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Herbert D. Kelleher

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DEREGULATION AND THE TROGLODYTES — HOW THE AIRLINES MET ADAM SMITH

BY HERBERT D. KELLEHER*

ALMOST 200 YEARS after his death, Adam Smith's ethereal invisible hand swept across the American airline industry, brushing aside in its wake a regulatory structure which for forty years had bred the arrogance, slothful inefficiency and unresponsiveness inherent in an industry which has substituted paternal "regulation" by a supposedly omniscient regent for the competitive impetus of a free marketplace. Through a single broad stroke, enacted with the support of a newly-enlightened regulatory agency under the leadership of Chairman Alfred Kahn, Congress set the airlines free of the regulatory strictures which had constrained the innovation of service alternatives, restricted market entry and discouraged price competition. As might be expected of a troupe of competitive troglodytes emerging from the protective cocoon of a regulated existence, some members of the newly liberated sect suffered, and some prospered, while some fell into a boiling caldron.¹

Because deregulation of the airline industry provided much of the stimulus for a general reevaluation of the beneficence of economic regulation of other potentially competitive industries (such as communications,² truck-

* President and Chief Executive Officer, Southwest Airlines Co.

¹ Cf. *The Three Little Pigs* (in which the boiling caldron was reserved for one who tried to eat too many little pigs in one day).

² See, e.g., *United States v. American Tel. & Tel. Co.*, 552 F.Supp. 131 (D.D.C. 1982), *aff'd sub nom. Maryland v. United States*, 103 S.Ct. 1240 (1983); Repeal of the 'Regional Concentration of Control' Provisions of the Commission's Multiple

ing,³ and financial services⁴), it may be of some moment, although perhaps somewhat premature, to evaluate the impact of airline deregulation upon the industry, the communities it serves and, most importantly, upon the consumers the industry exists to serve. Although the view is far from unanimous,⁵ the weight of evidence and experience strongly suggests that despite tremendous unforeseen obstacles arising from the unprecedented escalation of fuel costs, a severe economic "recession" which might be more aptly described as a "depression" in the airline industry, unprecedented high interest rates and the dis-jointing of our national air transportation system caused by the PATCO strike, deregulation has served our nation well. Indeed, a strong case can be made that it was only the flexibility and creativity made possible by deregulation that saved the airline industry from unmitigated disaster during the period from 1978 to 1983.

In reality, the Airline Deregulation Act of 1978⁶ did not instantaneously deregulate the airline industry, but instituted a gradual process of regulatory change, culminating in the abolition of the Civil Aeronautics Board (CAB) in 1985.⁷ Perceptive economists had for some time recog-

Ownership Rules, 49 Fed. Reg. 2,478 (1984) (to be codified at 47 C.F.R. pt. 73) (proposed Jan. 20, 1984); Multiple Ownership of AM, FM and Television Broadcast Stations, 48 Fed. Reg. 49,438 (1983) (to be codified at 47 C.F.R. pt. 73) (proposed Oct. 24, 1983), *corrected*, 48 Fed. Reg. 50,907 (Nov. 4, 1983).

³ See Motor Carrier Act of 1980, Pub. L. No. 96-296, 94 Stat. 793 (codified at 49 U.S.C. §§ 10101-11917 (1982)).

⁴ See Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (1980) (codified in scattered sections of 12 U.S.C.); see also Gorinson, *Depository Institution Regulatory Reform in the 1980s: The Issue of Geographic Restrictions*, 28 ANTITRUST BULL. 227 (1983).

⁵ See Kay, *All Flights Cancelled*, TEXAS BUSINESS, May 1984, at 36; *Deregulation Foes in Counterattack*, Los Angeles Times, July 3, 1983, pt. VI at 8, col. 1.

⁶ Airline Deregulation Act, Pub. L. No. 95-504, 92 Stat. 1705 (1978) (codified as amended at 49 U.S.C. §§ 1301 - 1552 (1982)).

⁷ An entertaining commentary on the "causes" of the airline Deregulation movement can be found in Callison, *Airline Deregulation-Only Partially A Hoax: The Current Status of the Airline Deregulation Movement*, 45 J. AIR L. & COM. 961, 962-64 n.4, 965 (1980). Mr. Callison, the Senior Vice President-General Counsel for Delta Air Lines, concludes that:

Viewed by hindsight, the leaders of the airline deregulation movement were Senators Cannon and Kennedy, Congressman Elliot

nized that CAB regulation resulted in greater inefficiency and higher fares than would otherwise have existed.⁸ These views gained support from the successful introduction of efficient low-fare air service in the intrastate markets of California by PSA and Air California, and Texas by Southwest Airlines, where state regulatory agencies adopted liberal entry and pricing policies approximating economic "deregulation."⁹ In 1975, the CAB appointed a special staff to study proposals for regulatory reform, resulting in a staff recommendation that public utility-type controls be eliminated within three to five years.¹⁰ The report concluded that the airline industry "is naturally competitive, not monopolistic," and that regulation caused higher-than-necessary costs and prices, weakened the ability of carriers to respond to market demands and narrowed the range of price/quality choices available to the consumer.¹¹ Thus, the industry was hardly shocked when Senator Kennedy's Subcommittee on Administrative Practice and Procedure recommended that the focus of the nation's aviation policy should shift from promoting the well-being of the aviation industry to making its service economically available to more of the American public.¹² Nor was the industry surprised when President

Levitas, Dr. Alfred Kahn, and the Ford Administration, spurred on, of course, by the various academic economists who pushed the theory in the beginning and throughout. The Carter Administration also played a role, but its major contribution was appointing Alfred Kahn to the CAB.

Id. at 964 n.4.

⁸ G. DOUGLAS & J. MILLER, *ECONOMIC REGULATION OF DOMESTIC AIR TRANSPORT: THEORY AND POLICY* (1974); Keelet, *Airline Regulation and Market Performance*, 3 BELL J. ECON. & MGT. SCI. 399 (1972); W. JORDAN, *AIRLINE REGULATION IN AMERICA* (1970); R. CAVES, *AIR TRANSPORT AND ITS REGULATORS: AN INDUSTRY STUDY* (1962).

⁹ See SIMAT, HELLIESON & EICHER INC., *AN ANALYSIS FOR THE INTRASTATE AIR CARRIER REGULATORY FORUM, VOLUME 1 SUMMARY REPORT* (1976); Note, *Is Regulation Necessary? California Air Transportation and National Regulatory Policy*, 74 YALE L.J. 1416 (1965).

¹⁰ Report of the CAB Special Staff on Regulatory Reform (1975).

¹¹ Executive Summary of Report of the CAB Special Staff on Regulatory Reform at 1 (1975).

¹² SENATE SUBCOMM. ON ADMINISTRATIVE PRACTICE AND PROCEDURE, 94TH

Ford sent to Congress a comprehensive program of reform entitled the Aviation Act of 1975, which was designed to allow greater pricing flexibility and freedom of entry.¹³

The transition to deregulation began in 1977 with the appointment of Dr. Alfred Kahn as Chairman of the CAB. Under the leadership of Dr. Kahn, the CAB commenced its first major low-fare route case, in which it expressly requested parties to explore whether the authority to enter a market should be permissive and whether more than one applicant should be granted authority in each city-pair market.¹⁴ A year later, the CAB went further and proposed to award multiple authority to all qualified applicants by nonhearing show cause proceedings, eliminating the lengthy hearings of the comparative selection process and the restriction of entry to a single carrier.¹⁵ About the same time, the CAB also began approving individual carriers' proposals for discount and promotional fares, such as Texas International's "Peanuts" fare,¹⁶ and American's "Supersaver" fare from New York to the West Coast.¹⁷ By the late fall of 1977, the CAB had decided not to intervene through promulgation of discount fare policies and had adopted the view that allowing airlines to implement their own pricing strategies could significantly improve the economic performance of the industry.¹⁸

The CAB's decision to reduce price restrictions coincided with the most favorable part of the business cycle

CONG., 1ST SESS., AIRLINE REGULATION OF THE CIVIL AERONAUTICS BOARD (Comm. Print 1975).

¹³ S. 2551, 94th Cong., 1st Sess., 121 Cong. Rec. 33,505-509 (1975).

¹⁴ Chicago-Midway Low-Fare Route Proceeding, 78 C.A.B. 454 (1978).

¹⁵ Oakland Service Case, 78 C.A.B. 593 (1978).

¹⁶ Texas International Airlines "Peanuts" Fares Proceeding, 72 C.A.B. 868 (1977).

¹⁷ American Airlines "Supersaver" Fares Proceeding, 73 C.A.B. 1066 (1977). The "Peanuts" fare and "Supersaver" fare decisions were made under Chairman John Robson, who preceded Alfred Kahn as CAB Chairman.

¹⁸ E. BAILEY, D. GRAHAM & D. KAPLAN, DEREGULATING THE AIRLINES - AN ECONOMIC ANALYSIS 121 (1983).

for the industry, so that substantial fare reductions tapped price-sensitive segments of the public and resulted in a substantial increase in demand for air service. In 1978, traffic grew markedly in response to the wide availability of deep discount fares. Average fares (adjusted for inflation) fell almost nine percent. Load factors increased more than five points, and carrier profits increased markedly.¹⁹

Thus, by the time President Carter signed the Airline Deregulation Act on October 18, 1978, the theories of the deregulation economists and the experiences of intra-state carriers in Texas and California seemed confirmed by the real-life experiment of limited deregulation of the CAB-regulated carriers. The trunk carriers were experiencing substantial increases in loads, enjoying healthy profits, and aggressively plotting their own post-deregulation courses. Aircraft manufacturers were enjoying bountiful orders for new aircraft. Deregulation appeared to be a panacea to everyone associated with the industry.

