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An Introducton to Regulatory Reform for Air Transportation

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AN INTRODUCTION TO REGULATORY REFORM FOR AIR TRANSPORTATION

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TO SUPPLEMENT the in-depth presentations which may be expected from the distinguished group of experts contributing to this symposium, the following article is intended to furnish basic background information on the current system of regulation of air transportation, on the causes of dissatisfaction with that system, and on proposals for change.[1]

I. WHAT IS THE EXISTING SYSTEM OF ECONOMIC REGULATION OF AIR CARRIERS?

Air carriers are now regulated as a public utility, needing authorization from the Civil Aeronautics Board (the CAB) for many decisions affecting the service they provide and the rates they charge.

A. *Service*

Before air carriers can provide service between two cities, they must be authorized to do so by a certificate of public convenience and necessity awarded by the Civil Aeronautics Board.

There are two important limitations on the CAB's regulation of service by air carriers. First, the Federal Aviation Act (the Act) prohibits the Board from regulating the schedules of air carriers or the equipment which they utilize.[2] The only exception to this prohibition is that the Board may take appropriate action to require a carrier to comply with its statutory duty to provide "adequate"

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[1] The views expressed in this article are those of the author only and should not be attributed to the Committee on Public Works and Transportation, U.S. House of Representatives, to which the author is Assistant Counsel.

[2] Federal Aviation Act of 1958, 72 Stat. 731, *as amended*, § 401(e)(4), 49 U.S.C. § 1371(e) (1970).

service.[3] In the past, the Board has used this power sparingly.

Secondly, the form in which the Board issues certificates gives the carriers a great deal of freedom to choose the markets they will serve. Certificates consist of a series of route segments, each of which includes two or more cities. Unless otherwise restricted from doing so, carriers are free to provide non-stop service between any two cities on the same segment. Service between cities on different segments may be provided via any junction point common to the two segments. Under these certificates, carriers have freedom to provide service in hundreds of markets. It would obviously be impractical for carriers to provide non-stop service in all of these markets and there is no legal requirement that they do so.

There are two often-noted features of the Board's administration of its regulatory powers over air carrier service. First, since it was established in 1938, the Board has not authorized any new trunk-line carriers. Secondly, the Board has been liberal in authorizing competing carriers in major markets, and in virtually all substantial markets, two or more carriers now provide service.

B. *Rates*

The Act establishes elaborate procedures for the regulation of air carrier rates. In recent years, the Board has exercised these powers to require that basic fares (coach and first class) be set according to a formula in which the fares for a carrier's entire system will be related to the mileage between cities. Under this regulatory scheme, a carrier cannot change a fare for a single market without changing fares over its entire system, so as to preserve the cost-mileage relationship.

The fare formula developed by the Board has several important features. The cost levels used to establish fares are averages for the industry.[4] It is assumed that carriers will operate with fifty-five percent of their seats filled and the fares are set at a level which should permit a carrier to realize approximately a twelve percent rate of return if it operates at the hypothetical fifty-five percent load factor.

The Board's policy on discount fares (*e.g.* no-frills fares, bicen-

[3] Federal Aviation Act of 1958, § 404(a), 49 U.S.C. § 1374(a) (1970).

[4] Under the formula, the cost per mile is lower for longer distances, creating a so-called "taper" in the fare creature.

tennial fares) is to allow those fares on a short term basis if it can be demonstrated that fares will generate revenues in excess of the added cost of carrying the passengers who will use the fares.

II. What Are the Economic Characteristics of the System Which the Board Has Established?

Service between major cities is now provided by ten trunkline carriers,[5] two or more of which are authorized to serve all major markets. These carriers dominate the domestic industry; in a recent year trunklines carried ninety-two percent of domestic scheduled revenue passenger miles.[6] Service in smaller markets is provided by nine regional carriers.[7] These carriers operate modern jet aircraft and are subject to the same regulatory scheme as trunklines, except that they receive subsidy for service to small communities.

The Board has also awarded certificates to several other classes of specialized carriers, including all-cargo carriers, Alaskan and Hawaiian carriers, and helicopter carriers. There are eight active supplemental carriers[8] which operate charters in which an organization or tour operator contracts for the entire capacity of an aircraft or a substantial fraction thereof. Supplementals have not been a major factor in domestic markets, arguably due to CAB-imposed restrictions which have limited the availability of charters.

