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ALTERNATIVES TO REGULATION: COMPETITION IN AIR TRANSPORTATION AND THE AVIATION ACT OF 1975*

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In a world of half-measures, complicated compromises, and political "realities" created by fervent repetition of untruths, the proposed Aviation Act of 1975 may represent as much progress (or more) as can be achieved in dissolving the costly cryptocartel embodied in the Federal Aviation Act of 1958. But the proposed act demonstrates once more the historical fact that once the government intervenes in markets to serve producer interests at consumer expense, these interventions become almost impossible to eradicate. To understand and evaluate the Ford Administration proposal, it may help first to imagine briefly the legislation as it would look if it reflected only the current state of knowledge about air transport regulation and remained unsullied by the necessity to accommodate a political process in which existing air carriers are considerably better represented than their customers or potential competitors. We can then lay this template against the proposed act and assess its strengths and shortfalls for some particular technical difficulties in the legislation as introduced¹ last fall.

An extraterrestrial visitor looking at the problem of airline regulation in America would almost certainly be confused. He would find that air transport in America, as in most of the rest of the world, is a very heavily regulated industry. He would discover that regulation had inexorably increased in stringency since 1934, both in terms of types of transportation covered (first mail, then scheduled passenger and cargo, then unscheduled service and military

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¹ S. 2551, 94th Cong., 1st Sess. (Introduced October 22, 1975). The bill has been reproduced in its entirety in this issue, beginning at page 581.

charters) and as to jurisdictional reach (California did not control entry for intrastate services until 1965). From this, our observer would no doubt conclude that a powerful rationale and a long history of efficient operation justified these institutional arrangements.

However, if our visitor then sought to learn for himself this theory and history and headed for the library to do so, he might well be bemused to find that an intensifying barrage of academic criticism has accompanied the growth of domestic airline regulation from its infancy and that answering fire from disinterested quarters has long since ceased to be heard.² He might initially be inclined to dismiss these academics as impractical theorists. An examination of this literature, however, would disclose that while it was necessarily theoretical at first, since 1962 an impressive body of empirical work³ has buttressed conclusions that airline regulation was both unnecessary and costly. Our observer might also infer support for the conclusion that airline regulation was of principal benefit to those participating in the process from the fact that virtually all recent defenses of the institution have come from certificated airlines, their trade associations, and the Civil Aeronautics Board. Indeed, even a special CAB staff, freed of the necessity to defend its Congressional mandate or the Board's past and present policies, was unable to find a convincing case for entry and rate regulation.⁴

² The principal efforts in defense of entry and price regulation are F.W. GILL & G.L. BATES, *AIRLINE COMPETITION* (1949); Bluestone, *The Problem of Competition Among Domestic Trunk Carriers, Part I*, 20 J. AIR L. & COM. 379, *Part II*, 21 J. AIR L. & COM. 50 (1954); P.W. CHERINGTON, *AIRLINE PRICE POLICY* (1958); S.B. RICHMOND, *REGULATION AND COMPETITION IN AIR TRANSPORTATION* (1961), and WHEATCROFT, *AIR TRANSPORT POLICY* (1964). Lucille Keyes' pioneering work, especially *FEDERAL CONTROL OF ENTRY INTO AIR TRANSPORTATION* (1951), and virtually all the academic literature since R.E. CAVES, *AIR TRANSPORT AND ITS REGULATORS* (1962) have attacked both the theoretical and empirical bases for advocating economic regulation of air transportation. See, e.g., Levine, *Is Regulation Necessary? California Air Transportation and National Regulatory Policy*, 74 YALE L. J. 1416 (1965); W.A. JORDAN, *AIRLINE REGULATION IN AMERICA* (1970); Keeler, *Airline Regulation and Market Performance*, 3 BELL J. OF ECON. AND MANAGEMENT SCI. 399 (1972); G.W. DOUGLAS & J.C. MILLER III, *ECONOMIC REGULATION OF DOMESTIC AIR TRANSPORT* (1974).

³ E.g., R.E. CAVES, G.W. DOUGLAS & J.C. MILLER III, W.A. JORDAN, T.E. KEELER, Levine *supra* note 2; U.S. CIVIL AERONAUTICS BOARD, *TRAFFIC, FARES AND COMPETITION*, LOS ANGELES - SAN FRANCISCO AIR TRAVEL CORRIDOR (1965); U.S. CIVIL AERONAUTICS BOARD, *REPORT OF THE C.A.B. SPECIAL STAFF ON REGULATORY REFORM* (1975) [hereinafter cited as *REGULATORY REFORM*].