In 1979, however, things began to turn sour for much of the industry. Events in the Middle East precipitated a sudden rise in fuel prices. Between the first quarters of 1979 and 1980, the CAB permitted average fares to increase by thirty-one percent, but even this could not keep pace with the rapid increase in costs occasioned largely by the more than doubling of the price of fuel.²⁰ The economy then began a prolonged recession. Interest rates skyrocketed, wreaking havoc on the balance sheets of highly leveraged carriers who had the misfortune to have recently-acquired or floating-rate debt. Carriers such as Braniff, which had aggressively acquired new aircraft and entered new markets in the anticipation of reaping a deregulation bonanza, and Republic, which borrowed heavily to acquire Hughes Airwest, were among the hardest hit.

In 1981, which was marked by the disruption following

¹⁹ *Id.* at 39-40.

²⁰ *Id.* at 42.

the PATCO strike, the former trunk airlines,²¹ in the aggregate, had an operating losses of approximately \$480 million. For 1982, the operating losses widened to approximately \$650 million, not including losses suffered by Braniff or Texas Air, the holding company parent of Continental.²² Adding Braniff and Continental increased the 1982 operating losses by over \$67 million.²³

Does this dismal aggregate performance by the largest, and formerly most regulated, members of the airline industry render deregulation a failure? Even assuming all the airlines' woes were attributable to deregulation, which they clearly are not, the answer would still be "no." Deregulation has produced substantial societal benefits in the form of lower fares, increased service, diversity of service and price alternatives, reduced industry concentration, more efficient allocation of resources and, in the long run, a more healthy, efficient and innovative airline industry.

Analysis of the effect of deregulation on airlines fares must begin with a recognition of the fact that between 1976, the last year before relaxation of regulation began, and 1983, the year after the CAB's route, rate and tariff authority ended,²⁴ airline costs increased by seventy-one percent, yet fares increased by only forty-five percent. Between the year ending September 1978, just before the Deregulation Act was passed, and June 1983, costs increased by fifty-four percent while fares increased thirty-nine percent.²⁵ Thus, it appears that the cost-plus method of pricing, which existed under CAB regulation, has been destroyed and that, in the aggregate, consumers are enjoying the benefits of substantially lower fares than

²¹ American, Braniff, Continental, Delta, Eastern, Northwest, Pan American, TWA, United and Western. Republic and U.S. Air have, since deregulation, been added to the list of "trunks."

²² Derchin & Tortor, *First Boston Research Aviation Bulletin*, Mar. 7, 1983.

²³ Civil Aeronautics Board Report to Congress, Implementation of the Provisions of the Airline Deregulation Act of 1978, Appendix D (1984).

²⁴ 49 U.S.C. § 1551(a) (1984).

²⁵ Civil Aeronautics Board Report to Congress, *supra* note 23, at 20.

would otherwise exist. Under regulation, the CAB adjusted fares with a focus on industry profitability. From 1960 to 1974, the Board set fares to achieve an average 10.5 percent rate of return for the industry based on actual industry operating costs. Beginning in 1974, the Board set fares to yield a twelve percent return based on "optimal" industry load factors and seating density.²⁶

The benefit of the substantial aggregate savings resulting from deregulation has not, of course, been spread evenly. The CAB adjustment of fares operated uniformly for all markets, without regard to market density or level of competition. Fare levels were generally related to distance, with long-haul fares set substantially above cost and short-haul fares deliberately set below cost.²⁷ Consequently, the CAB-regulated carriers frequently allowed their quality of service on the unprofitable short-haul routes to reflect their disdain for these markets.²⁸

With carriers now free to set their own pricing policies, prices tend to reflect market forces as well as cost. Although subject to temporary distortions, fares are generally tending to find their natural level, reflecting the price at which service can economically be provided on a market-by-market basis. The competitive market forces now shaping the airlines' fare structures reflect, in a way government regulators never could, the actual cost of providing the most efficient service to a specific market. The presence of actual and potential competition in every market provides strong discipline against pricing practices which would produce super-normal profits.

The impact of actual competition on fares has been dramatic in many markets. For example, when Southwest opened its first interstate route from Houston to New Orleans in early 1979, the one-way standard coach fares in

²⁶ E. BAILEY, D. GRAHAM & D. KAPLAN, *supra* note 18, at 103.

