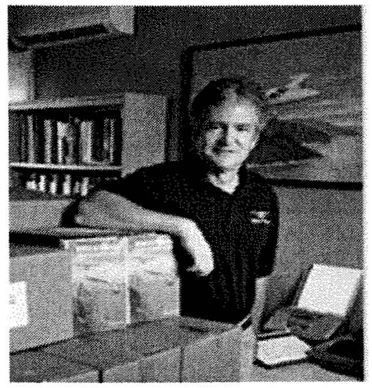
July 2008

About the Authors

Robert R. Bumgarner

Robert Bumgarner is Managing Director of Global Aeronautics, LLC, an aviation-consulting firm. Bob began his flying career as a U.S. Navy carrier pilot in1959. He joined Hawaiian Airlines in 1965 where he served as a pilot, technical writer, and instructor. While at Hawaiian, Bob also served as chairman of the pilots' union. Retiring early from Hawaiian in 1991, he joined Evergreen Airlines where he qualified as captain on the Boeing 747. In 1992, Taiwan's EVA Airways recruited him to help start-up its B747-400 operations. China Airlines recruited Bob in 1996 to head its human factors training program. Bob later served as Assistant to the Vice President of Operations and retired in 2001 as General Manager of Flight Standards with responsibility for more than 1000 pilots.

Since retiring from China Airlines, Bob has held various consulting and training positions with prominent aeronautical clients such as Boeing's training subsidiary, Alteon Training LLC, Flight Safety International, and Honolulu Community College.



Peter N. Forman

Peter Forman is the preeminent authority on aviation history in Hawaii. He has written two books: *Wings of Paradise, Hawaii's Incomparable Airlines,* and *Flying Hawaii, A Pilot's Guide to the Islands,* He is in the process of writing another that examines the failure of Aloha Airlines and the role of antitrust law in aviation.

A frequent commentator on events in the Hawaii air transportation system, Peter possesses deep knowledge regarding Hawaii's airlines, the development of the market, and events that led up to the recent demise of Aloha Airlines.

Peter is a retired airline pilot who spent years as a flight instructor and captain of commuter airlines in Hawaii before joining Continental Airlines.

Abstract

Deteriorating conditions in the U.S. airline industry, coupled with the immediate impact of the Aloha Airlines and ATA Airlines failures, prompted the 2008 Hawaii Legislature to enact, over a gubernatorial veto, HB 2250, a bill aimed at re-regulating interisland air transportation. This Act would establish an Air Carrier Commission, comprised of five uncompensated political appointees with the power to approve or disapprove entry of new airlines into the market, as well as the financial arrangements of existing airlines. Changes to airfares and other charges would be subject to approval, as would the issuance of stock, loan or lease commitments of more than 5 years, purchase and sale of aircraft, construction of other improvements, and, of course, inter-carrier agreements.

The authors of this white paper believe that the Legislature has, for all the right reasons, enacted legislation that is inappropriate under current market conditions and could cause serious harm to existing carriers and the interisland air transportation market. In the alternative, we have recommended a more moderate form of regulation, lying between the polar extremes of heavy-hand regulation and *laissez faire* competition. We believe this approach will enable the State to address the problems that contributed to the failure of Aloha Airlines but will also allow airlines to retain the economic flexibility needed to survive under volatile market conditions.

The Federal Aviation Act preempts states from regulating the routes, rates, or services of airlines, so the State of Hawaii will have to seek a Congressional exemption in order to implement the provisions of HB2250. It is likely that the scope of airline regulation contemplated by the HB2250 will not be well received by Congress. The authors believe that Congress would look more favorably on the moderate regulatory approach advocated herein, particularly since it is based on the current federal methodology for certificating airlines for international operations.

Attached, as an Appendix to this white paper, is a marked–up version of HB 2250. Amendments include addition of a policy statement that establishes competition as the primary mechanism for controlling market prices, thus paralleling the current Federal Aviation Act policy, and assigns Hawaii D.O.T. responsibility for implementing the policy. Commission control over airline economic decisions has been deleted but the power to issue and revoke certificates of convenience and necessity is retained. We believe this authority will enable the State to control anticompetitive or unfair practices in the interisland market and, thus, enhance market stability.