⁴ *REGULATORY REFORM*, esp. 291-307.

What the literature demonstrates is that air transportation regulation in the United States has produced:

1) High fares, by one estimate⁵ thirty to fifty-six percent⁶ higher than would prevail without regulation.

2) Excess capacity, with aircraft operated using only two-thirds of their designed seating capacity and with only half of those seats occupied.⁷ This excess capacity lowers labor productivity, wastes resources, and greatly increases the fuel burned per revenue passenger mile.

3) A limited range of service options, requiring passengers to pay for more frequent service in roomier seats at lower occupancy levels than many would prefer, given a choice; a higher level of service amenity than many passengers would pay for; less low-fare off-peak service than would be offered in an unregulated market, resulting in less efficient equipment use patterns and therefore in a higher cost to consumers of any given aggregate quantity of air transportation; less use of low-congestion satellite airports; and fewer experiments with no-reservation service and other options that sacrifice passenger convenience for minimum possible cost.

4) Suppression of new fare and service combinations that might be offered by firms not at present offering scheduled interstate serv-

⁵ Testimony of T.E. Keeler in the *Hearings on the Oversight of Civil Aeronautics Board Practices and Procedures Before the Subcomm. on Admin. Practice and Procedure of the Senate Committee on the Judiciary*, 94th Cong., 1st Sess. at 1304 (1975). [hereinafter cited as *C.A.B. Hearings*]. See also T.E. KEELER, *supra* note 2 at 416-17.

⁶ Keeler's figures are quite conservative in that they do not allow for the innovative effects of new entry, nor do they take into account the lower indirect costs per passenger possible on long hauls. As an example, Keeler calculates a New York-Los Angeles fare of \$126.70, compared to the then-existing fare of \$173.15. *C.A.B. Hearings* at Table 4. He allows for the effect of possible higher load factors on long-haul flights by adjusting this fare downward to \$114.30. *Id.* But World Airways has applied to fly this route for \$89.00.

⁷ The passenger load factor for domestic certificated carriers was 52.9% for the year ended August 31, 1975. U.S. CIVIL AERONAUTICS BOARD, AIR CARRIER TRAFFIC STATISTICS, at 4 (August, 1975). Typical seating configurations for some commonly used widebody aircraft, with maximum certificated capacity following in parentheses are: B-747, 362 (500); DC-10, 240 (380, 330 at equivalent seat pitch to the B-747 500-seat interior); L-1011, 250 (400, 330 at B-747 500-seat pitch). Data derived from *Operating and Cost Data 747, DC-10, and L-1011—Second Quarter, 1975*, AVIATION WEEK AND SPACE TECHNOLOGY, Sept. 22, 1975, at 36-37, and LOCKHEED-CALIFORNIA CO., COMPARATIVE WIDE-BODY AIRPLANE CHARACTERISTICS (1974).

ice. No new domestic trunkline has been certificated since the passage of the Civil Aeronautics Act of 1938, yet the most significant fare and service innovations since the passage of that Act—coach service and irregular (charter) service at 100% load factors—were pioneered by carriers other than domestic trunklines.

5) Larger air carriers than are necessary from an efficiency standpoint. Academic⁸ and CAB⁹ studies suggest that airline costs are independent of scale over a wide range of output, and crude data¹⁰ and some industry opinion¹¹ suggest that medium-sized carriers may even have an advantage over the largest carriers currently certificated.

The principal benefits received in return for these costs are:

1) Greater schedule frequency than would prevail in many markets without regulation, at least over the near term;¹² and

2) Minor service benefits to some smaller cities.¹³

Virtually all disinterested analysts have concluded that these benefits are not worth what they cost. Estimates of the annual cost of air transport regulation to the traveling public range from a very conservative and probably erroneous \$366-\$538 million for 1969¹⁴ to a more reasonable but still conservative \$1.0-\$2.0 billion for 1972.¹⁵ If one allowed for the possibility of managerial innovation

⁸ R.E. CAVES, *supra* note 2 at 56-64.

⁹ REGULATORY REFORM, 102-07.

¹⁰ U.S. CIVIL AERONAUTICS BOARD, INTERIM FINANCIAL REPORT at 4 (Sept., 1975).

¹¹ *C.A.B. Hearings* at 1233 (Testimony of Thomas D. Finney, Jr., Counsel, Continental Airlines).

¹² G.W. DOUGLAS & J.C. MILLER III, *supra* note 2, at 83-96.

