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## Introduction

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## INTRODUCTION

ROY PULSIFER\*

NOW UNDER comprehensive review by the Congress for the first time in nearly forty years and the subject of this issue of the *Journal of Air Law and Commerce* are the public policy questions of whether federal economic regulation of the airlines should be changed and if so, to what extent. The existing law, which created and defined the powers of the Civil Aeronautics Board, was originally enacted in 1938, and represented the culmination of a legislative process that had commenced several years earlier.

Although the airlines in 1938 were less than 0.5% of their present size and an insignificant factor in intercity travel, the Civil Aeronautics Act<sup>1</sup> was perceived by the airline industry, by the Congress, and by the country at large as a major legislative reform. First, it was fully consistent with general public policies intended to stabilize and stimulate a depressed economy and to correct abuses that were understood at the time to have resulted from inherent destructive tendencies in an unregulated business environment; and it was fully consistent with contemporary transportation legislation—the airline regulatory system was modeled on the Motor Carrier Act of 1935, except that a new, independent regulatory body was created to administer airline regulation (motor carrier regulation was placed under the Interstate Commerce Commission). Secondly, the legislation eliminated the air mail contract system which was generally known to be defective and open to abuse. Congressional investigations had exposed scandals relating to the conduct of the

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<sup>1</sup> Civil Aeronautics Act of 1938, ch. 601, 52 Stat. 973, now succeeded by The Federal Aviation Act of 1958, 72 Stat. 731, *as amended*, § 101 *et seq.*, 49 U.S.C. § 1301 *et seq.* (1970).

Hoover Administration's Postmaster General, W. F. Brown, in engineering a series of mergers and consolidations and in circumventing competitive bidding. These revelations resulted in the suspension of domestic air mail contracts for a period in 1934 and created the popular impression that the contracts had been poorly administered by the Executive even though the promotional subsidies paid out had, since the 1920's, sustained and permitted the expansion of the airlines.

From the mid-1930's the airlines—the "Big Four"<sup>2</sup> which in 1938 held eighty-six percent of the domestic market measured by revenue passenger miles, and about a dozen much smaller contract carriers—pressed for legislation to create financial stability for themselves, and in so doing, to eliminate the contract system.

Carrier stability was in fact the central theme of the Civil Aeronautics Act of 1938, which was enacted from a draft prepared jointly by industry and government representatives. It was argued by the proponents, and accepted by the Congress, that preserving the financial integrity and security of the existing airlines was desirable as a matter of *public* policy in order for the country to obtain safe and regular airline services with modern aircraft.

The statute provided for a regime of regulatory control over entry, exit, price, subsidy, and intercarrier relationships. The most important feature of the new law *at the time of its enactment* was the "grandfather" provision under which existing contract carriers received permanent licenses—"certificates of public convenience and necessity"—automatically. By making subsidy payable only to certificate holders, the uncertainties of the contract system were eliminated: subsidy was statutorily converted into a system of sole source supply on the basis of system "need" remunerations, including a return on investment factor. Of small significance in 1938 were the commercial rate provisions, given that rates were lower than they would otherwise have been in the absence of subsidy.

The feature of the law that clearly had the greatest *potential* importance (looking toward the time when the airlines would no longer require subsidy)—and was fully recognized as such by the airlines and in some Congressional testimony—was entry control.<sup>3</sup>

<sup>2</sup> American, Eastern, TWA and United, the predecessors of which were created in 1930 on the initiative of Postmaster General Brown.

<sup>3</sup> Moreover, it is probably accurate to say that the entry control provisions

The draft bill provided that the CAB could not authorize additional carriers to operate over routes already authorized to receive certificated service. Although this was rejected, the law as enacted, and still in force, provides that new entry, including the extension of existing carriers into additional city-pair markets, is subject to CAB control requiring that the financial stability of incumbent carriers (as well as existing carriers as new entrants in city-pair markets) be taken into account under procedures mandating administrative hearings on carrier applications. The economic implications of entry control are at the heart of the present debate over regulatory reform, as the articles in this issue demonstrate.

Although there has been extensive new entry in specialist and peripheral areas of air transportation, new scheduled passenger carriers in major interstate markets have been limited to the local service carriers, now numbering nine. These serve about eight percent of the domestic 48-state market; about half is operated in competition with trunk carriers.