We respectfully propose that the Legislature reconsider the scope of HB 2250 during the next legislative session.

Aloha's failure was a wake up call for all of us on the importance of our transportation infrastructure.

The Honorable Calvin Say

Executive Summary

Three weeks after Aloha Airlines ceased passenger operations and went out of business March 31, 2008, the Hawaii Legislature enacted HB 2250, a bill aimed at instituting comprehensive State regulation of interisland air transportation. Although a serious effort to address the predatory pricing practices that contributed to Aloha's demise but too late to actually help Aloha, this legislation cannot be implemented unless Congress first grants Hawaii an exemption from provisions in the Federal Aviation Act that preempt state regulation of air carriers.[1]

Although the authors of this white paper concur that State regulation of interisland air commerce may be appropriate at some level, we believe that HB 2250 comprises a regulatory scheme that is much too restrictive under current market conditions and may actually do serious harm to interisland air carriers and the state's indispensible air transportation network. It is also likely that a State request for a Congressional exemption would meet with considerable opposition if HB 2250 were presented as the State's plan for interisland airline regulation.

Congress enacted the Airline Deregulation Act of 1978 because it believed that airline regulation under the Civil Aeronautics Board had institutionalized inefficiency in the airlines, resulting in excessive ticket prices, and had generated extraordinary regulatory delays. HB 2250 would impose a similar regulatory scheme by requiring interisland airlines to submit for approval their rates, fares, and other charges to a State Air Carrier Commission, populated by five uncompensated political appointees. Hawaii airlines would also be required to seek Commission approval before buying or selling aircraft or other property, prior to constructing or improving facilities, and prior to issuing stocks, bonds, and notes, or entering into loans or leases of more than five years. While this stultifying level of control might be appropriate if only a single air carrier was serving interisland markets, it would make it virtually impossible to successfully operate an airline under the volatile economic conditions that caused eight U.S. airlines to fail during the first four months of this year. Moreover, it would deny airline passengers and shippers the price and service benefits afforded by a competitive market.

In our view, forty years of U.S. airline regulation (1938 – 1978) and thirty years of deregulation (1978 –

[1] 49 USC 41713(b)(1).

2008) have unmistakably demonstrated that neither stultifying government regulation nor *laissez faire* competition constitute an ideal environment for critical air transportation services.[2] Regulation concentrated the U.S. airline industry under the control of ten or so major airlines that seldom competed on a price basis; this was bad for consumers but good for big airlines. On the other hand, unfettered competition in a deregulated environment stimulated start-up of over 200 new airlines, more than 170 of which have failed, and led to bankruptcy filings by five out of the six largest airlines. Having collectively lost all of the profits it earned since the advent of commercial flight, the once-powerful U.S. airline industry is on its knees, facing skyrocketing fuel prices and excessive competitive pressures

Obviously, the State of Hawaii cannot save the floundering U.S. airline industry, but there is much it can do to improve the prospects of interisland airlines while also protecting the public interest. What it must be careful not to do, however, is to over-regulate local carriers to the point that they are unable to keep pace with unstable, rapidly changing economic conditions. So the debate over what should be done to bolster our critical air transportation infrastructure must move beyond the polar extremes of heavy-handed regulation and *laissez faire* competition to explore more moderate alternatives, particularly in light of today's volatile economy.

To strike a proper regulatory balance, it is first necessary to define the cause of action for State regulatory intervention. This requires a quick review of the history of the competition between interisland airlines.

Prior to the 2006 start-up of Mesa's Hawaii subsidiary, go!, interisland airline competition had been vigorous, resulting in the failure of three airline competitors and bankruptcy filings by both Hawaiian and Aloha – Hawaiian filed twice. Airline capacity stabilized at a profitable level only once, during 2002-2003 when Aloha and Hawaiian were allowed to discuss capacity limits under a State-sponsored grant of antitrust immunity from U.S. D.O.T.