Commuter carriers provide scheduled or charter service with aircraft of less than thirty seats or 7,500 pounds capacity. The Board has issued a special exemption leaving these carriers complete freedom to enter and exit from markets and to set their fares.[9]

Several aspects of economic performance are noteworthy:

—It is generally agreed that the industry has provided reliable service, with modern equipment, at fares as low or lower than are offered for scheduled service elsewhere in the world.

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[5] American, Braniff, Delta, Eastern, National, Northwest, Pan Am, TWA, United, and Western.

[6] Report of the Civil Aeronautics Board Special Staff, Regulatory Reform 53 (1975).

[7] Air New England, Allegheny, Frontier, Hughes Airwest, North Central, Ozark, Piedmont, Texas International, and Southern.

[8] Capitol, Evergreen, McCullough, Modern, ONA, Saturn, T.I.A., and World.

[9] 14 C.F.R. § 298 (1975).

Although, as has been pointed out, there is service by two or more certificated carriers in most major markets, there is little price competition between these carriers and all competitors generally offer the same fares. There is extensive service competition, however, and flights are frequently operated with a substantial number of empty seats. In recent years, the certificated carriers' load factors have been in the fifty to sixty percent range.

—The certificated carriers have not been highly profitable and have only rarely achieved the rate of return used as a target by the Board.

III. WHY HAVE THERE BEEN DEMANDS FOR CHANGES IN THE PRESENT SYSTEM OF REGULATION?

A number of developments have recently coalesced to produce a strong demand for reform of air carrier economic regulation.

A. *Economic Theory*

For many years, economists have pointed out that the present system of public-utility type regulation for air carriers is inconsistent with conventional economic theory.[10] In simple terms, economic theory holds that free competition is the system which leads to production at the lowest cost and to the optimum distribution of resources. The regulatory scheme for aviation departs from this theoretical model by restricting the freedom of air carriers to choose the service they will provide and the prices they will charge. Independent economists studying aviation have generally concluded that there are no unique characteristics of the aviation industry which would warrant a departure from the basic system of free competition.

Until recently, the economists urging deregulation have had limited impact on the policy makers and the general public. In the last few years a number of factors have brought the economists' views to the forefront.

B. *Example of Intra-State Carriers*

The public has become increasingly aware of the fact that intrastate carriers, operating under a less restrictive regulatory scheme

[10] *See* SPECIAL STAFF REPORT, *supra* note 6 at 7-13.

than CAB regulated carriers, have been able to offer service at lower fares. A prime example cited is Pacific Southwest Airlines (PSA) in California.

PSA has escaped CAB regulation because the CAB's jurisdiction does not extend to carriers which carry passengers whose journey is limited to points in a single state. For many years the state of California had a system of free entry for intra-state carriers. Under this regulatory scheme, a large number of airlines began providing service. Most of them failed, but the survivors, particularly PSA, were able to provide service at fares well below those charged by CAB regulated carriers in comparable markets.

C. *Higher Air Fares*

The public has become dissatisfied with recent increases in airline fares and this discontent has been translated into dissatisfaction with the regulatory system. The main causes of the recent fare increases have been general inflation and even greater inflation in the cost of aviation fuel. The increases have come at a time when air carriers were not realizing productivity increases comparable to those which accompanied the conversion from piston to jet equipment.

D. *CAB Policies*

A number of practices and policies followed by the CAB have led to public dissatisfaction with the agency and this has also been translated into demands for reform. In 1974 and 1975, widely-publicized congressional investigations revealed several instances of alleged misconduct by CAB officials.[11] The hearings also challenged aspects of CAB regulatory policy. One widely criticized policy was the so-called "route moratorium" in which the Board attempted to deal with the financial difficulties of the industry by not authorizing any new air service. Even if this policy was economically sound, the means by which the Board implemented it were questionable. The Board did not deny certificate application on their merits, but simply refused to set applications for hearings and delayed decisions in pending cases for years. These procedural

[11] *Hearings Before the Subcomm. on Administrative Practice and Procedure of the Senate Comm. on the Judiciary*, 94th Cong., 2d Sess. (1975); Investigations without hearings were conducted by the House Committee on Interstate and Foreign Commerce in 1974.

devices made it difficult for the Board's policies to be challenged in court. The adverse reaction to this policy was compounded by the Board's use of procedural devices to avoid dealing with the application of World Airways to provide transcontinental service at sharply reduced fares.