²⁷ *Id.* at 102-44.

²⁸ See Texas Aeronautics Comm'n v. Braniff Airways, 454 S.W.2d 199, 202-03 (Tex. 1970) (record of cancelled flights and late flights on routes served by CAB certificated carriers in the Dallas, Houston and San Antonio markets).

the market were \$50 to \$52. Southwest entered the market offering unrestricted fares of \$30 for every seat on every flight before 7:00 p.m. on weekdays, and \$20 on weekends and weekday evenings.²⁹ Six years later, despite precipitous increases in fuel costs and six years of inflation, Southwest serves that market with hourly flights and unrestricted fares of \$55 and \$40. Today Southwest offers unrestricted weekend and evening fares for every seat substantially below the prevailing standard coach fares offered by the old CAB-regulated carriers in 1979. And several competitors match Southwest's fares, although most do so on a "restricted" basis.³⁰

The benefits of actual competition have, to be sure, taken longer to reach some markets than others. For example, in March 1984, when Southwest commenced service between Dallas and Little Rock, the standard coach fare offered by incumbent carriers was \$139 and \$149, and the lowest restricted fare was \$89.³¹ Southwest entered the market offering unrestricted coach fares of \$47 for every seat on weekdays before 7:00 p.m., and \$32 for every seat on weekends and weekday evenings. The incumbent carriers suddenly discovered that they, too, could economically provide service at those fares, albeit on a restricted basis.³² Other low-fare carriers, such as People Express and Northeastern, have brought about similar dramatic fare reductions upon entering new markets.

Although fares are markedly higher in markets not served by new, low-fare entrants, even in these markets the threat of competition from potential new-market entrants serves to discipline pricing practices. The freedom of airlines to enter markets at will has caused most airline city-pair markets to become readily contestable. The ma-

²⁹ OFFICIAL AIRLINE GUIDE NORTH AMERICAN EDITION (February 1, 1979) [hereinafter cited as OAG].

³⁰ OAG FARE ISSUE, *supra* note 29 (March 1, 1984).

³¹ OAG, *supra* note 29 (Mar. 1, 1984).

³² OAG, *supra* note 29 (Apr. 15, 1984).

major economic barrier to entry into specific markets is the acquisition and location of aircraft. Aircraft, however, are readily movable from one market to another, and do not represent the type of "sunk costs" which, once sunk, become a true barrier to entry.³³

The principle of market contestability means that a carrier which overprices its product risks market entry by a lower-priced competitor. In the three years from 1978 to 1981, 122 of the 200 most heavily traveled markets experienced entry by at least one new carrier.³⁴ A prudent competitor will seek out markets that are underserved or overpriced, for these markets present the greatest potential for profit. Moreover, experience demonstrates that lower fares and increased competition serve to increase traffic, making underserved and overpriced markets particularly attractive. For example, with the entry of Southwest Airlines' low fares and frequent service in 1971, air traffic between Dallas and Houston increased 127.5% from 1970 to 1974, while ten similar high-density CAB-regulated markets grew an average of only 9.8 percent during the same period.³⁵ Similar experiences have been encountered repeatedly as Southwest has entered new markets with its low fares and frequent flights. This increase in total traffic, generally resulting in high load factors for Southwest, is frequently accomplished without a significant impact upon the incumbent carriers' traffic in the market. In part, this is attributable to the incumbents' own reduction in fares and is, in part, the result of traffic which is newly generated or attracted from surface transportation in short-haul markets.

The impact of fares upon traffic is demonstrated on a more global scale by the experience of carriers as a whole under deregulation. In 1978, fare rates per revenue passenger mile (RPM) fell by 8.5% while traffic grew by

³³ Bailey & Panzar, *The Contestability of Airline Markets During the Transition to Deregulation*, 44 LAW & CONTEMP. PROBLEMS 125, 128-29 (1981).

³⁴ E. BAILEY, D. GRAHAM, & D. KAPLAN, *supra* note 18, at 90.

³⁵ *Id.* at 22.

16.7% The next year fares again fell, this time by only 5.3% while traffic again grew, by a more modest 11.1%. In 1980, however, impelled by higher fuel costs, fares rose by 13.5%. Traffic, consequently, fell by 5.4%. In 1981, fares rose by 2.5% and traffic dropped by 3.7%.³⁶ In 1982, the carriers' fares fell 3.76%; traffic rose 6.2%.³⁷ In 1983, fares fell by 0.5%, and traffic climbed by a strong 11.2%.³⁸ The pattern is unmistakable.

