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LET THE PROCESS OF DEREGULATION CONTINUE*

BY WESLEY G. KALDAHL**

UNDER DEREGULATION, events in the airline industry have moved so rapidly that we have tended to lose track of major milestones — and the places events occupy in time. It therefore comes as somewhat of a surprise to note that deregulation is now six years old. After all, wasn't it only yesterday that airline representatives were camped outside CAB headquarters, waiting to apply for dormant route authority?

Whether it was yesterday or not, one thing is clear: the Deregulation Act of 1978¹ ushered in for the nation's airlines a revolution as profound and far-reaching as the revolution upon which our nation was founded. After Congress and the President acted in 1978, the airline business was changed forever. The question on this sixth anniversary, however, is whether all of the upheaval and dramatic change that have characterized the industry's adjustment to deregulation have been good or bad, both for the industry and for the public it serves?

In my view the jury is still out on that question. But the record should also show that there is mounting evidence to support the view that deregulation has done more harm than good. I may make this statement with a touch of irony because American Airlines on the whole has ad-

* This article is taken from a speech prepared by Mr. Kaldahl in early 1984.

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¹ Airline Deregulation Act of 1978, Pub. L. No. 95-504, 92 Stat. 1705 (1978) (amending Federal Aviation Act of 1958, 49 U.S.C. §§ 1301-1552 (1982)).

justed well to the new environment. I also strongly believe that the industry is now down the road of change much too far to turn back. Nevertheless, one cannot deny the excruciating difficulties that have beset the industry — and most especially the large, established carriers like American — in this tough new age.

During the initial phases of debate on deregulation, American was among the staunchest opponents of deregulation. At that time, the question was rather clear-cut: Should the existing regulatory system be *retained* or should it be *discarded* in favor of a new, deregulated order? In that context, American argued for keeping the regulatory system. Without question, there were elements of self-interest, but the overriding concern was for the air transport system itself (of which American was a key component). The regulatory system, although not without flaws, had served the industry and the public extremely well for forty years. American maintained that any requirement to stimulate price and route competition could be accomplished within that structure. American pointed out that deregulation, with its uncertainty and instability, could not avoid producing a detrimental effect on the airline system, including airports and airport operators.

Over time, however, the fundamental question before the nation changed. No longer was it a choice between regulation and deregulation, but only a question of what form deregulation should take. American then came out forcefully for total and immediate deregulation as the preferable alternative to the piecemeal proposals that would leave the industry half free and half restrained. Ultimately, in what could only be termed a supreme philosophical contradiction, the piecemeal approach prevailed, and the industry found itself partially deregulated.

How the industry has fared since that fateful day in October of 1978 best illustrates the onerous effects of the deregulatory scheme finally enacted. Financially, of course, the industry is presently in serious trouble. Supporters of deregulation, however, quickly point to the in-

dustry's outstanding profit performance in 1978. Indeed, 1978 was an exceptional year for the airlines. As a group, the majors alone reported operating earnings of almost \$1.2 billion, and some carriers, including American, set individual profit records.

In no way, however, can these results be attributed to the positive effects of deregulation. The Airline Deregulation Act was not passed until late October of 1978. Several months elapsed before the new regulatory order began to have a competitive impact, and consequently to have an effect on the airlines' financial results. In truth, 1979 was the industry's first full year of deregulation. By the end of that year, the industry was awash in the red ink that has since been flowing freely among most of the airlines.

The numbers speak for themselves. Between 1979 and 1982, the major airlines had combined operating losses of over \$1.2 billion. Losses have continued for some carriers, even in a supposed recovery. Although some individual carriers have shown improvement, the majors as a whole had net losses of more than \$181 million in 1983 with rough financial weather continuing into 1984. Even Delta, one of the industry's traditional profit leaders, suffered financially in the 1983 fiscal year.²

Significantly, the industry is losing money and continues to struggle financially in spite of several developments which, on the surface, should be improving airline balance sheets. For example, fuel prices have declined, saving the industry about \$100 million a year with each one cent drop in the price per gallon. Various wage and work-rule concessions by labor unions are saving some carriers many millions of dollars each year. Agreements by major lending institutions are assisting certain struggling airlines either by restructuring their debt or by forgiving portions of their debt entirely. Furthermore, some air-

² See 1984 MOODY'S TRANSPORTATION MANUAL 1427-28.

lines are reducing overall costs by contributing less to employee pension funds.

