Attachment 2

The Role of Deregulation in Aviation Planning

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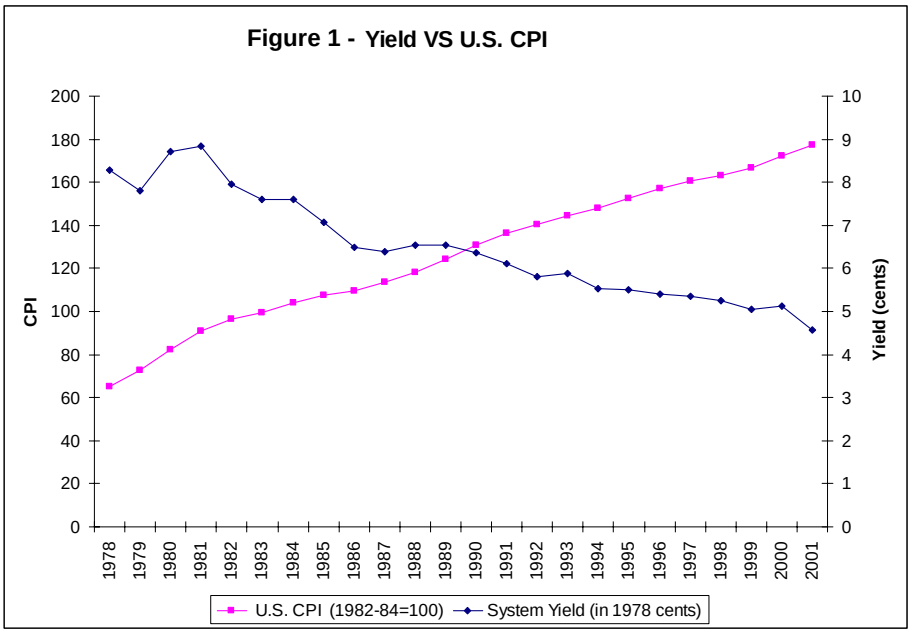
Introduction

Numerous comments received on the Draft EIS/EIR and the Supplement to the Draft EIS/EIR called for a more strict regulation of airline activities at LAX and proposed that airlines be required to use other airports in the region in lieu of LAX. In response to these comments, Topical Response TR-RC-2 briefly described the role of deregulation in aviation planning and directed those wanting more detailed information on the subject to this Appendix. In particular, this Appendix discusses the following subjects: airline regulation and deregulation; select regulatory policies and rules; use agreements; and fractured airport governance.

Airline Regulation and Deregulation

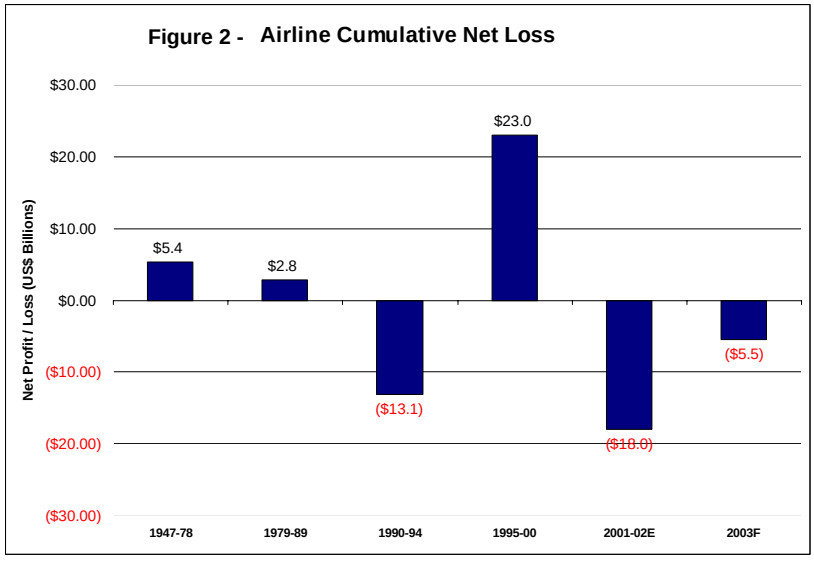
The beginning of commercial aviation was derived through the U.S. Postal Service's ("USPS") demand for airmail services. The Air Commerce Act of 1925 firmly established the airmail business as the federal government transferred airmail services to the private sector through a competitive bid process. Also in 1925, President Coolidge established the Morrow Board to recommend a national aviation policy including the development of civil aviation standards. A decade later, the Air Mail Act of 1934 was promulgated which led to a more competitive airmail contract bidding process that resulted in a sharp decrease in airmail rates and the airlines' resultant development of the passenger segment of the industry as a means to generate incremental revenue. Finally, in 1938, the Civil Aeronautics Authority ("CAA"), later re-named the Civil Aeronautics Board ('CAB"), was created to regulate rates and tariffs for passengers and airmail, routes and mergers. The CAB remained the regulatory body for commercial aviation until the passage of the Airline Deregulation Act in 1978. The Airline Deregulation Act transformed the highly regulated aviation industry into a market-driven industry as domestic route and rate/fare restrictions were eliminated over a four-year period.