¹³ But most such service is now directly subsidized or supplied by unregulated Part 298 carriers. REGULATORY REFORM, 195-203. The principal added service benefit to small or medium-sized communities as a result of regulation is probably increased non-stop service bypassing large hubs, made possible by uniformly high, distance-based regulated fares. Under competition, fares between large hubs would probably be low enough to attract connecting passengers from nearby smaller cities. If enough passengers preferred the less-dense, more direct service to pay the higher costs associated with it, it would be provided.

¹⁴ G.W. DOUGLAS & J.C. MILLER III, *supra* note 2 at 172.

¹⁵ T.E. Keeler, *Airline Regulation Revisited*, 1976 (unpublished manuscript). Even this estimate is conservative, in that it uses an elasticity coefficient of -1.2 in estimating welfare losses. While this may be a useful estimate for the response to relatively small price changes, evidence suggests that the response to larger price changes is probably much greater, probably larger than -2. *C.A.B. Hearings* at 1245. In addition, Keeler's model still does not fully allow for reductions in

from new entry and attempted to calculate the lost benefits to individuals priced out of the air travel market by present high fares, the figure would undoubtedly be even higher.

While there is no point in retelling already well-known stories,¹⁶ the histories of the Los Angeles-San Francisco and Texas intrastate markets provide convincing evidence of the costs of regulation. Those markets are intrastate, and the CAB lacks the power to suppress entry into them by new carriers.¹⁷ They are also provided with lower-cost, more flexibly priced air service than are CAB-regulated markets. In fact, service in these markets is provided at fares which in many cases are less than half the CAB-formula fare.¹⁸ Somewhat less well known is the fact that the only major long-haul market which has received nonstop service from a non-grandfather¹⁹ carrier, New York-San Juan, Puerto Rico, also experienced a dramatic fare reduction.²⁰ And the intense price competition in these markets has produced a relatively simple fare structure primarily differentiated by traffic peaking characteristics, rather than a bewildering structure designed to keep basic fare levels high while using promotional fares with complex and inconvenient restrictions to attract passengers who will not travel at the high basic rates.

Another important piece of evidence concerning possible rate levels in an unregulated environment can be found in the history of the large irregular air carriers, who provided transcontinental service at fares well below CAB rates until they were finally prohibited from offering individually-ticketed service by the Board and the Congress.²¹ Competition from these carriers was almost

indirect costs through management innovations by new entrants and thus still does not predict the World Airways transcontinental fare. *Cf. supra* note 6.

¹⁶ Levine, W. JORDAN, U.S. CIVIL AERONAUTICS BOARD, *supra* note 3. C.A.B. Hearings at 1242-60 (Testimony of M. Lamar Muse, President, Southwest Airlines).

¹⁷ Levine, *supra* note 2 at 1430. For an extended discussion of the legal implications of the interstate-intrastate distinction, see Means & Chasnoff, *State Regulation of Air Transportation: The Texas Aeronautics Committee*, 53 TEXAS L. REV. 653 (1975).

¹⁸ See, e.g., OFFICIAL AIRLINE GUIDE, Feb. 1, 1976, at 483, 793.

¹⁹ A "grandfather" carrier is one of the carriers originally certificated under the Civil Aeronautics Act of 1938 by virtue of its then-existing operations.

²⁰ Levine, *supra* note 2 at 1426, n.29. See also REGULATORY REFORM at 51, n.1.

²¹ Large Irregular Carrier Investigation, 28 C.A.B. 224 (1959), and 76 Stat. 143 (1963).

certainly an important factor in the adoption of transcontinental coach fares by Board-certificated carriers.²²

While the Board certificated carriers²³ and the Board itself²⁴ would obviously differ in the conclusions they might draw from the analytical and evidentiary record on air transport regulation, our extraterrestrial observer might well come to the conclusion that the record overwhelmingly proves that economic regulation of the type embodied in the Federal Aviation Act of 1958 is totally unjustified. Given this conclusion, and *carte blanche* to modify the statute (we may perhaps presume that our extraterrestrial observer has been asked to make policy recommendations to his own hyperrational legislature), what changes in the Act would our observer suggest?

The general outlines are clear: CAB regulatory jurisdiction over interstate and overseas air transportation should simply be abolished, with the exception that a specialized antitrust jurisdiction concurrent with that of the Justice Department and Federal Trade Commission could be retained.²⁵ Regulation of foreign air transportation, a contracting function for subsidized air transportation, and a statistical service would also remain. Foreign air transportation must continue to be regulated only because the pervasive involvement of other governments in the economic activities of international carriers creates a need for coordinated strategic behavior to deal with their efforts. Contracting for subsidized services would replace certificated local service, Hawaiian, and Alaskan carriers, and whatever cross-subsidy is still provided by trunklines. Although statistical reporting is not without its costs, the statistical base provided by the reporting requirements of the Act has made the analysis that supports these recommendations possible, and on the supposition that future public policy analysis or antitrust inquiries will find a well-developed data base similarly indispensable, required reporting should be retained. In sum, the Board should have no economic power over any domestic carrier able to

²² See *Transcontinental Coach-Type Service Case*, 14 C.A.B. 720 (1951).