Each of these developments has produced tens of millions of dollars in savings for the struggling carriers. Nevertheless, these savings have not been enough to prevent the massive losses that have been making business page headlines for more than three years. Something in the airline environment, then, must be standing in the way of renewed profitability. Is the industry suffering from some chronic financial deficiency? Or is the industry simply suffering from the effects of a lingering and pronounced recession? There can be no denying that the recession has hurt; yet to suggest that the recession is our sole economic problem and that deregulation has been entirely beneficial is to deny the history of the last six years. Deregulation has had and continues to have a profound complicating effect on the financial health, not only of the airline business, but also of aircraft manufacturing and other allied industries. The answer may be stated in two words: excessive competition.

When Congress enacted deregulation, it fully expected that the new law would intensify competition. What Congress did not anticipate, however, is the ruinous degree to which this competition has developed. Amid the oversimplifications that sometimes prevail when a legislative body considers an issue as complex as airline operations, Congress tended to equate increased competition with a set of perceived social benefits, most notably lower air fares and more service. Congress overlooked the less than obvious risks of deregulation.

More airline players, for example, mean less control over the critical economic factors that play such key roles in day-to-day business decisions and "long-range planning." More players mean greater cost disparity among individual airlines, placing some carriers at a serious competitive disadvantage not necessarily of their own making. More players mean excessive capacity in certain key markets, encouraging unsound pricing practices and even

sparking some disastrous fare wars. And, conversely, more players mean a serious reduction in service in many less glamorous markets. More players mean a waste of precious jet fuel as more carriers fly more empty seats over more routes. As history has unfolded, these risks have become some of the harsh economic realities of deregulation, creating a business climate not conducive to making money. Such has been the crux of the industry's problems for the past six years.

At the same time, deregulation has not delivered to the public all of the benefits that were suggested would flow almost automatically. The lower fares that were to become a natural consequence of increased competition provide a good illustration. In actuality, fares have fallen in a few markets, though not in the smaller communities. Although competition under deregulation has indeed intensified, that competition has tended to be highly concentrated around a handful of major cities. It is on these routes and in these cities where most of the fare cutting has been initiated. In those markets where competition has not developed or has declined, fares have remained at much higher levels and, in some cases, are higher than they might have been without deregulation.

Perhaps the most vivid example of concentration in competition is the New York-Los Angeles and New York-San Francisco markets. Under the old system, each route was aggressively and adequately served by three nonstop carriers: American, United and TWA. Within a year after the Deregulation Act became effective, seven nonstop carriers were competing in the New York-Los Angeles market while six were competing on the New York-San Francisco route. Intense price cutting ensued, making those two markets much less rewarding for everyone.

Listing those cities whose air service has increased by at least forty daily departures since 1978 provides another example. The list contains just twenty-two cities or markets. At the top is New York/Newark. Others are such major metropolitan centers as Houston, Dallas/Fort

Worth, Denver, Phoenix, Minneapolis/St. Paul, Atlanta and Los Angeles. There are only a few modestly sized cities on the list. Significantly, none are in the category of medium or small markets.³

Although destructive competition has raged in the largest cities, more cities have lost service or experienced service reductions than have gained service or seen existing service increased. On the basis of total weekly scheduled departures, for example, 364 markets had declined or remain unchanged between 1978 and March of 1983, while only 289 markets had increased. Similarly, 436 markets had lost total weekly seats since 1978, while only 217 markets had gained. In other words, between March of 1979 and March of 1983, 116 cities have lost *all* air service while only 40 cities have service today that never had it before. Losers have outnumbered gainers by almost three to one!