The benefit most often cited resulting from Deregulation is the reduction in real airfares. Average airfares since 1978 have fallen considerably as compared to the aggregate inflation rate. As illustrated in **Figure 1**, the Consumer Price Index ("CPI") has outpaced Average Yield (airfares converted into cents per revenue seat mile - a common industry metric) since approximately 1990. Airlines developed highly sophisticated pricing models that are time-of-day, day of week, airport-to-airport specific. The advances in airline pricing are referred to as Yield Management. In addition, the general success of low-fare airlines, most notably Southwest, American Trans Air, AirTran and jetBlue Airways, have put additional downward pressure on airfares and yields, a trend expected to continue in the future.



Source: Air Transport Association of America

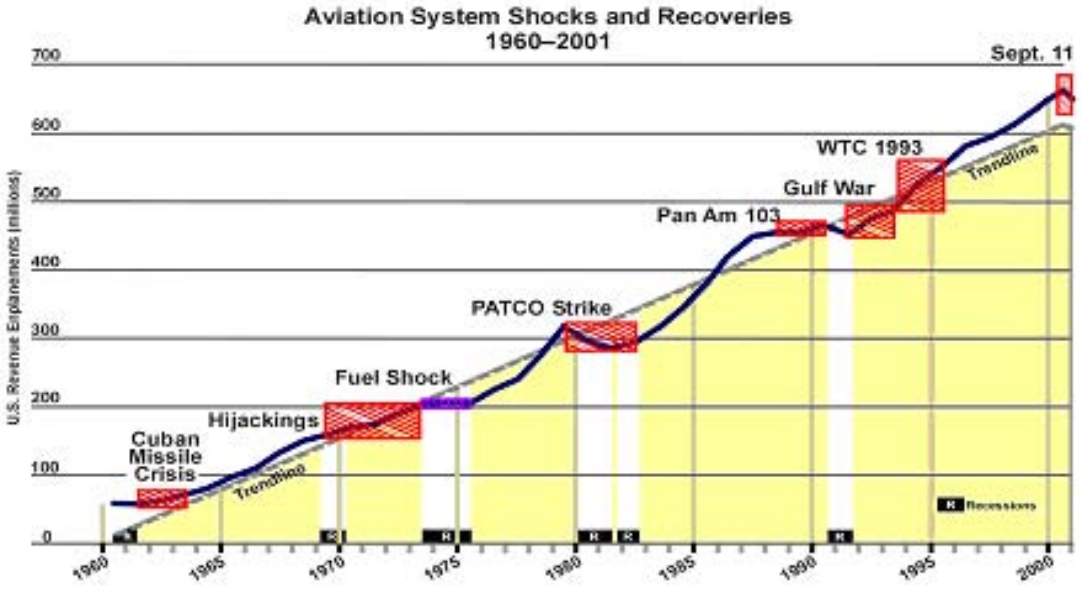
Deregulation has generated some "dis-benefits" for the industry as well including massive periodic losses and spotty profitability. As illustrated in **Figure 2**, during the pre-Deregulation period (i.e., 1947-1978), airlines posted modest profits as CAB and airlines priced routes and service so that profitability would be achieved. Modest profitability was achieved in the 1980s only to be eroded in the early 1990s as the combination of recession and the Gulf War generated enormous losses in net income. During the nation's longest sustainable expansion, airlines recorded historical highs in profitability only to be largely wiped out as a result of the current recession and the events of September 11, 2001.