Another Board policy which was widely criticized was the approval of "capacity agreements" in which the airlines authorized to serve major markets were permitted to reach agreement on the amount of service they would provide. These agreements were objectionable to both supporters of free competition and supporters of complete government regulation, since the agreements eliminated competition, but left market decisions in private hands.

E. *General Anti-Government Feeling.*

To an undeterminable extent, the movement for regulatory reform in air transportation has been the beneficiary of general public dissatisfaction with government regulation, and particularly with the recent proliferation of health, safety, and economic regulations applicable to businesses. Ironically, in the case of aviation, the enterprises most directly affected, the air carriers, show no great enthusiasm for a lessening of regulation.

IV. What Are the Basic Arguments for and Against Deregulation?

There is a large gap between the views of the supporters of regulatory reform ("deregulators") and the opponents ("proregulators"). The disagreements extend to "facts" as well as policy.

A. *Arguments Supporting Deregulation.*

The deregulators start with the assumption that free competition leads to the best economic results. They find no persuasive reason why free competition would not work in aviation.

The deregulators believe that free competition in aviation would have the same benefits as it does in other industries. The threat of new competition would spur existing carriers to operate at maximum efficiency. New entrants and incumbents would be under constant pressure to reduce costs and to experiment with fare reductions and higher load factor-lower price service.

In support of their predictions of the benefits of free competi-

tion, deregulators cite experience with Pacific Southwest Airlines which, as discussed above, survived a free-entry system for intrastate transportation in California, and has been able to offer fares lower than those of interstate carriers serving the same or comparable markets.

The deregulators reject the contention of proregulators that free entry would lead to a poorer quality of air service. The deregullators do not agree that certificated carriers presently provide a substantial amount of unprofitable service which they cross-subsidize with more profitable routes. In any event, the deregulators point out that if there were a system of free competition, commuter carriers could provide service in any markets abandoned by certificated carriers, and commuters would be likely to do so if there were more than minimal demand.

The deregulators do not believe that liberalized entry would lead to predatory pricing and eventual survival of only a few carriers. They argue that airline management would not be irrational and operate at below-cost prices. Large carriers would not have a competitive advantage since in air transportation capital costs are relatively low (compared, for example, to automobile manufacturing), and there are no economic efficiencies to be realized from reaching a size beyond that of existing small trunk carriers (*e.g.*, Continental).

B. *Arguments Against Deregulation*

The proregulators start from the assumption that the present system is good, and that the burden is on those proposing change to establish that the change would not be for the worse. The proregulators point out that certificated carriers now provide a network of service linking 58,000 markets, at fare levels only twenty percent above those offered in 1948. The proregulators believe that a liberalized system of entry and exit would lead to a substantial reduction in the number of markets served and in the amount of service provided. The proregulators further believe that under free entry there would be desperate price cutting, leading to carrier failure. In the long run only a few carriers would be strong enough to survive in this environment, and they would, if anything, raise fares.

The proregulators also point out that the industry is presently in a weak financial condition due to heavy losses caused by economic

recession and rising fuel prices. Deregulation legislation would be the final blow. It would lead to a loss of confidence in the industry by banks, insurance companies, and individual investors.

The proregulators argue that PSA operates under special conditions favorable to low cost operations. They also note that the California system resulted in the bankruptcy of about fifteen carriers along with the success of PSA.

V. What Changes Would the Aviation Act of 1975 Make in the Existing Scheme?

The Administration's regulatory reform bill, the Aviation Act of 1975 (the Act of 1975),[12] would take major steps towards loosening CAB regulation of service and fares.[13] Under the Act, however, there would still be substantial regulation, and the resulting system would fall well short of full deregulation.