Moreover, many of those cities adversely affected are important commercial and population centers. The list includes cities such as Chattanooga, Tennessee; Charleston, West Virginia; Columbia, South Carolina; Jackson, Mississippi; and Monroe, Louisiana. The inescapable conclusion is that a few large markets have prospered from deregulation while many smaller markets have suffered.

The effects on air fares are equally confusing. One of the glaring flaws of the pricing structure in the new environment has been its lack of fairness and equity for consumers, a deficiency that has damaged the credibility of the entire industry. The examples are already notorious. In January of 1982, a passenger could fly 2,500 miles from New York to San Francisco for \$99, but would pay \$268 to fly 1,800 miles from Memphis to San Francisco.⁴ This disparity made no sense economically and seemed grossly unfair to the consumer, but it was a reflection of the com-

³ CAB STAFF STUDY, REPORT ON AIRLINE SERVICE, FARES, TRAFFIC, LOAD FACTORS AND MARKET SHARES (Issue No. 26, June 1983).

⁴ OFFICIAL AIRLINE GUIDE, NORTH AMERICAN EDITION (Jan. 15, 1982).

petitive realities that existed at the time. Unfortunately, competition still produces the same results in certain markets. Deregulation implied lower fares for most, but has delivered them only to the chosen few. Most passengers are now paying higher fares or at least more than they might be paying if fares were still regulated.

Meanwhile, the fare system has had a disastrous effect on the industry. The explosion of new fares under deregulation created nothing short of chaos for airline personnel and travel agents. And outrageous discounting, often below costs, almost brought the industry to its knees financially in 1981 and 1982. The mileage-based pricing system introduced by American early in 1983 has improved the situation by eliminating some of the worst fare inequities. In many markets, fares are now being offered on a more sensible and economically realistic basis. The problem has not been solved, however. The competitive dynamics of this industry are such that the potential for renewed chaos and complexity always exists, as the events of 1984 are proving. Hopefully, though, the members of the industry have learned from the bitter financial lessons of the past few years.

Other anomalies abound. The industry, for example, is offering less nonstop and effective single-plane service than under the old system, because of the extensive development of hubs and their emphasis on connecting services. In the days of regulation when route franchises were clearly defined, airlines could afford to operate on a nonstop or single-plane basis between many pairs of cities. Accordingly, the public became accustomed to this level of convenience and came to associate it with good airline service. Business travelers, for whom schedule frequency and convenience are paramount, in particular grew dependent on this level of service.

Under the extreme competitive and economic pressures of deregulation, however, airlines have had to find new and more efficient ways of scheduling their flights. The result has been less nonstop, or point-to-point, flying and

a dramatic shift to the hub-and-spoke system (where flights from one part of the system feed into an intermediate point and exchange passengers and freight with flights going to other parts of the system). This massive realignment of schedules and routes into huge hub-and-spoke operations has developed into one of the most significant themes of the deregulation era and is being practiced by dozens of airlines, large and small, in all parts of the country. Indeed, the practice is so widespread today that even the hubs themselves compete with one another for passengers and freight.

The emergence of hubs has fostered a dramatic change in air travel patterns. Today there are fewer opportunities to fly nonstop to a final destination because there are fewer nonstop flights available. Most passengers also find themselves traveling the entire distance with the same airline, rather than making interline connections to another airline at the intermediate point, because most airlines built their hubs with the aim of keeping passengers within their respective systems.

The numbers once again tell the story. Over the past six years, the percentage of passengers using on-line service (that is, those remaining within a single airline's system) has jumped from 84 percent to 92 percent. At the same time, however, the percentage of passengers using single-plane service to their final destination has dropped significantly in all but a token number of markets. In the Louisville-Los Angeles market, for example, 62.2 percent of all passengers used single-plane service in 1978 but only 3.7 percent did so in 1982.⁵ Boston-Nashville is another example. On that route, 78.7 percent were single-plane passengers in 1978 but only 36.4 percent flew single-plane in 1982.⁶ The point is further illustrated by a recent study which showed that 24 percent of American Airlines' on-line passengers required connecting flights in

⁵ CIVIL AERONAUTICS BOARD, ORIGIN - DESTINATION SURVEY OF AIRLINE PASSENGER TRAFFIC DOMESTIC, Table 12, Fourth Quarters of 1978 and 1982.