Source: Air Transport Association of America

The aviation industry has been susceptible to short term "system shocks" such as recession and conflict. Until recently, aviation has been a growth industry that is largely cyclical coterminous with a number of identifiable system shocks. **Figure 3** provides some long-term context in which peaks and troughs over a 40-year historical horizon can be observed in light of such identifiable system shocks.

Figure 3



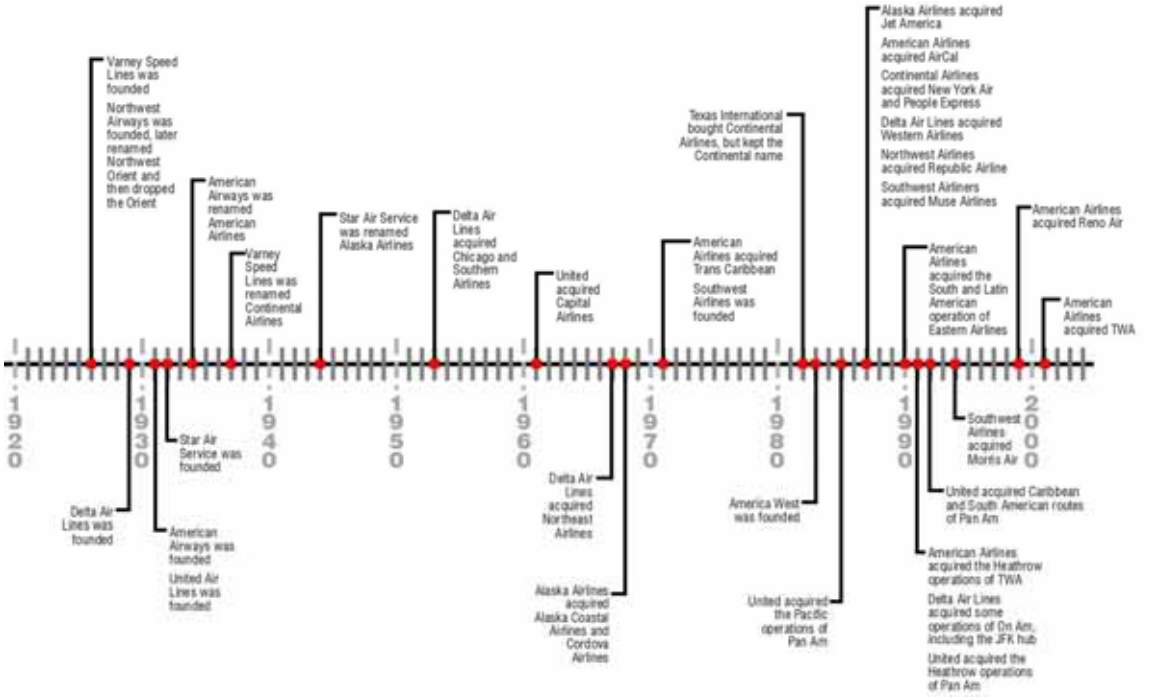
Source: Air Transportation Association, Landrum & Brown, Inc.

Prior to September 11th, the national air transportation system was beleaguered with high demand and capacity constraints that generated unprecedented airport-specific and system-wide delays. Delays and congestion throughout the national air transportation system were largely a result of demand (i.e., passengers) exceeding supply (i.e., airport/airspace capacity) - a clear dis-benefit stemming from a deregulated aviation marketplace.

According to a General Accounting Office study published in 1998 that evaluated the impact of Deregulation, there were more scheduled large carriers in 1998 than in 1978, but the largest carriers have increased their market share from approximately 43 percent in 1978 to 65 percent in 1998. Market power has also become highly concentrated at many of the airline "fortress" hubs including, for example, near dominance by USAirways at Charlotte and Northwest's dominance at Detroit and Minneapolis.