The impact of potential competition on fares is demonstrated by the fact that ticket prices at slot-constrained airports tend to be higher than those at airports that are not slot-constrained.³⁹ Similarly, markets with only one CAB-certificated carrier in 1979, when market entry still generally entailed cumbersome CAB proceedings, had statistically higher fares than those with multiple authorized carriers. Markets with only one authorized carrier averaged fares at ninety-seven percent of the standard industry fare level (SIFL), while those markets with more than one authorized carrier, where actual or potential entry was readily possible, averaged ninety percent of the SIFL.⁴⁰

Experience with fare deregulation suggests that markets which continue to endure noncompetitive fares either cannot economically support service at lower fares, or have simply not yet been "found" by an aggressive competitor ready to cut fares to gain market share. If the former is the case, then there should be little room for complaint, since the market is receiving exactly the level of service it is capable of supporting. If the latter is the case, time and natural market forces will resolve the situa-

³⁶ *Id.* at 40. These fare figures are adjusted for inflation.

³⁷ M. Derchin & R. Tortora, *supra* note 22.

³⁸ M. DERCHIN & R. TORTORA, AIRLINE INDUSTRY: FOURTH QUARTER AND FULL YEAR 1983 RETROSPECTIVE (Mar. 7, 1984). Derchin and Tortora's fare figures are not adjusted for inflation. The magnitude of the 1983 and 1984 fare decreases is therefore understated.

³⁹ Graham, Kaplan & Sibley, *Efficiency and Competition in the Airline Industry*, 14 BELL J. ECON. 118, 124 (1983); Note, *Airline Deregulation and Airport Regulation*, 93 YALE L.J. 319, 328 (1983).

⁴⁰ Bailey & Panzar, *supra* note 33, at 137-38.

tion in due course. Perceptive airline route managers regularly scan maps, airline boarding figures, and prevailing fare levels in search of market openings. In any event, it is clear that the free market can better tell airlines where to cut fares than the government can (which it seldom did).

Discussion of air service to small communities since deregulation has frequently centered upon two misconceptions: (1) that the rate of loss of air service to small communities has increased with deregulation; and (2) that the loss of service that has occurred is attributable to deregulation. Each of these assumptions is incorrect.

During the ten years from 1968 to 1978, the CAB deleted 127 points from carrier certificates, often concluding that the subsidy cost did not justify continued service. Suspension of service without replacement was permitted at another 64 points.⁴¹ Thus, the Board was deleting points at a rate of over one per month prior to deregulation, and even the points receiving service frequently received inadequate or unsatisfactory service (with flights at inconvenient times to remote locations). The Deregulation Act sought to halt this trend with the establishment of the Essential Air Service (EAS) Program. Under this program, the CAB was charged with assuring through subsidies or carrier "lock-in" procedures that "essential air service" is provided to any community receiving service from only one certificated carrier on October 24, 1978, to any community whose service was thereafter reduced to only one carrier, and to any community whose service was authorized, but had been suspended, on October 28, 1978.⁴² The CAB was also responsible for resuscitating service to communities whose service had been deleted from carrier certificates before deregulation.⁴³ Between 1978 and 1983, the number of departures at

⁴¹ Civil Aeronautics Board Report to Congress, *supra* note 23, at 47-49.

⁴² 49 U.S.C. § 1389(2) (1982). Authority over the EAS became housed in the Department of Transportation when the CAB was dismantled on December 31, 1984. 49 U.S.C.A. § 1551(b)(1)(a) (West Supp. 1984).

⁴³ 49 U.S.C. § 1389(b) (1982). The Department of Transportation now exercises this authority. 49 U.S.C.A. § 1551(b)(1)(a) (West Supp. 1984).

EAS points actually increased by 5.2%, although the number of seats in these markets decreased by 13.7%.⁴⁴ This increase in departures and decrease in seats is largely attributable to the improved suitability of aircraft size to markets.

Convenient air service, especially in thinly traveled markets, is far more related to frequency of service than to the number of available seats. If the frequency is available, the market will have an opportunity to demand for itself the number of seats necessary to serve the market. Although the size of aircraft serving small communities has generally decreased, the quality of service has probably improved overall. Small communities now receive more flights and greater service to small hubs than before, giving them better access to major commercial centers and connecting flights, rather than the "milk runs" they historically had received.⁴⁵

While the facts suggest that small communities have benefitted from the passage of the Deregulation Act, the continued comparatively high level of government regulation of small-to-medium markets may actually be injuring efforts of those communities to attract air service by larger carriers. Unlike other unregulated markets, EAS points may not be freely exited by the "last" carrier providing service. A certificated carrier must give the CAB ninety days notice before exiting the market. Even after the ninety-day waiting period expires, the carrier is subject to being "locked-in" and prevented from leaving the market until a replacement carrier is found.⁴⁶ This well-meaning attempt to protect communities from the total loss of air service represents a formidable obstacle to a carrier seeking the most efficient allocation of its resources. Although the carrier is entitled ultimately to be reimbursed for any "losses" incurred after the ninety-day no-

⁴⁴ Civil Aeronautics Board Report to Congress, *supra* note 23, at 49.