²³ See, e.g., *C.A.B. Hearings* at 99-140 (Testimony of Dr. George James, Air Transport Association of America), at 512-23 (Testimony of Mr. Malin, American Airlines), at 556-60, 629-36 (Testimony of Mr. DeVoursney, United Air Lines).

²⁴ See, e.g., *C.A.B. Hearings* at 498-503, 660-63 (Testimony of Mr. O'Melia, Acting Chairman, Civil Aeronautics Board).

²⁵ See text following note 32 *infra*.

get an operating certificate from the FAA (whose safety jurisdiction is *not* in issue here) and willing to operate in conformity to the reporting requirements and the antitrust laws.

More specifically, these amendments, deletions, and additions to the 1958 Act which the extraterrestrial observer would suggest might resemble the following:

§ 102 (policy statement) as it exists would be deleted. It would be replaced by a statement of purposes limited to:

a) the maintenance of open and competitive market where air service could be self-supporting;

b) the provision of subsidized air service procured through competitive bidding when required by isolation or other extraordinary circumstances creating a compelling public need;

c) the provision of air service responsive to the needs of the public and adapted to the present and future needs of the foreign commerce of the United States, including postal and foreign policy considerations, but with particular emphasis on the provision of a variety of efficient service, including low-cost service;

d) the collection and dissemination of sufficient data to accomplish purposes a) through c) and to provide adequate information to permit evaluation of the performance of the nation's air transportation system.

§ 401 (certification) would be deleted.

§ 402 would be replaced by a provision requiring a certificate (or permit) for any U.S. (or foreign) carrier wishing to provide service between the U.S. and a foreign state that required U.S. carriers to be certificated, licensed, or designated to serve it, or which discriminated in the provision of navigation or terminal services between its own carriers and U.S. carriers. All such certificates and permits would require the approval of the President. Air transportation between the U.S. and any foreign state that did not restrict access by U.S. carriers could be provided by U.S. carriers or carriers of the destination state without a certificate or permit. These provisions would provide an incentive to other nations to adopt a less restrictive regime for international air service by allowing their carriers unrestricted access to all but Fifth Freedom²⁶ traffic. This

²⁶ "Fifth Freedom" traffic is traffic moving between two states, neither of which is the home country of the carrier.

would include access to Sixth Freedom²⁷ traffic, but would preclude undue exploitation of traffic rights by unimportant destination states (thus limiting U.S. ability to deal with major transportation states) or the use of "flags of convenience" to provide unlimited Fifth Freedom service.

§ 403 (requiring adherence to published tariffs filed with the Board) would remain unmodified as to foreign transportation requiring a certificate or permit under § 402. For other air transportation, carriers would be required to publish and file tariffs showing fares at which they would be required to provide transportation, but deviations downward from these tariffs would be permitted. All advertised fares would have to be filed as part of the carrier's tariff. The purpose of these provisions is to prevent tariffs from serving their historic function as cartel-enforcement devices, but to preserve their value as consumer information. Downward movements in fares would be facilitated by encouraging erosion through discounting, while price-gouging of the uninformed would be made difficult.

§ 404 (duty to provide service and connections, prohibition of discrimination) would be amended to apply only to carriers required to have a certificate or permit under § 402. For all other air carriers holding themselves out to the public as common carriers, there would be substituted a duty to provide common carrier service at rates no higher than those contained in their tariffs. This would preserve the public's right to use common carriers but eliminate any impediments to variations in fares based on route density, airport used, services provided, time of day, or promotional efforts.

§ 405 (transportation of mail) would be supplanted by legislation empowering the Postal Service to contract with any person for the carriage of domestic or overseas mail by air. Foreign mail to destinations for which no § 402 certificate or permit was needed would be subject to existing foreign postal arrangements per § 405(e). Mail to and from foreign destinations for which a § 402 certificate or permit was required would be subject to the existing provisions of § 405. Provisions of § 405 inconsistent with

²⁷ "Sixth Freedom" traffic is traffic moving between two states, neither of which is the home country of the carrier, which moves via the home country as an intermediate point.

the abolition of certificates for domestic and overseas transportation would be repealed. The contract provisions would restore competition to the provision of domestic airmail service which has arguably been missing since 1930, and satisfy a long-standing request of the Postal Service. It would end the vestigial relationship by which the Board extracts above-cost rates from the Postal Service to aid air carriers.²⁸

§ 406 (fixing of mail rates) would apply only to foreign mail.