The timeline illustrated in **Figure 4** summarizes the history of airline consolidation from the dawn of commercial aviation through 2001 with the American Airlines' acquisition of Trans World Airlines.

Figure 4 - History of Airline Consolidation



Select Regulatory Polices and Rules

The U.S. Department of Transportation and the Federal Aviation Administration ("FAA") remain the regulatory bodies overseeing the domestic aviation industry, certain rules and policies remain in effect from FAA or local airport operators including Slot Controls, Perimeter Rules, Bilateral Agreements, and Grant Assurances. These select regulatory policies and rules are discussed below.

Slot Controls

The High Density Rule ("HDR"), issued by the FAA in 1969, was a measure to reduce delays and congestion at five select airports including New York's LaGuardia, JFK International and Newark International, Washington-Reagan National and Chicago O'Hare International. The HDR provided for hourly arrival and departure caps for both commercial airline and general aviation operators. The HDR was suspended indefinitely at Newark and eliminated effective July 2, 2002 at O'Hare. The HDR has been amended on several occasions, most recently in the AIR 21 legislation passed by the U.S. Congress in 2000 that eliminates slot restrictions at JFK and LaGuardia on January 1, 2007. The AIR-21 legislation removed hourly restrictions at LaGuardia in April 2000 for certain flights by new entrants and carriers offering service to small-hub and non-hub airports. By September 2000, delays at LaGuardia had increased 238 percent. Slot restrictions were re-instituted by the FAA. LaGuardia may operate permanently under one or more revised policy restrictions that are under review by the FAA.

Perimeter Rules

Airport operators and Congress have instituted "perimeter rules" to restrict, in part, the type of scheduled, non-stop air service provided by scheduled air carriers at affected airports. Three perimeter rules are summarized below.

- **LaGuardia Airport ("LGA")** - The perimeter rule at LGA prohibits non-stop scheduled flights from exceeding 1,500 statute miles. Denver is excluded from the rule as a concession to allow air carriers to flow traffic over the Denver hub. The Port Authority of NY & NJ, as the airport operator for LGA, instituted the perimeter rule for a number of reasons related to LGA's runway length, the desire to keep transcontinental activity at JFK and the lack of long-term parking among other local airport considerations. The institution of the perimeter rule was challenged by air carriers all the way to the

U.S. Supreme Court where the Court ruled that local airport system operators can decide the allocation of traffic across an airport system.

- **Washington Reagan National Airport ("DCA") -** The DCA perimeter rule prohibits non-stop scheduled flights from exceeding 1,250 statute miles. The Metropolitan Washington Airports Authority instituted the rule for many of same reasons as the Port Authority of NY & NJ cited with respect to LGA including DCA's runway length and to encourage long-haul traffic at Dulles International Airport. Recent Congressional legislation provided America West with an exemption to serve Phoenix from DCA, a point well beyond the DCA 1,250 mile limit.
- **Dallas Love Field ("DAL")** - With the development Dallas/Ft. Worth International Airport ("DFW") in the early 1970s, Dallas Love Field ("DAL") was slated for closure with the opening of DFW in 1974. Southwest Airlines successfully challenged the City of Dallas and was granted permission to provide intrastate service from DAL. In 1979, Congress passed the Wright Amendment granting Southwest permission to serve any state contiguous to Texas. Other carriers and entities have sought additional rights under the Amendment from time to time.

Bilateral Agreements

Although the domestic aviation industry has been deregulated for nearly 25 years, the international aviation market remains a bilateral trade issue between the United States and its trading partners. Commercial aviation between countries is governed by bilateral air service agreements that have been negotiated between the United States and its trading partners. Historically, these bilateral agreements have been restrictive and were designed to protect national flag carriers from competition. Most of these agreements imposed significant restrictions on airline operations by limiting the destinations served, the number of airlines permitted to serve the market and the level of fares levied.

While the basic framework of bilateral agreements remains in effect, the U.S. government has advocated "open skies" agreements aimed at increasing competition, reducing fares and air cargo rates, and increasing air service. "Open skies" agreements permit unrestricted international air service between participating countries, allowing each country's airlines to fly between any city (i.e., origin gateway) in its home country and any city (i.e., destination gateway) in participating countries. This type of agreement is designed to maximize potential competition. So far, the U.S. has signed approximately 60 open skies agreements, which eliminate all restrictions on airline service between the signatory countries. In many cases, air service rights (i.e., bilateral authority) have been granted between the signatory countries and a third country (i.e., 7th Freedom Rights) thereby providing additional and liberalized bilateral authority.