⁴⁵ E. BAILEY, D. GRAHAM, & D. KAPLAN, *supra* note 18, at 94-96.

⁴⁶ 49 U.S.C. § 1389(a)(6).

tice period,⁴⁷ trunk and major regional airlines are not likely to be attracted by the prospect of a government subsidy to cover "losses" whose calculation may be subject to lengthy and contested proceedings. Airlines looking at the commitment of an aircraft costing at least \$15 million are more likely to be deterred by the knowledge that they cannot easily remove the aircraft to a market where it can make a profit. Thus, the spirit of entrepreneurial experimentation which might lead prudent businesspersons in a free market to "take a chance" on many smaller communities may well be dampened. The obligation of the "last carrier" to continue service indefinitely has, moreover, undoubtedly hastened the departures of numerous "next to last" carriers seeking to "bail out" before being saddled with an essential service obligation. To the extent that small communities can complain of their inability to attract "major" carriers since deregulation, their frustrations might, in some cases at least, be more appropriately directed at the remnants of regulation rather than deregulation.

Airline routes and service patterns have undergone substantial change since market entry was made discretionary and the rules for market exit were greatly liberalized. On the average, a carrier served about the same number of nonstop routes in 1983 as in 1978, but only about forty percent of its nonstop routes were between the same points.⁴⁸ The origins of the regulated domestic route structure can be traced back to the Hoover Administration, which granted transcontinental mail route authority to the predecessors of American, TWA, and United, and established Eastern as the north-south carrier on the East Coast.⁴⁹ Piecemeal route awards by the CAB for the new single-plane or nonstop service hardly contributed to the creation of rational or economic route structures for the regulated carriers. Route applications

⁴⁷ *Id.* § 1389(a)(7)(B).

⁴⁸ Civil Aeronautics Board Report to Congress, *supra* note 23, at 28-29.

⁴⁹ E. BAILEY, D. GRAHAM & D. KAPLAN, *supra* note 18, at 55.

sometimes took years for decision. In addition, the choice between competing applicants was frequently influenced by a carrier's economic need.⁵⁰

Quite predictably, the carriers, once given the opportunity, set about reorganizing their route structures. The trunk airlines have generally sought to convert to "hub-and-spoke" networks centered at major airports where they can gather and sort passengers. Through the use of hubs,⁵¹ carriers hope to dominate traffic in their respective geographic regions. Such a system has strong economic justification, allocating resources quite efficiently. For example, a connecting complex serving 20 points actually services 400 potential city-pairs with every complete "turn." Many markets, including small and mid-size markets, which could not otherwise support the level of service they receive, are thereby afforded efficient single-carrier through and connecting service to much of the country. Through its connecting complex at the Dallas-Fort Worth International Airport, for example, American provides passengers from Lubbock, Amarillo, Midland-Odessa and virtually every other sizable city in the Southwest efficient single-carrier connecting service to New York, Boston, Detroit and even London — service of a quality that those and comparable cities would likely lack in the absence of a "hub-and spoke" system.

Deregulation has certainly resulted in the loss of non-stop and single-plane service in some markets, but such service has also been added to others. The proportion of passengers receiving single-plane service has actually increased from 73% in 1978 to 74.7% in 1983. The percentage of passengers able to complete their journey on a single carrier has also increased, from 89.1% in 1978 to

⁵⁰ *Id.* at 59-61.

⁵¹ Among the trunk carriers, American has established an outstanding hub at Dallas-Fort Worth International Airport; Delta and Eastern, at Atlanta; United at Chicago, Denver and San Francisco; and US Air, at Pittsburgh. Other major hubs include Continental at Houston Intercontinental and Denver, TWA at St. Louis, Frontier at Denver, Northwest at Minneapolis-St. Paul, Ozark at St. Louis, Western at Salt Lake City, and People Express at Newark.

96.7% in 1982.⁵² Although isolated examples of loss of nonstop and single-plane service can undoubtedly be cited, the statistics suggest that the airlines' reorganization of their route systems has improved rather than diminished the quality of service. While Nashville, for example, may have lost its American nonstop flights to Los Angeles, it gained the benefit of American's efficient connecting complex at DFW, giving it single-carrier service throughout much of the Southwest and West. Furthermore, if the service that was lost were in sufficient demand, another carrier would likely fill the void in due course. Airlines, like nature, abhor a vacuum.

