

GAO

Testimony

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**COMMERCIAL
AVIATION**

**A Framework for
Considering Federal
Financial Assistance**

Statement of David M. Walker, Comptroller General of the United States

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Mr. Chairman and Members of the Committee:

We appreciate the opportunity to testify on an issue so important to the national interests. On September 11, 2001, thousands of Americans were killed or injured through terrorist attacks at the World Trade Center and the Pentagon and in the crash that occurred in Pennsylvania. We mourn their deaths and extend our deepest sympathies to their loved ones. While the human toll of last week's events was tragic and significant, there were economic implications as well. The jobs of many employees and the retirement funds of others are threatened in the aftermath of these attacks. In addition, aviation and related industries have suffered significant additional financial losses which are projected to continue, perhaps threatening the viability not just of individual firms, but of the entire industry. Estimates of the total expected loss for major U.S. commercial passenger airlines for this year range from over \$4 billion by many industry analysts to over \$20 billion by certain airline officials. The continuation of a strong, vibrant, and competitive commercial air transportation system is in the national interest. A financially strong air transport system is critical not only for the basic movement of people and goods, but also because of the broader effects this sector exerts throughout the economy. As a result, the federal government may need and want to provide financial assistance to this industry. At the same time, care must be taken to assure that the interest of the federal government and the American taxpayers are safeguarded in connection with any such assistance program.

The Congress has already appropriated \$40 billion for emergency expenses to respond to the terrorist attacks on the United States. Among other purposes, these funds are available to provide increased transportation security. Now, the Congress is considering various proposals to provide other financial assistance specifically to the airline industry. In my statement today, I would like to discuss some broad principles or guidance that the Congress may wish to bear in mind when it considers providing financial assistance to the airlines. We base our observations on prior GAO work and lessons learned from previous federal financial assistance efforts, including those directed to individual large corporations (such as the Chrysler Corporation and Lockheed Aircraft Corporation) as well as public entities, such as New York City.¹ These

¹See, for example, *Troubled Financial Institutions: Solutions to the Thrift Industry Problem* (GAO/GGD-89-47, Feb. 21, 1989), *Resolving the Savings and Loan Crisis* (GAO/T-GGD-89-3, Jan. 26, 1989), *Options For Dealing With Farm Credit System Problems* (GAO/T-GGD-87-11), and *Guidelines for Rescuing Large Failing Firms and Municipalities* (GAO/GGD-84-34, Mar. 29, 1984).

principles and guidelines can be grouped into three broad categories: clearly defining the problems that need to be addressed, tailoring the appropriate tools of government to address the identified problems, and protecting the interests of both the federal government and the American taxpayers.

In summary:

- The government needs to clearly define the specific nature of the problems confronting the industry—separating out short-term needs versus long term challenges and industry wants from genuine needs. While all airlines are now facing major financial challenges, government assistance cannot nullify the serious but different financial positions that several carriers faced prior to September 11. As a result, the Congress may wish to consider what losses are being incurred that would not have occurred “but for” the tragic events of September 11. Moreover, the Congress may wish to further distinguish between losses that are directly attributable to federal actions (such as the closing of the entire national airspace or Reagan National Airport) and those that are due to consumer shifts that may occur in the overall demand for air travel.
- The government has a range of tools it can consider to address the problems of the industry, from loans and guarantees to grants and tax subsidies. The selection and design of the tool is critical to targeting federal aid on the immediate problems, ensuring the sharing of responsibility by all industry stakeholders, and promoting accountability to the Congress and the public. Federal aid should be viewed as targeted and temporary, and it should be designed to restore the industry to a self-sufficient financial position.
- Because these assistance programs pose an uncertain level of risk to the federal government, it is important to include appropriate mechanisms to protect the federal government and the American taxpayers from excessive or unnecessary losses. Specific mechanisms, structures, and protections should be implemented to be prudent with taxpayer resources and manage the government's risk consistent with a good faith attempt to achieve congressional goals and objectives of any federal financial assistance program.