⁶ *Id.*

1982, as compared with 8 percent in 1978.⁷ Thus, a system that was to produce better service has instead led the industry to offer fewer nonstop and direct flights and more flights requiring connections.

Yet another anomaly exists in that one-stop or connecting flights are often cheaper than nonstop flights in many large markets like New York-Los Angeles. The desire of airlines to promote their hubs by luring passengers away from airlines with nonstop services in particular markets accounts for this pricing contradiction. A few years ago, for example, a competitor of American established a major hub in Denver and began offering coast-to-coast fares over the Denver hub that seriously undercut the already low fares in effect for transcontinental nonstop flights. To protect its market position, American was forced to match the hub fares over its connecting center at Dallas/Fort Worth, even though the fares were clearly unwise and unrelated to the production costs of connecting service. In effect, the attractive one stop flight required the passengers to be handled one additional time on the ground and to be flown on 727 aircraft that are not as efficient per seat mile as the wide-body aircraft used in the nonstop transcontinental markets. It simply does not make sense to offer lower prices for a product that costs more to produce. Neither does it make sense to use fares to discourage nonstop travel while promoting service that involves greater circuitry and elapsed travel time. And it does not make sense to divert traffic to less efficient and less productive aircraft. Logic and reason, however, are often overshadowed in the new age by the demands of competition.

One of the major complaints about the old regulatory system was that passengers in short-haul markets were subsidized through generally higher fares paid by passengers on long-haul routes. One of the curious ironies of deregulation is that subsidization still occurs. Today, the cost of traveling between the New York area and Los An-

⁷ *Id.*

geles can be as low as \$119 each way. But to fly from Memphis to Phoenix (just half the distance) will cost \$341.⁸ The higher fare paid by the Memphis passenger helps to underwrite the big transcontinental discount. Scores of other hidden examples can be found throughout the system.

Another anomaly of the new age is that while some cities are losing service or are seeing a decline in the frequency of their service, schedules are being built around hub airports. These schedules are entirely out of proportion to the local passenger demand in hub cities. The Los Angeles market illustrates this point. For years, American operated nonstop service between Nashville and Los Angeles. With the emphasis on hubs in the new environment, however, it became prudent to discontinue the Nashville nonstops and instead route those airplanes through the DFW hub. In order to build the DFW hub, American increased its nonstop frequency between DFW and Los Angeles and even added widebody airplanes on the route. The end result, of course, is that Dallas/Ft. Worth residents flying to Los Angeles have six daily nonstop flights to choose from, but Nashville residents, who once could fly nonstop to Los Angeles, now have to change planes at DFW. The proponents of deregulation did not allude to this consequence when selling the concept of deregulation to Congress and the public.

The proponents of deregulation also failed to indicate that new airlines entering the industry in the new environment would receive the kind of preferential treatment that has been accorded such newcomers. The federal government, for example, has given many new airlines loan guarantees, and thus lower costs, to facilitate aircraft acquisitions. From its founding until 1983, about two years ago, People Express enjoyed CAB exemptions from the baggage liability and denied boarding compensation rules that apply to the rest of the industry. The CAB

⁸ OFFICIAL AIRLINE GUIDE, NORTH AMERICAN EDITION (Oct. 15, 1984).

granted the exemption on the theory that People's Express was a new, low-fare airline and therefore should not be expected to bear the same expense burdens as established carriers. People's Express stated that the administrative burden — for an airline with less than 50 aircraft — would be in excess \$3 million annually. Imagine the cost to a huge, established airline! Strangely, of course, there was no similar CAB edict to prevent People's Express from using its low fares to steal traffic from the rest of the industry. The inconsistency in the government's logic is astounding.