In many U.S. and foreign aviation markets there are multiple gateway destinations that are capable of sustaining international air service. In the United States, there are now dozens of international gateways. During the post-Deregulation era in the United States and the subsequent development of new and expanded airport infrastructure (i.e., hubs) and Federal Inspection Services ("FIS"), many new U.S. gateways became eligible for direct international air service.

According to the Air Transport Association of America, the United States has approximately 100 air service bilateral agreements with its trading partners. An analysis of these agreements was conducted in the context of the critical importance of the Los Angeles gateway. LAX is a Named Gateway in 19, or approximately 46 percent, of the bilateral agreements in which Named Gateways are specified for U.S. or foreign flag carriers. Named Gateways are those gateways that are specifically identified in a bilateral agreement as a point permitted (i.e., requested) to be served. Of the approximately 100 air service bilateral agreements, 41 have one or more Named Gateways. A Named Gateway is most often a destination that is highly desirable for either the U.S. or foreign flag carriers for its economic, cultural, and/or ethnic concentrations as well as other key market features.

Grant Assurances

As part of the terms of conditions for accepting FAA grant funds, both entitlement and discretionary, and collecting passenger facility charges, airport operators are required to comply with general airport pricing principles that exclude many economic-based pricing practices including peak-hour pricing, congestion pricing, demand management pricing, etc.

Any commercial or general aviation airport operator, as a recipient of Federal Airport Improvement Program grants, is obligated to heed the FAA's Airport Assurances. FAA Airport Assurance No. 22 *Economic Nondiscrimination* would prohibit the use of pricing as a means to influence traffic distribution within a multi-airport system. The sub-sections of that assurance are provided below.

a. It will make the airport available as an airport for public use on reasonable terms and without unjust discrimination to all types, kinds and classes of aeronautical activities, including commercial aeronautical activities offering services to the public at the airport.

b. In any agreement, contract lease, or other arrangement under which a right or privilege at the airport is granted to any person, form, or corporation to conduct or to engage in any aeronautical activity for furnishing services to the public at the airport, the sponsor will insert and enforce provisions requiring the contractor to

   1. furnish said services on a reasonable, and not unjustly discriminatory, basis to all users thereof, and

   2. charge reasonable, and not unjustly discriminatory, prices for each unit or service, provided that the contractor may be allowed to make reasonable and nondiscriminatory discounts, rebates, or other similar airport types of price reductions to volume purchases.

c. Each fixed-based operator at the airport shall be subject to the same rates, fees, rentals, and other charges as are uniformly applicable to all other fixed-based operators making the same or similar uses of such airport and utilizing the same or similar facilities.

d. Each air carrier using such airport shall have the right to service itself or to use any fixed-based operator that is authorized or permitted by the airport to serve any air carrier at such airport.

e. Each air carrier using such airport (whether as a tenant, non-tenant, or subtenant of another air carrier tenant) shall be subject to such non-discriminatory and substantially comparable rule, regulations, conditions, rates, fees, rentals, and other charges with respect to facilities directly and substantially related to providing air transportation as are applicable to all such air carriers which make similar use of such airport and utilize similar facilities, subject to reasonable classifications such as tenants or non-tenants and signatory carriers shall not be unreasonably withheld by any airport provided an air carrier assumes obligations substantially similar to those already imposed on air carriers in such classification or status.

f. It will not exercise or grant any right or privilege which operates to prevent any person, firm, or corporation operating aircraft on the airport from performing any services on its one aircraft with its own employees [including, but not limited to maintenance, repair, and fueling] that is may choose to perform.

g. In the event the sponsor itself exercises any of the rights and privileges referred to in this assurance, the services involved will be provided on the same conditions as would apply to the furnishings of such services by commercial aeronautical service providers authorized by the sponsor under these provisions.

h. The sponsor may establish such reasonable, and not unjustly discriminatory, conditions to be met by all users of the airport as may be necessary for the safe and efficient operations of the airport. The sponsor may prohibit or limit any given type, kind or class of aeronautical use of the airport if such actions is necessary for the safe operation of the airport or necessary to serve the civil aviation needs of the public.