Defining the Problems to Be Addressed

Although U.S. commercial airlines have been subject to cyclical swings in profitability since deregulation, the industry has never before faced financial hardship of the magnitude currently being discussed. During the mid- to late 1990s, major airlines generated significant profits. Yet in the past year or so, as the economy slowed and fuel prices rose, the industry's profits turned to losses. Until last Monday, industry analysts had projected that the U.S. commercial airline industry would lose over \$2 billion in 2001. Of course, not all carriers faced the same financial challenges prior to the tragic events of last week. Southwest Airlines and Continental Airlines, for example, were still able to report net operating profits during the first two quarters of the year. United Airlines, on the other hand, reported net operating losses exceeding \$600 million. Following last Tuesday's tragedy, some industry analysts estimated losses for the major airlines will now exceed \$4 billion for the year. Even airlines that had reported second quarter operating profits are now experiencing significant financial difficulties. According to reports from industry analysts, these losses are of an unprecedented magnitude.

During the first few days of trading this week, airline stock values have been very volatile—most dropped by roughly 40 percent on Monday, although they rebounded somewhat in trading on Tuesday. A variety of factors may be behind this decline, including uncertainty about the airlines' future and public statements by airline executives that they may need to file for bankruptcy protection if the federal government does not offer significant financial assistance to the industry.

The airlines appear to face both short- and long-term financial needs. The most immediate threat to many carriers is reported to be inadequate cash reserves and negative projected cash flows combined with a tightening or denial of credit by commercial lending institutions. This liquidity problem is likely due to the interruption in operations following last week's tragedy. The Department of Transportation closed U.S. airspace for several days, basing its decision on what it felt was in the overall interest of the nation, given the facts and circumstances existing at the time. Some analysts have estimated that U.S. airlines lost tens of millions of dollars every day they could not operate. In addition, the federal government has not yet decided when and under what conditions it may allow Reagan Washington National Airport to reopen. This situation has clear financial implications for the airlines and other businesses with significant operations at

that facility. Additionally, commercial lenders may be less willing to extend credit to the carriers because of uncertainty about the industry's economic viability.

The industry also faces potential longer-term financial needs. Some analysts are further concerned that last week's tragic events may have a profound and lasting effect on the demand for air travel. Although it is too early to tell how passenger demand will be affected in the long term by last week's events, it is clear that the airline industry now has significant excess capacity, given the current and near-term expected demand. In addition, several carriers had excess capacity prior to the events of September 11.

The long-term viability of American Airlines and United Airlines as individual corporate entities could be heavily impacted by the extent to which they are found to be legally liable for claims stemming from the events of September 11, 2001. If these airlines are found to be liable for claims stemming from the loss of life, personal injury, and property damage that occurred, their potential liability is likely to be unprecedented. While these carriers presumably have liability insurance, insurance coverage typically has limits beyond which the insurers had no legal liability. Also, although airlines are responsible for the safety and security of their own flights, if American and United had arrangements or contracts with other carriers or security firms to provide security, those firms may also share liability with American and United.²

Furthermore, lenders and insurers will undoubtedly be concerned about losses from possible future terrorist events. As a result, the issue of potential limitations on liability for losses relating to such events needs to be resolved in order to provide stability to related market activity.

Tailoring the Authority and Tools to Address Defined Problems

After the problems confronting the industry are better defined, the Congress can then better determine which policy tools may be most relevant to addressing the particular goals of the assistance program. The federal government has a range of policy tools that might be considered to help the industry – grants, loans, loan guarantees, regulatory relief, and tax

²Additionally, because insurers recognize additional risks and because they face the high cost of paying potential claims, liability insurance premiums for the entire industry could rise considerably in the future.

subsidies are leading examples. Different tools may be more appropriate for addressing different needs. Each tool has different implications for the federal government and for the industry. These implications need to be carefully weighed and balanced.

Our previous work on federal programs in general suggests that the choice and design of policy tools have important consequences for performance and accountability. Regardless of the tool selected, the federal government should take steps to design and manage the assistance with the following considerations in mind. First, immediate assistance should be targeted to address the short-term problems associated with the attack last week, not to resolve the longer-term structural problems affecting particular carriers in the industry. Second, the federal assistance should be designed and managed to promote shared responsibility by all interested parties in the industry's recovery from last week's tragedy. Additionally, incentives can be provided to help strengthen the longer-term competitive position of the industry in the market. Finally, accountability should be built in so that the Congress and the public can have confidence that the assistance provided was prudent and consistent with the accomplishment of stated public objectives.