Looking back over the last five years, it is evident that deregulation certainly has not lived up to its euphoric billing. Additionally, the new air transport system which has emerged under deregulation has done very little for the industry's major constituents. *The public* has not benefitted. There is less nonstop service, most lengthy trips require stops at intermediate hubs, and fares are widely inconsistent and tend to favor the few chosen markets. *Stockholders* have not benefitted. Most carriers have struggled financially in the new age, eroding stockholder equity and preventing the kind of solid, sustained profitability that leads to renewed or increased dividends. *Airline employees* have not benefitted. Layoffs, wage cuts, benefit reductions and other austerity measures have almost become the norm in the industry as airlines fight for survival in an intensely competitive environment. *Most cities* have not benefitted. More cities have lost service than have gained service. Airline schedules have become concentrated around hub airports in a few major cities at the expense of many small markets. *Aircraft manufacturers* have not benefitted. As losses have mounted over the past few years, airlines have been forced to cancel orders, delay aircraft deliveries, and discontinue plans for new orders that, absent deregulation, would have been placed. As a result, the manufacturers themselves are struggling and are finding it hard to compete in world markets where some competitors are backed by foreign governments that

assist their manufacturers in luring new orders with various financing incentives. *Lenders and creditors* have not benefitted. Some airlines — Braniff, Continental, Air New England, Altair, Air Florida, Golden West — have gone bankrupt. Other carriers with serious financial troubles have had to seek debt restructuring and other concessions that impede the recovery of massive investments in the industry. Airlines now have a “bad name” in the financial community. Lenders already heavily committed to poor-risk carriers now have little money for the good-risk airlines who need capital for growth and revitalization.

Should these harsh facts suggest that the industry return to some form of regulation? I would respond an emphatic “no.” The industry is too complex, too dynamic and too far down the road of deregulation ever to be re-regulated in any equitable, sensible way. The deregulators intended to totally dismantle the economic structure of regulation. The deregulators sought to throw the industry completely open so that free market forces alone would determine the prices charged, the markets served, and the manner of doing business. Though the results are open to question, the attempt itself was a complete success, as far as it went.

On every economic front, the industry has been revolutionized. All of the old boundaries and restrictions have vanished. The airlines move today through a new and largely uncharted terrain. The boundaries of a former age, however sensible and beneficial they may look in retrospect, can no longer be erected in any logical way. Any attempt by legislators to undo deregulation and put the old system back together would simply make conditions in the industry worse. Again, this is an extremely complex industry. There was little congressional understanding of these complexities during the deregulation debates of the 1970's, and there is no reason to believe that Congress, as a whole, is any more knowledgeable today. The airlines could just as easily again become the victims of misguided notions and simplistic judgments.

Many in the airline industry have paid a heavy price for change. When deregulation was enacted, the industry found itself with the wrong airplanes, with a cost structure that was too high, with too many point-to-point routes, with too many employees, and with airport facilities that were too large in some markets and too small in others. Adaptation has not been easily achieved, but American is finally adjusting to the new environment. American's hubs are in place, it is whittling away at its cost structure; employment levels are more realistic, it is acquiring new, more efficient aircraft, and it is bringing airport facilities in line with the needs of a realigned route network.

To complete the task and prosper once again, a higher degree of labor/management cooperation than has been historically practiced in the industry is essential. Under deregulation no high-cost airline can hope for long-term profitability. American's labor and management are working hard to effect the transition from high to low cost without sacrificing the income or the jobs and security of career employees.

Now, just as American's reputation, service skills, marketing and operational abilities, and revamped route structure are beginning to come together, some suggest that perhaps the industry should reverse itself in mid-stream and undo everything that has been accomplished since 1978. Such a suggestion is not only naive, it is unrealistic. The wiser, sounder course is to complete the adjustment to deregulation that is already well underway. At this advanced stage in the game, it is clearly preferable that the *marketplace*, rather than the government, determine American's future and the future of the industry. While the government continues to hold an important position in matters pertaining to safety, other issues are best left to free enterprise and open competition, just as the proponents of deregulation intended.