Airport Pricing

The pricing methodologies used by most airport operators are a hybrid of the residual and compensatory methods. Under the residual method, all of the airport's net revenues including those earned from parking and concessions operations are used to off-set direct airline operating costs through crediting such net revenues to airline landing fees and other cost centers. Under the compensatory method, airport operators retain all net revenues for operations and maintenance and airport capital projects.

Table 1

Types of Airport Finance Methodology

Residual	Hybrid	Compensatory
Airlines guarantee an airport's solvency by agreeing to pay all remaining costs (residual costs) not covered by revenues from non-airline sources (e.g., parking).	Combination of the two methods. Key to this method is how costs are defined.	Airport operator assumes the underlying financial risk of operating the airport, but retains all net revenues for its own use.

Source:

In both the residual and compensatory methods, airport pricing (i.e., landing fees) is set using an average cost method in which landing fees are calculated by estimating total airline landed weight divided by the total capital recovery and operating expenses for the airfield (i.e., runways and taxiways) to derive the annual landing fee. Federal policy and grant assurances currently prohibit discriminatory pricing (i.e., different landing fees for different classes of users such as commercial and general aviation) and peak-hour/demand management schemes. Terminal rental rates are established much the same way.

On a number of occasions since Deregulation, airport operators have sought to implement more economically-based pricing models with mixed success including:

- **Massport** - In 1988, the Massachusetts Port Authority ("Massport") proposed to replace traditional weight-based landing fees (i.e., average cost pricing) at Logan International Airport with fees assessed primarily on a per landing basis. Massport argued peak period pricing theory in defense of its actions. The Department of Transportation rejected the plan based on a faulty cost-allocation methodology. However, the Department of Transportation noted that peak period pricing was theoretically possible if (1) there was an actual shortage of runway capacity, and (2) if the opportunity costs associated with that lack of capacity were rationally allocated. Massport dropped its plan but remains committed to seeking a peak-hour pricing model.
- **PANYNJ** - In 2000, the Port Authority of NY & NJ, in collaboration with the FAA, was successful in promulgating a "congestion pricing" recommendation through the FAA's Notice to Proposed Rule Making ("NPRM"). Given the events of September 11th and the current downturn in aviation activity, consideration of the NPRM has been largely shelved. However, the PANYNJ maintains that in order to better "manage" demand at LaGuardia Airport in particular, new pricing and administrative mechanisms are required to solve the congestion issue.

In the FAA's current Rule on Rates and Charges, under the principle of "Prohibition of Unjust Discrimination" it states:

> A properly structured peak pricing system that allocates limited resources using price during periods of congestion will not be considered to be unjustly discriminatory. An airport proprietor may, consistent with the policies expressed in this policy statement, establish fees that enhance the efficient utilization of the airport.

This rule would not seem to permit peak pricing in order to force aircraft operators to use another airport. In fact, the Department of Transportation discussed its sensitivity to the possibility of abuse of peak hour pricing:

> The Department does not intend the policy statement to function as a blanket authorization for peak pricing. In reviewing a peak pricing system, the Department would scrutinize it carefully to determine first whether the airport in fact suffers from congestion, and whether the peak-pricing system is an appropriate response.

Use Agreements

Airport operators and airlines negotiate and execute "use agreements" which outline the method(s) by which airports calculate fees and charges to signatory carriers. The terms of these agreements vary although there is a distinct trend favoring shorter-term agreements in the 5-10 year range. Use agreements are a form of "regulation" insofar as during the term(s) of these agreements, the airport pricing formula (i.e., setting fees and charges) is fixed to the agreed upon method outlined in the agreement. Typically, all operating and maintenance, capital cost recovery (e.g., eligible debt service),

debt service coverage requirements among other direct and indirect airport expenses are allocated and charged to signatory carriers. In some cases, airport system costs (i.e., general aviation reliever airport expenses or a portion thereof) are also allocated to the signatory carrier formula.