When go! entered the market in June, 2006, one-way interisland fares averaged about $75.[3] Go! promptly initiated a fare war, dropping ticket prices first to $49, then $39, then $29, and as low as $1 at one point. Of course interisland passengers were quite happy to be able to travel at such low fares, but the fare war caused the three competitors to collectively lose nearly $200 million in the next eighteen months, leaving

---

2 For a detailed analysis of this subject, refer to Dempsey and Goetz, *Airline Deregulation and Laissez-Faire Mythology*, Quorum Books, Westport, CT (1992).

3 Statement of Michael W. Reynolds, Acting Assistant Secretary for Aviation & International Affairs, U.S. Department of Transportation before the U.S. Senate Committee on Commerce, Science, and Transportation, April 10, 2008; Washington, D.C.; Attachment 1.

Aloha too weak to survive.

Competition, when fairly conducted, exerts more effective pressure on airlines to control costs than does regulation. But unfair or cutthroat competition can be ruinous, destructive, or destabilizing and can ultimately lead to monopoly pricing.

During the course of discovery in Hawaiian's successful 2006 lawsuit against Mesa, a prestart-up email from Mesa's Chief Financial Officer seems to confirm Mesa's predatory intent:

> *"If we assume Aloha stays in market and in business forever, this project makes no sense. We definitely don't want to wait for them to die, rather we should be the ones who give them the last push."*

Another Mesa planning document indicated that it would be necessary to unseat Aloha within two years and then raise fares by 5 percent above pre-entry levels in order for its operations to be economically feasible.

Go! has represented itself to the public as the low-fare airline in Hawaii. In fact, go! is not the low-cost operator. Shortly after go! entered the market, Aloha commissioned a break-even study by Sabre Airline Solutions. The Sabre study concluded that Aloha's breakeven fare per ticket was $50, Hawaiian's was $55, and go!'s was $67. . . and that was when jet fuel prices were half what they are today. So, according to the Sabre study, go! was able to offer such low fares only by cutting prices below its cost of operation; deeper pockets enabled it to outlast Aloha, the most efficient operator.

The unreasonableness of go!'s 2006/2007 airfares is underscored by its growing losses, which tripled in the third quarter of 2007, and average airfares in other U.S. markets of comparable distance and density to those in Hawaii, including markets served by low-fare carriers such as Southwest, JetBlue, and AirTran.[4] For example, the Honolulu-Kona market at a distance of 163 miles had an average fare of $50 at the end of third quarter 2007. By comparison, Southwest's fare in similar markets ranged from $80 and $111. In the Kona-Lihue market, the average fare was $81, whereas average fares for Southwest in markets of comparable distance ranged from $91 to $116.[5]

Go! operates 50-seat regional jets that have been called "the least efficient airplane in America's

4 Michael W. Reynolds, op cit, page 2.

5 Ibid.

commercial aviation fleet."[6] Go load factors ranged between 62% to 65% in 2006-2007; by comparison, Aloha and Hawaiian operated jets with two and a half times as many seats at load factors of 77% and 87%, respectively. So, not only did go! manage its inefficient aircraft from headquarters 3,000 miles distant, it conceded economies of scale to local competitors.[7]

The struggle between Aloha, Hawaiian, and go! was bound to end badly, so why didn't somebody do something to stop the cutthroat competition? Aloha complained to both the U.S. Department of Transportation and the Department of Justice about Mesa's predatory practices, but was advised that predation is extremely difficult to prove[8] . . . and then nothing happened.

In fact, D.O.T. does have the authority to stop unfair competitive practices on its own initiative or upon complaint.[9] However, D.O.T. seems blinded by its unwavering faith in the effectiveness of unfettered competition, which stays its hand in the case of predation such as that sponsored by Mesa in Hawaii. Moreover, its own internal regulations are aimed primarily at interdicting attempts by a "major" airline to force a new entrant from one of its hub markets.[10] In Hawaii, the situation was reversed: a major airline (Mesa) used predatory pricing in an attempt to force from the market one or more local, non-major airlines. And short of filing what would have been a politically unpopular complaint with federal regulators that airfares were too low, the State was powerless to intervene in the competitive situation.