A. *Service*

(1) *Entry*

(a) *Existing Certificated Carriers*

The Act of 1975 grants substantially improved operating authority to existing carriers. By 1981 all certificated domestic scheduled carriers would be given unrestricted non-stop authority between all points named in their certificates.[14] The U.S. International carriers would receive non-stop authority between their domestic points.

Additionally, CAB certificated scheduled carriers, state certificated carriers operating in excess of 100 million annual available seat miles,[15] and CAB certificated cargo carriers would receive discretionary authority to enter new markets. The authority would be

[12] Introduced as H.R. 10364, 94th Cong., 1st Sess. (1975).

[13] In related areas, not discussed in the text, the Act would prohibit CAB approval of capacity agreements and agreements setting commissions for travel agents; impose new procedures for judicial review of air carrier mergers; broaden the types of charters which supplementals can operate; and require the CAB to decide within sixty days whether to dismiss an application or set it for hearing, and to issue a final decision in twelve months on applications set for hearing.

[14] As indicated above, at present carriers do not have non-stop authority between many of the points they are authorized to serve. Certificates impose specific restrictions on service in some markets, and other markets must be served via segment junction points. In many markets the number of stops required, and/or the circuity of the required routing make a carrier's authority non-competitive.

[15] This would include PSA, Southwest Airlines, and Air California.

five percent of average total operations for larger carriers and ten percent for smaller carriers. A carrier which used discretionary authority in a market for twelve months would be entitled to obtain certificate authority for the market.

(b) *New Carriers*

Under the Act of 1975, a carrier not presently holding a certificate could enter the industry in several ways. First, it could obtain a certificate from the Board by proving that the "public convenience and necessity" required the service it proposed, and that it was financially and operationally "fit" to provide the service. These tests are in the present law; under the Act of 1975, the public convenience and necessity test would be liberalized and the Board would find it more difficult to deny an application for the purpose of protecting incumbent carriers.

The foregoing procedures could also be used by a presently certificated scheduled carrier wishing to serve new markets, or by a supplemental carrier seeking scheduled authority.

In several situations the test for new entry would be more liberal. If the market an applicant proposed to serve was not receiving non-stop service, the applicant could obtain a certificate by meeting a fitness test only; there would be no requirement of demonstrating that the "public convenience and necessity" required the service. If a certificated carrier wished to sell its authority in a market to another carrier (certificated or new), the Board would be required to approve the transfer if it found the applicant "fit."

(c) *Commuter Carriers.*

Under the proposed Act commuter carriers would be authorized to provide service with aircraft of up to fifty-five seat capacity, free from regulation of service or fares. Under the present law the CAB has permitted commuters to provide scheduled or charter service with aircraft of up to thirty seat capacity.

(2) *Exit*

Under present law, carriers must obtain a certificate amendment from the Board before permanently abandoning service to a city. The Act of 1975 would continue the requirement of Board approval, but make the criteria for abandonment more precise.

Abandonment would be permitted if revenues (including sub-

sidy) were below fully allocated costs for one year,[16] or below direct costs for three months,[17] or if the applicant could demonstrate that replacement service would be provided. Service could not be abandoned if the federal, state, or local government wished to subsidize it.

B. *Pricing*

The Aviation Act of 1975 would limit the Board's powers to interfere with price competition. Whether such competition would actually take place would depend on the actions of individual carriers.

Under the present law, the Board establishes basic fares (*e.g.*, coach, first class) on the basis of average fully allocated costs for the industry. The Aviation Act of 1975 would require the Board to allow fares which were above the level of a carrier's "direct costs" (*i.e.*, the variable costs of operating a service not including overhead and fixed costs).[18] The Board would retain its present authority to disallow fares which exceed fully allocated costs.

The Act would also change the Board's powers to temporarily suspend proposed fare changes pending a hearing. The suspension power is critically important, and frequently a decision on suspension is the only Board action on a proposed fare change.

Under present law the Board has virtually complete discretion to suspend, and ordinarily does so if it believes that increases or decreases are not cost justified. The Act of 1975 would permit suspension only if the board found that a fare would be below direct costs or if the fare fell outside of an allowable range of increase or decrease. The allowable range of increase would be up to ten percent of the rate in effect one year prior to the proposed change. The allowable decrease would be up to twenty percent of the rate in effect on date of enactment, during the first year after enactment, and up to forty percent during the second year. After the

[16] Subject to a requirement of an additional year of service at the discretion of the Board.