Moreover, the movement to "hub-and-spoke" systems has created the opportunity for new market initiatives by aggressive competitors. Piedmont, for example, has developed "hubs" at such relatively less congested points as Charlotte, Dayton and Baltimore and has actively promoted its "bypass" strategy of allowing passengers to avoid congested major hubs. Southwest, of course, has significant hubs at Dallas Love Field and Houston Hobby Airport, both previously abandoned by the trunk carriers.⁵³ Southwest has also successfully introduced point-to-point nonstop service in numerous markets, bypassing its hubs in order, for example, to fly San Antonio passengers nonstop to El Paso, Phoenix, Los Angeles and the Rio Grande Valley. Austin passengers likewise have nonstop service to Midland-Odessa, Lubbock, El Paso, the Rio Grande Valley and Phoenix. Other airlines evaluating opportunities for their own markets will undoubtedly take notice of these successful route systems bypassing major hubs. In 1985, however, unlike 1975, public demand for the service, rather than governmental decisions or mere

⁵² Civil Aeronautics Board Report to Congress, *supra* note 23, at 35.

⁵³ Since it was reopened to commercial service by Southwest in 1972, Hobby Airport has undergone a complete revitalization and is presently served by American, Delta, Republic, Ozark, Muse, and Southwest, as well as several commuter carriers.

happenstance, will dictate the airlines' decisions to enter new markets.

The product of free price competition and market entry has been an unprecedented array of service alternatives for the consumer. The rigidity of the regulatory structure allowed passengers few choices of fares or of levels of service. Rivalry among carriers tended to be in the form of nonprice competition — flight frequency, food and beverage services, flight equipment and advertising. The former regulatory scheme encouraged this cost-increasing nonprice competition and necessitated fare increases justified only by the rising costs for which it was responsible.⁵⁴

With the advent of deregulation, the market has experienced new levels of service and fare competition. Newly certificated carriers have adopted widely varying business strategies. The success of People Express has proven that a substantial percentage of airline passengers are not willing, given the choice, to pay for such amenities as meals or baggage checking. People Express charges extra even for such amenities as soft drinks and sells tickets on the airplane while the passengers are in the air. But it offers the lowest fares in the industry, has extremely high load factors, and generally makes money. At the other end of the "new entrant" spectrum, Air One offered nothing but first class service, flew 727 aircraft equipped exclusively with first class seats four abreast, and served complimentary meals on china while charging standard coach and discount fares and went bankrupt. New York Air started as a low-fare carrier, but has successfully converted to a more business-oriented service, charging comparatively higher fares and offering what is perceived as a higher quality of service. Midway has similarly shifted corporate strategy from its initial low-fare concept to its upscale business-class "Metrolink" service, offered at standard coach fares. Muse Air introduced its service as the non-

⁵⁴ Phillips, *Airline Mergers in the New Regulatory Environment*, 129 U. PA. L. REV. 856, 856 (1981).

smoking airline by banning smoking on all flights. Jet America has found its market niche by providing standard services between Southern, though the satellite Long Beach Airport, California and major cities such as Chicago and Dallas-Fort Worth. Southwest has maintained its strategy of offering unrestricted low fares, high frequency and single-class service while expanding its service from Texas to ten additional states since deregulation.

These newly certificated carriers, and others like them, have brought something unique to the markets they serve. The widespread impact and acceptance of these new services is evidenced by the decline in the proportion of passengers traveling on standard "Y" coach fares from sixty percent in 1977 to twenty-five percent in 1982.⁵⁵ Such innovation and variety would have been unlikely under a regulatory scheme which in forty years had never awarded a single major route to a new entrant.⁵⁶

The ability of new carriers to start service and the opportunity for expansion by existing carriers have, contrary to some predictions, reduced the level of concentration in the airline industry. New entrants represent the fastest growing segment of the industry. Between 1976 and 1982, the trunk carriers' share of domestic traffic dropped from eighty-eight percent to seventy-nine percent.⁵⁷ This limited deconcentration of the industry has coincided with widespread public acceptance of the fare and service alternatives offered by the new entrants.

The ultimate standard by which deregulation is measured, however, often is the effect of deregulation on the economic health of the airline industry itself. As suggested earlier, it is at least arguable that deregulation came along just in time to save the airline industry, and the nation itself, from a major debacle. Given the inverse relationship between fares and passenger boardings, what would have happened to passenger traffic if fare levels

⁵⁵ E. BAILEY, D. GRAHAM & D. KAPLAN, *supra* note 18, at 130.

⁵⁶ Civil Aeronautics Board Report to Congress, *supra* note 23, at 7.