The chart on the following page shows the growth of the 48-state domestic passenger market from 1938 to 1975 together with the market shares of the carriers.<sup>4</sup>

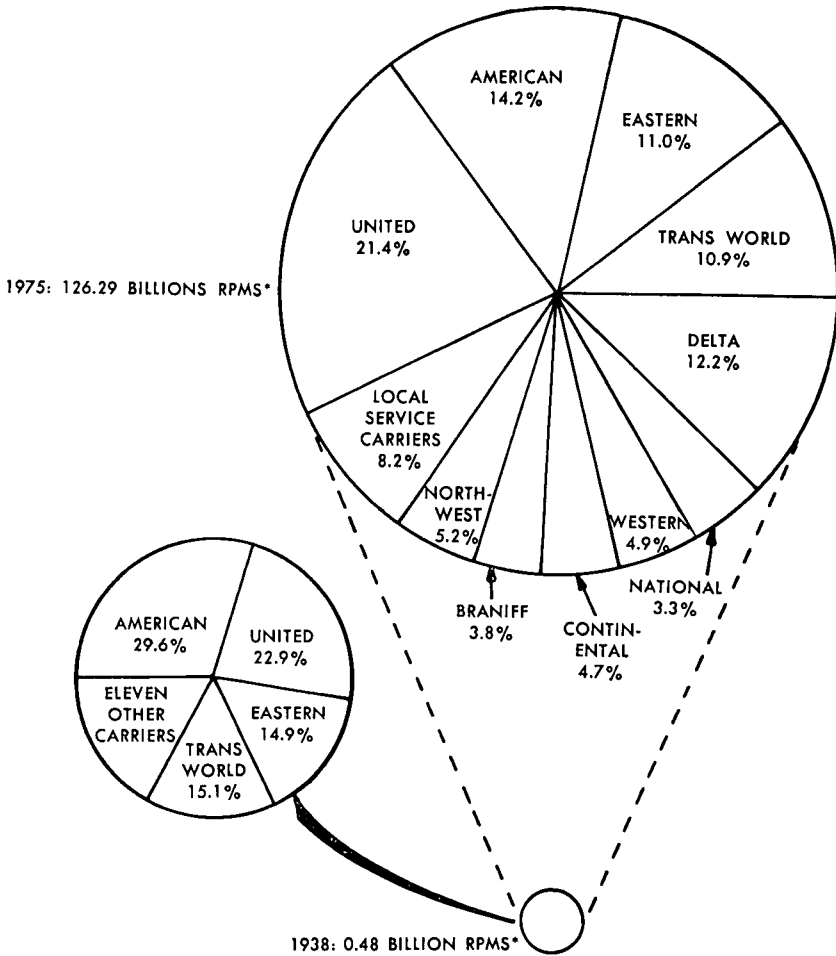
The fact that the present regime of economic regulation has remained intact since 1938 suggests that, in general, the public and the Congress have been satisfied with the performance of the industry under regulation and, therefore, with the regulatory regime itself. Why, then, should the criticisms that academic economists have been making for more than twenty years and government economists since the early 1960's suddenly become popular issues, and why should the Administration be proposing drastic changes in the law? The basic reason appears to be that the end of the great post-World War II boom, and the recent recession, compounded by the negative impact on income resulting from petroleum price increases, have made the public sensitive to claims of the adverse impact of eco-

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required the adoption of rate regulation and exit control. These were, in effect, trade-offs to compensate for the elimination of market pressures resulting from the threat of new entry in all markets at all times.

<sup>4</sup> Economically unregulated interstate commuter carriers, which number over 100 and serve about 150 points exclusively with aircraft limited to thirty or fewer seats, about 0.5% of the domestic market in terms of RPM, are not included.

REVENUE PASSENGER-MILES IN  
SCHEDULED DOMESTIC SERVICE, 1938 AND 1975<sup>1</sup>  
(CIRCLE AREAS ARE PROPORTIONAL TO RPMS)



\* EXCLUDES HELICOPTERS, INTRA-ALASKA & INTRA-HAWAII CARRIERS AND PAN AM.

\*\* 1975 NOT ADJUSTED FOR STRIKES AT NATIONAL AND NORTHWEST.  
1/12 MONTHS ENDING SEPTEMBER 30, 1975

conomic regulation on consumer prices. Put another way, the impact of government regulation on the allocation of resources, on how the pie is sliced, becomes a matter of intensified public concern when the overall economy, the pie, is not expanding. A second factor, although far from fully understood, is the maturation of the

generation born during and in the decade after World War II. This group, by education and upbringing in a time of prosperity, is skeptical of government protectionism, and is likely to call for changes in any government policy which does not maximize opportunity, including regulatory regimes that seem to favor the *status quo* in industrial organization.

Congress will primarily focus on the Administration's proposed Aviation Act of 1975 which would considerably loosen entry control. Based on comments received by the CAB, it is clear that the airlines and most allied interests will oppose the legislation and favor the *status quo*, more or less.<sup>5</sup> The latter—airline labor, large banks and insurance companies holding outstanding airline debt, airline equity investors, and airport operators—constitute formidable forces which may be expected to assert their position with vigor.