Historically, the federal government has used loan guarantees in its financial assistance to specific companies. Such guarantees assume that the federal role is to help the industry overcome a cyclical or event-specific crisis by gaining access to cash in the short term that it otherwise cannot obtain through markets. Loan guarantees and loans alike assume that the aided firms will eventually return to financial health and have the capacity to pay back the loans. Credit assistance is often premised on the provision of various forms of collateral and equity to protect the federal interest, as well as various concessions by interested parties to share the risk and promote a stronger outlook for the firm in the future.

Other tools are under consideration as well. For instance, grants may be appropriate for reimbursing airlines for losses attributable to direct actions mandated by the federal government, such as closing the national airspace and particular airports. This decision, while prudent and understandable, had a direct and negative impact on the airline industry—carriers would not have incurred certain losses “but for” the acts of the government. Grants can provide an infusion of cash in the short term and can be part of the recovery process. Grants can be

designed with eligibility criteria to target them to those most in need as well as to ensure a federal agency role in approving plans and applications up front from prospective grantees. As with credit, grants can be conditioned on various concessions by interested parties.

Tax subsidies have also been proposed. For example, the carriers are reported to have proposed being able to retain all ticket and cargo waybill taxes and for relief from the federal tax on jet fuel. Unlike grants and loans, tax subsidies are a more automatic tool of government and do not generally permit the degree of federal oversight and targeting that these other tools do. Generally, tax subsidies are designed to be available by formula to all firms that satisfy congressionally-established criteria. Federal oversight of tax subsidies generally comes after the fact through audits of firms by the Internal Revenue Service. While federal oversight is less direct, many argue that tax subsidies have certain inherent advantages as well. For example, they can quickly become available for firms and are generally less costly to administer.

Federal direct spending might also help to relieve the industry of certain costs. For instance, it has been suggested that the screening function at airports be taken over by the federal government, thereby freeing up resources in the industry.

Although the Congress may well decide there is a compelling national interest in providing financial assistance to ensure the viability of the commercial airline industry, no one envisions that this industry should remain under federal protection indefinitely. Having an exit strategy at the beginning will provide congressional guidance to the airlines and the program administrators on how the industry should emerge from the assistance program.

Protecting the Interests of the Federal Government and American Taxpayers

Various mechanisms can be built into the design of an assistance program and its oversight to protect the interests of the federal government and American taxpayers. The Congress may want to create an oversight board whose membership reflects the diverse elements that contribute to the assistance program. For example, to administer the loan guarantee program created to assist Lockheed, the government established a three-person board consisting of the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, and the Chairman of the Securities and Exchange Commission. Staff could also be

detailed from federal agencies represented on the board to support the board's review and oversight function. It would also be prudent to provide the board with access to the financial records of any recipients of assistance under the program. Furthermore, prior federal assistance programs for failing firms and municipalities gave us the authority to audit the accounts of the recipients; this authority enabled us to support congressional oversight of the program's administration.

If a board is established to oversee federal financial assistance for the airline industry, the board could be tasked with implementing specific procedures and controls over the financial assistance program to protect the government's interests. The board could also be required to report periodically to the Congress on the assistance program's operations and results and the board's stewardship of the program. The board would likely be the logical entity to establish clearly defined eligibility criteria for borrowers, consistent with statutory direction provided by the Congress, and establish specific safeguards to help protect the government's interests. The specific safeguards could vary, depending on the nature of the financial assistance tools used. Examples of safeguards over loans and loan guarantees include the following.

- Potential borrowers should demonstrate that they meet specific eligibility criteria, while at the same time demonstrating that their prospective earning power, together with the character and value of any security pledged, provides reasonable assurance of repayment of the loan in accordance with its terms.
- Potential borrowers should clearly state the purpose of the loans so that the board can make appropriate decisions about terms and conditions, as well as collateral.
- Fees can be charged by the government to help offset the risks it assumes in providing such assistance.
- The government's loss exposure can be reduced by a requirement for pledged security or liens as collateral.