So the central issue facing the State is not how to bring interisland airfares down with rate controls, but how best to control destabilizing unfair or cutthroat competition when Washington regulators are not inclined to enforce existing antitrust laws or regulations. For this reason, we recommend that the Legislature consider amending HB 2250 to minimize the level of State intervention in airline economic affairs and, instead, adopt an approach similar to that found in the Federal Aviation Act relative to regulation of international airline operations.

---

6 *Bad New Piles Up for Mesa Air Group*; The Maui News, April 11, 2008.

7 Economies of scale result when an airline is able to spread its fixed costs over a larger number of daily seat-miles flown. This can be accomplished by flying larger aircraft or by utilizing aircraft more each day.

8 David Banmiller, testimony before the U.S. Department of Transportation before the U.S. Senate Committee on Commerce, Science, and Transportation, April 10, 2008; Washington, D.C.; p. 8.

9 49 USC ¶41712

10 D.O.T. classifies airlines with more than $1 billion in annual revenues as major airlines.

D.O.T.'s approval process for international airlines is quite different from that used in certifying domestic carriers. Applicants for domestic operating authority must be certificated by D.O.T. as *fit, willing, and able* to provide the transportation authorized by their certificate and in compliance with applicable regulations.[11] This determination focuses primarily on the capabilities and experience of an applicant and does not consider the need for additional service, routes to be flown, fares charged, or services to be provided. Once certificated, an airline may then enter or exit any domestic U.S. market at its discretion and may charge whatever fares the market will bear.

In the case of international airline service, D.O.T. must determine that there is actually a need for the proposed service and that the airline's proposal is *consistent with the public convenience and necessity.*[12] So, an assessment of the need for additional service, while not part of domestic awards, is very much part of the selection process for international routes. If an international carrier later fails to deliver services specified in its certificate, D.O.T. may suspend or revoke the certificate.

Attached as an Appendix to this white paper is a marked-up version of HB 2250 that incorporates our recommended changes. Amendments include the addition of a policy statement that establishes competition as the primary mechanism for controlling market prices, thus paralleling the current Federal Aviation Act policy, and which assigns to Hawaii D.O.T. responsibility for implementing the policy. Commission authority to control airline economic decisions has been deleted but the power to issue and revoke certificates of convenience and necessity is retained. We believe these powers will enable the State to control unfair competitive practices such as those that contributed to the failure of Aloha Airlines, but will also allow airlines to retain the economic flexibility needed to survive under volatile market conditions.

If the State does intend to seek regulatory authority from Congress, care must be taken to clearly define the term "intrastate air transportation" in the exemption. Here's the problem: 49 USC ¶41102 defines intrastate air transportation as transportation conducted entirely within the same State. Although it would seem that a flight from Honolulu to Kahului would satisfy this criteria, the courts have held that Hawaii state boundaries extend not more than three miles beyond the shoreline. Thus, absent a specific definition to the contrary, interisland flights are generally considered to be <u>interstate</u> air transportation.

The authors recommend that the State's application for a Congressional regulatory exemption include the following definition of intrastate air commerce:

---

11 49 USC ¶41102.

12 49 USC ¶41102B)(2).

> "Intrastate air commerce" means the transportation by a Hawaii air carrier of passengers or property for compensation, entirely within the State of Hawaii or between two places in the State of Hawaii through airspace over a place outside the State of Hawaii.

Support for the premises and conclusions stated in this executive summary can be found in the body of this white paper, which is presented in three parts: (1) a definition of the problem, based on the history of interisland airline competition and conditions in the market since the year 2000; (2) an assessment of the *contextual* factors that shape and delimit potential solutions to Hawaii's intrastate airline concerns; and (3) a comparative analysis of regulatory alternatives. Key points are summarized at the beginning of each sub-topic.

The authors would be pleased to meet with members of the Legislature and/or the Department of Transportation to discuss in detail our findings and recommendations.