⁵⁷ E. BAILEY, D. GRAHAM & D. KAPLAN, *supra* note 18, at 44.

had followed the historical cost-plus approach of regulation and actually exceeded, rather than falling 15 points short of, the fifty-four percent increase in costs between 1978 and 1983? It is not difficult to imagine the incantation of the regulated carriers: "We need even higher fares because of the lower loads caused by our high fares." In the airline industry, the cost of a flight is affected relatively little by the number of passengers. The incremental cost of carrying one additional passenger is slight while the loss of that passenger represents a disproportionate loss of revenue. Put another way, a decrease in the number of passengers results in an increase in the average cost per passenger because total costs are relatively constant regardless of the number of passengers. The rising fare/declining load cycle may feed on itself, potentially sending airlines balance sheets into a death spiral.

Moreover, if not for deregulation, airline costs would probably have increased much more rapidly than they did between 1978 and 1983. Deregulation both enabled and compelled the formerly regulated carriers to seek ways to cut costs. Regulation had done little to promote efficiency or economy, since higher costs could simply be built into every new fare level approved by the CAB. The reorganization of the carriers' route structures allowed the carriers to achieve substantial "economies of scope."⁵⁸ By increasing the numbers of related city-pairs through "hubbing," carriers were able to achieve "network" economies in the form of more efficient airport facility usage, improved scheduling and more optimal equipment utilization. For example, by eliminating nonstop flights between Nashville and Los Angeles, a carrier could use a moderate-size 727 aircraft to carry passengers going to Dallas and a dozen other cities to its DFW hub, where the

⁵⁸ Phillips, *supra* note 54, at 864-65 n.28. "Economies of scope exist if the cost of producing given levels of outputs of two (or more) products in a single enterprise is less than that of producing the same products in separate enterprises." *Id.* Such economies "have found a home in the corporate planning and strategy field . . . under the vague concept of 'synergy.'" *Id.*

Los-Angeles-bound passengers might join passengers from twenty other mid-size cities aboard a larger and more efficient DC-10 for the trip to Los Angeles. Airport facilities in Nashville and Los Angeles could also be efficiently utilized as bases for additional flights to DFW or other stations of the carrier's choice. Further network economies could then be realized. In addition, this network can better satisfy passenger preference for single-carrier service, which is widely preferred over inter-carrier connections.

Deregulation also forced the airlines to reevaluate the level of utilization of their aircraft and employees. Years of public utility-type regulation produced inefficiencies reflected in the regulated carriers' cost structures. Most of the new entrants, who built their organizations under deregulation, have achieved more efficient, less costly structures. For example, in 1981 Southwest's fully allocated cost per passenger for a 200 mile market was \$24 as compared to \$58 for United.⁵⁹ This cost difference was due in large part to the higher productivity of Southwest's employees. Southwest's pilots and flight attendants flew more hours than their counterparts with the regulated carriers. Southwest's pilots flew 73 hours per month in 1981 while United's pilots averaged only 43 hours per month. Southwest operated its aircraft 9.5 hours per day in 1981; United operated its aircraft only 5.2 hours per day.⁶⁰ Southwest keeps its planes in the air with its unparalleled ten-minute turnaround at the gates. If its average turnaround time were increased by just ten minutes, Southwest would require five more aircraft, costing over \$16 million each, to operate the same number of flights. Finally, Southwest's frequent flights enable it to more fully utilize its airport facilities and employees.

These economies were forged in the heat of the competition which Southwest has experienced since its inception. Lack of price competition reduced the regulated

⁵⁹ E. BAILEY, D. KAPLAN & D. GRAHAM, *supra* note 18, at 179.

⁶⁰ *Id.* at 180-181.

carriers' incentives to control costs and promote efficiency. In a competitive environment, the successful firm will be one which can reduce its costs and provide its product at an attractive price to the consumer. Regulation denied society the benefit of an efficient airline industry.

Although the transition has been difficult for many airlines, the industry has finally been forced to consider the efficient allocation of resources. In 1983, the airline industry realized its first profitable year since 1979, with an aggregate operating profit over \$500 million.⁶¹ The effects of the transformation of the industry will continue to be uneven, however. American, which made a record profit of \$228 million in 1983, followed by a 1984 profit of \$234 million, has brilliantly positioned itself (with its strategic DFW hub, strong balance sheet, revised labor contracts, and planned deliveries of new aircraft) to be a dominant member of the airline industry well into the 21st century. Undoubtedly, some others will fare less well.

In a freely competitive market, the future can never be predicted with certainty. The one certainty of the future is that as long as the temptation to let the government do "just a little" re-regulating can be resisted, a deregulated airline industry will deliver its product efficiently and economically. We can be assured of this, not by any government edict, but only by the competitive forces of the marketplace which dictate that the slothful, the unresponsive, and the arrogant will not survive.

⁶¹ M. DERCHIN & R. TORTORA, *supra* note 38.

Casenotes and Statute Notes