Fractured Airport Governance

Regulation of the aviation industry takes place at several levels including federal, state, and local: local regulation may also be directed by more than one operator or jurisdiction. In large metropolitan markets, there is often a number of commercial service and reliever airports such as the case in the Los Angeles Basin. Different airports within the LA region have different facilities, capacities, operating conditions and constraints (e.g., gate capacity, accessibility, and voluntary curfews) and governance structures. This "fracturing" of airport management, operation, and governance can generate system inefficiencies particularly as they relate to demand management and capacity enhancement. Summarized in **Table 2,** Fractured Airport Governance, are select major metropolitan, multi-airport markets and each markets set of airports, airports' roles, and operator/owner of each facility.

Table 2

Fractured Airport Governance

Airport System	Airport	Code	Type of Airport	Type of Operations	Dominant Airline[1]	Ownership
New York (6)						
Some Coordination	La Guardia	LGA	Domestic	Scheduled	-	Airport Authority
	John F. Kennedy Intl	JFK	Gateway	Scheduled/Cargo	American	Airport Authority
	Newark Intl	EWR	Gateway Hub	Scheduled	Continental	Airport Authority
	Westchester Co	HPN	Reliever	Limited scheduled	-	County
	Teterboro	TEB	GA only	GA	-	Airport Authority
	Long Island Mac Arthur	ISP	Reliever	Scheduled/GA	Southwest	-
Chicago (3)						
Coordinated	Chicago O'Hare Intl	ORD	Gateway Hub	Scheduled	United/American	Municipal
	Chicago Midway	MDW	Reliever	Scheduled	Southwest/ATA	Municipal
	Meigs Field	CGX[2]	GA Only	GA		Municipal
South Florida (3)						
Fractured	Miami Intl	MIA	Gateway Hub	Scheduled	American	County
	Fort Lauderdale	FLL	Reliever	Scheduled		County
	Palm Beach Intl	PBI	Reliever	Scheduled		County
Washington (3)						
Fractured	Washington Dulles Intl	IAD	Gateway Hub	Scheduled	United	Federal
	National	DCA	Domestic Hub	Scheduled		Federal
	Baltimore Washington Intl	BWI	Reliever	Scheduled	US Airways/Southwest	State
Bay Area (3)						
Fractured	San Jose Intl	SJC	Domestic	Scheduled/GA	Southwest	Municipal
	San Francisco Intl	SFO	Gateway Hub	Scheduled	United	Municipal
	Metropolitan Oakland Intl	OAK	Domestic	Scheduled/GA/Cargo	Southwest	Port of Oakland
LA Basin (5)						
Fractured	Burbank Glendale Pasadena	BUR	Reliever	Scheduled		Airport Authority
	Long Beach	LGB	Domestic Hub	Scheduled		Municipal
	Los Angeles Intl	LAX	Gateway Hub	Scheduled/Cargo	United	Municipal
	Ontario Intl	ONT	Reliever	Scheduled/Cargo		Municipal
	Palmdale	PMD	Reliever	GA		Municipal
	John Wayne Orange Co	SNA	Reliever	Scheduled		County

1 Gateway Hub, Domestic Hub, Reliever, GA, Cargo
2 CGX - closed as of April 2003

Source: Landrum & Brown, Inc.

Conclusion

Although the Airline Deregulation Act in 1978 provided for new market freedoms (e.g., fare setting, scheduling, etc) and market consequences (e.g., consolidation and competition) for *airlines*, *airports* remain a highly regulated component of the transportation infrastructure at both the federal and local levels. A more coordinated airport system approach from a demand management/capacity enhancement perspective may well be, at first glance, more prudent and efficient, but the political and regulatory obstacles to achieve such coordination may prove discouraging in light of the likely and intense industry opposition from commercial, corporate and leisure aviation stakeholders. The use of price as either an incentive/disincentive to affect demand distribution among a set of regional airports is untested and non-compliant with current federal aviation regulations. With that said, aviation remains a pioneering industry and new rational approaches to demand management/capacity enhancement within an airport system (or among a set of airports with different owners/operators) may yet be achievable.

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