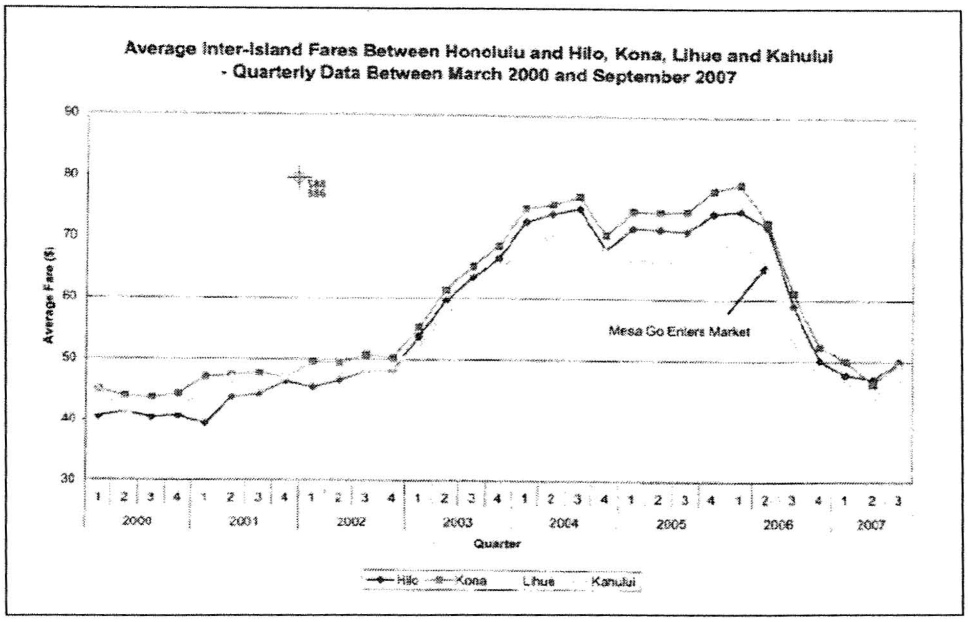
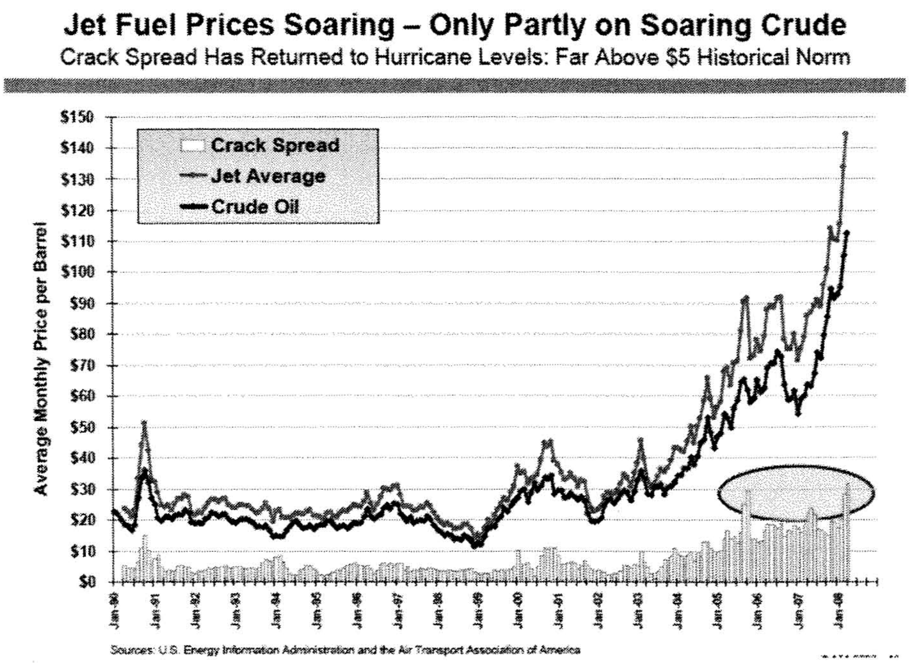


Figure 3 – Interisland Airfares[10]



10 Michael W. Reynolds, op cit; p. 7.