- For loan guarantees, the level of guarantee can be limited to a given percentage of the total amount of the loan outstanding.

The oversight board would be in a position to monitor the status of loans and guarantees on a regular basis and to require regular reporting on the part of the borrowers regarding their cash flow, the results of their operations, and their financial position, including independent audits of their records, as appropriate.

In evaluating applications for direct loans or loan guarantees, the oversight board would be charged with acting on applications as quickly as possible to meet the objectives of the assistance, while thoroughly analyzing the risks to the government of providing the loans or guarantees. Examples of external risk factors involve the pricing and demand risks that are currently impacting the airline industry. Internal borrower risks, however, result from a borrower's own disadvantages or limitations, which may have been present before the recent, tragic events, but are now being magnified by those events. Potential borrowers would need to clearly state the purpose of the financial assistance and provide operating and financial plans that integrate their internal and external risk factors so that appropriate decisions can be made about the nature and amount of assistance to be provided by the government.

Another potential tool for providing financial assistance would be grants for specific purposes, as noted previously. Examples of safeguards over grants include the following:

- Applicants should demonstrate that they meet specific eligibility criteria and clearly specify how they will use the assistance they receive.
- The oversight board should have clearly defined procedures and criteria for approving grants.
- The oversight board should monitor the use of grant funds on a regular basis, and require regular reporting on the part of the recipients regarding the use of funds and results, including independent audits of grantees' records.

Additional protections to the government's interest could be achieved by tying financial assistance to certain concessions from the recipients of the assistance or others who have a stake in the outcome. For instance, recipients could be required to provide the government with an equity interest in exchange for the assistance, or with priority claims guaranteeing that government loans or government-guaranteed loans be paid first, thus subordinating other lenders' interests.

Conclusions

Clearly the tragic events of September 11, 2001 have had a dramatic impact on not only many individual Americans, but also our nation as a whole. Obviously, those who lost their lives and their family members and friends have been affected the most. However, as we have discussed today, there are significant implications for the U.S. economy—and the airline industry has been affected in a dramatic and fundamental way. Given the clear national interest in a sound aviation system, it is appropriate that the federal government consider measures to assist this critical industry in recovering from the tragic events of last week. At the same time, any such assistance needs to be properly targeted, managed, and overseen in order to protect the federal government and American taxpayers.

My remarks today have focused on principles the Congress may wish to consider as you contemplate possible financial assistance for the airline industry. These lessons are drawn directly from GAO's support of Congressional efforts over several decades to assist segments of industries, firms, the savings and loan industry, and even New York City. Our counsel hinges on three basic elements:

- (1) the need to clearly understand distinct dimensions of the problems confronting the industry, including short- and long-term concerns as appropriate;
- (2) the need to carefully tailor appropriate tools to address well-defined problems; and finally
- (3) the importance of crafting effective mechanisms, controls, and oversight to protect the interests of the federal government and American taxpayers.

The application of clear principles to the consideration of federal assistance is especially important, since actions to assist the commercial aviation sector are likely to set precedents for additional parties already coming forward and seeking relief. In addition, we must be prudent about the decisions we make for this industry because we still have long-range fiscal challenges in other areas of the federal budget and our economy.

It is important to remain mindful that in a market economy the federal role in aiding industrial sectors should generally be of limited duration and purpose. The assistance should be structured to ensure that it prompts the industry to recover and become self-sustaining in the future. It may be appropriate to distinguish between losses that are directly attributable to federal action (such as closing the nation's airspace) and those that are due to either individual circumstances of carriers or broad shifts that may occur in the market demand for air travel. While this is a difficult and tumultuous time, the Congress would be prudent to be clear about precise objectives of assistance to the industry and assure a clear path for how the industry can be expected to emerge from the assistance program—hopefully as a vibrant, stable and efficient force in the American economy.

GAO stands ready to assist the Congress in examining this issue—as well as the many interrelated issues brought to the fore by these tragic events—including measures to improve airport security, provide air marshals, and examine the future of Reagan Washington National Airport.

This concludes my prepared remarks. We hope that our testimony today has been of assistance to you.

Contact

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