[17] In the proposed act direct costs are defined as "the direct operating cost of providing a service to which a rate, fare, or charge applies and shall not include such items as general and administrative expenses; costs associated with the development of a new rate or service; and other fixed costs or costs which do not vary immediately and directly as a result of the service at issue."

[18] *Id.*

second year decreases could be suspended only if the fare was below direct costs.

VI. What Issues Are Raised by the Aviation Act of 1975?

The Act of 1975 raises the basic disagreements between the supporters and opponents of regulatory reform, discussed in section III above. Since the Act falls short of full deregulation, it also raises additional questions.

An extremely important feature of the Act is that in creating opportunities for new competition, existing certificated carriers are favored over carriers not now holding certificates.

The Act gives existing carriers unlimited authority between all cities they now serve. The benefits would be substantial; for example, National Airlines, which now has authority between major northeastern cities and major cities in Florida and between the Florida cities and the west coast would obtain non-stop authority between the northeast and west coasts including such markets as New York-Los Angeles, New York-San Francisco, Washington-Los Angeles, and Washington-San Francisco. The Act would also give incumbent carriers discretionary authority to expand their systems to new cities.

The rights which would be available to carriers not now certificated would be considerably more limited. Prospective new carriers would have the opportunity to purchase unused authority from incumbent carriers or to gain authority in markets not now receiving non-stop service. The latter authority, however, is unlikely to be available in important markets, and the purchase of replacement authority in a major market is likely to be expensive. The other alternative for prospective new carriers would be to persuade the CAB that the public convenience and necessity requires additional service in a market. This is likely to be difficult when a large number of incumbent carriers will have authority in every major market.

The Act's reliance on existing carriers to furnish the main thrust of new competition raises difficult questions. Can carriers which have survived because of their ability to operate effectively in a highly regulated environment develop the skills ordinarily associated with success in free competition? Success in a

regulated environment frequently depends on a carrier's skill in persuading a regulatory agency (and if necessary, the legislature) to grant needed new authorizations to the carrier, to approve desired fares, and to deny authority to potential competitors. Different skills are needed in the competitive environment in which a carrier and its competitors are free to institute major new service without anyone's permission and where there is no assurance that fares will cover all costs. It cannot be predicted with certainty that the presently certificated carriers would be able to operate as successful free competitors. Will these carriers be able to utilize intelligently the extensive freedom the Act will give them to adjust their route systems? Will they cut costs and experiment creatively with new fares and types of service? The issues go beyond the survival of existing carriers. If the Act is passed and the carriers do not operate competitively, the public will be deprived of the benefits associated with free competition.

A related question is whether the award of massive new authority to incumbent carriers would give them so much market power that newcomers would be unable to compete successfully. The Act would give existing certificated carriers substantial authority to redesign their route systems. This will help them to overcome disadvantages in the existing systems which were developed from grandfather rights in 1938, supplemented by piecemeal CAB decisions. As might be expected, each carrier's present route system has problems which limit its profitability. Some systems are seasonally imbalanced. Some make it difficult to obtain maximum utilization of aircraft. Some rely too heavily on smaller markets. Many of these difficulties can be corrected under the Act of 1975, and there is a need for a full exploration of whether the realigned route systems will give the incumbents insurmountable advantages over new entrants.

Another question raised by the Act of 1975 is whether the "deregulation" permitted is skewed against the industry. The Act appears to remove more restrictions on entry into new markets than it does on exit from existing markets. The Act also limits the CAB's power to suspend fare increases more than the CAB's power to suspend fare decreases. It must be carefuly determined whether the differing approaches to entry and exit, and to fare

increases and decreases, are equitable, and whether they will permit a system of workable competition.

CONCLUSION

Even from a simplified summary it should be apparent that regulatory reform is a complex subject, and that any changes in the regulatory scheme could have major, and perhaps unanticipated, consequences. Although the issues of reform have been extensively debated over the past year, there is a need for further intensive study, particularly of specific legislative proposals such as the Aviation Act of 1975. The symposium of the *Journal of Air Law and Commerce* should be an important step in his direction.