The arguments advanced by the airlines and allied interests will be of two sorts: *first*, that the present regulatory framework is financially beneficial to them (or that total or substantial abandonment of the present framework would be financially harmful); and, *secondly*, that there are *public* reasons—relating to the level, quality and stability of service, safety, industry concentration, etc.—for adhering to the present regime.<sup>6</sup> As evidenced by the articles in this issue, it is likely that the *public* reasons will obscure the private reasons for favoring regulation. Clearly, the Congress will wish to gain as much insight as possible into the actual private financial benefits deriving from regulation.<sup>7</sup>

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<sup>5</sup> It is likely that the airlines will propose some change to the rate provisions under the current law as well as suggest procedural reforms.

<sup>6</sup> This issue contains several articles by airline representatives which set forth the private and public bases for the airline economic regulation, and particularly entry control; these probably cover many of the arguments that will be advanced by the allied interests above enumerated. Representatives of the latter interests declined invitations to contribute to the issue.

<sup>7</sup> For example, if wages are higher or output per unit of labor expense is lower than would be the case in the absence of regulation, the government is, in effect, allocating resources from airline ratepayers and, to the extent subsidy is involved, the general taxpayer, to airline employees. Similarly, governmental protection may have given the carriers an undue advantage in obtaining long-term fixed interest financing. If the certificate right has been regarded by prospective lenders as a form of government guarantee of the loan, interest rates for the airlines may be lower than they would otherwise be, in which event the government has been, in effect, intervening in the capital market to the detriment of all other borrowers.

These private benefits, however, do not represent net gains from the point of view of the entire economic community; rather, they represent *transfers* among various constituent groups which may well involve a net loss to the economy as a whole. The public policy question is whether there are identifiable *public* benefits justifying regulation, and whether such benefits could be achieved more efficiently, from the point of view of the economy as a whole, by other means.

Whether the air carriers and allied interests will remain basically committed to the *status quo* will depend on the degree to which the perceived private benefits of regulation continue. The economy is dynamic in character, and regulatory policies are not static; hence, the impact of external forces on the industry, and the influence of such forces on regulatory policy, will determine the extent to which solidarity will continue between the enumerated interests, and among the components of each group. For example, some airlines may conclude that entry control is not worth very tight, public utility-type rate regulation and, therefore, favor deregulation (United may well take this position). Similarly, support for the regulatory regime will be diminished to the extent that external factors reduce the perceived value of the certificates now held by the carriers. There are reasons to believe that the value of the license is, in fact, declining at the present time and will continue to do so.<sup>8</sup> Nevertheless, today only the supplemental (*i.e.*, charter only) carriers support

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<sup>8</sup> Principal among these reasons is the fact that the larger carriers experiencing financial difficulties have not been able to achieve merger agreements with other carriers. Historically, the acquiring carrier in a merger pays the monopoly value of the license of the acquired carrier to the equity holders and labor, and takes on or discharges long-term debt. Today, however, it would appear that the high, immediate cash costs of the labor protective arrangements affecting the larger carriers as well as other adverse factors have precluded the negotiation of a financially satisfactory merger agreement between a financially distressed larger carrier and another carrier. In effect, this has forced the senior lenders to choose between extending debt payments and forcing a sale to outside interests, with the monopoly value of the license heavily discounted, or forcing bankruptcy. Another factor that will affect the value of the license is the expansion of domestic charter transportation under liberalized charter rules. In effect, the existing supplemental carriers, which number eight, have been accorded significantly improved access to the domestic discretionary travel market. The impact of these changes has not yet been felt by the domestic scheduled carriers. But it is clear that charter travel is about to grow significantly and that the scheduled carriers will be forced to compete in price to retain discretionary travelers, who constitute almost fifty percent of the total travel market and are likely to grow more rapidly than business travel in the years ahead.

the Administration bill which, if implemented, would further significantly reduce the monopoly value of existing scheduled licenses.<sup>9</sup>

Obviously the Congress has before it a formidable assignment. Based on the time required in the 1930's to formulate a completely new regulatory regime, it is likely that a legislative consensus of a significantly different system of regulation will not be forthcoming this year, and may take several years to develop. This is not to say, however, that the Congress could not modify the present statute consistent with the preservation of protective entry control and its purpose of preserving the financial integrity of existing airlines. Suggestions for change are coming from many sources, and several are proposed in this issue of the *Journal*.

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<sup>9</sup> Apparently they regard the provisions allowing them access to the scheduled transportation market as sufficient to justify general support. On the other hand, it is important to note that the bill would not allow open entry for new supplemental carriers, but would continue to require that entry be based on "public convenience and necessity" findings.