§ 407 (statistical reports and disclosure of ownership interests) would be retained for informational and antitrust purposes.

§ 408 (consolidation, merger, and acquisition of control) would be deleted. Anticompetitive combinations would be subject to the antitrust laws as they apply to industry in general.

§ 409 (interlocking ownership and management relationships) would be deleted. Relationships which threatened competition would be subject to the antitrust laws. § 409 is a product of the 1934 Senate investigation which uncovered a web of seemingly unhealthy relationships among the carriers, between the carriers and President Hoover's postmaster general, and between the infant airframe industry and the infant airline industry.²⁹ However justified special fears about such relationships might have been in the context of the industry as it existed in 1934, relationships between aeronautical firms in the industry of the present can be adequately handled through the antitrust laws.

§ 410 (approval of applications pursuant to a special loan program for local service carriers) would be repealed, since feeder service would be provided by open markets and adequate capital funds appear to be available to carriers now operating in that environment. Where subsidized service was purchased by contract, bidders would arrange their capital financing in the same manner as other suppliers of services to the government. The Government Guaranty of Equipment Loans Act³⁰ would be repealed.

§§ 411-414 (Antitrust and Antitrust Exemption provisions). These provisions would be replaced by an antitrust enforcement

²⁸ See a forthcoming article, Levine, *Regulating Airmail Transportation*, J. LAW & ECON. (Oct. 1975).

²⁹ See SENATE SPECIAL INVESTIGATION ON AIR MAIL AND OCEAN MAIL CONTRACTS, S. REP. NO. 254, 73rd Cong., 2d Sess. (1934).

³⁰ 71 Stat. 629 (1957), as amended, 49 U.S.C. § 1324 (1970).

scheme for the air transport industry. The substantive provisions would subject the industry to the Sherman and Clayton Acts³¹ and to the unfair competition and deceptive practices prohibitions of § 5 of the Federal Trade Commission Act.³² The enforcing agency could be the Board, sharing concurrent jurisdiction with the Department of Justice and the Federal Trade Commission,³³ or a special section could be set up in the Antitrust Division of the Department of Justice to oversee aviation. As long as concurrent jurisdiction allowed the other agencies to remedy any laxness on the part of the Board, it would be useful to retain a specialized body with jurisdiction to enforce all the antitrust laws as they apply to air transportation. Thus the antitrust sections of the new act should explicitly confirm the applicability of the Sherman, Clayton and FTC Acts to the aviation industry, explicitly confer concurrent jurisdiction, and perhaps explicitly prohibit as *per se* violations of the antitrust laws capacity reduction agreements, pooling agreements, and rate-fixing agreements.

§ 415 (empowering the Board to obtain information from air carriers) should be retained to enable the Board to carry out its antitrust and statistical functions.

§ 416 (b) (authority to exempt carriers from certification requirements) would be retained for use in foreign air transportation.

§ 417 (special operating authorizations) would be repealed, since the repeal of domestic certification would make it moot.

§ 1002 (d), (e), (g), (h), (i) (power to prescribe rates and establish through service) would be retained only for foreign air transportation to or between foreign states that regulated rates charged by U.S. carriers. Like the proposed § 402, this provision would provide an incentive for a foreign state to allow unrestricted rate competition on services involving that state and U.S. carriers.

§ 1003 (joint CAB-ICC ratemaking power) would be repealed as to domestic services.

Finally, a section would be added to the Act empowering the

³¹ 15 U.S.C. §§ 1-7, 12-27 (1970).

³² 16 U.S.C. § 5 (1970).

³³ This would require an amendment to § 5(a)(6) of the Federal Trade Commission Act deleting the language excepting air carriers subject to the Federal Aviation Act of 1958 from the Commission's jurisdiction.

Board to determine the need for and to contract with air carriers to provide subsidized service in markets where isolation or other compelling public need were found to require it. Arrangements along these general lines have been proposed by several analysts.³⁴ The standard proposed here to justify such service is fairly restrictive, due in part to a CAB staff study³⁵ which determined that unsubsidized service will generally be provided in markets that generate more than twenty-five passengers per day. This suggests that there should be relatively few instances in which subsidy is both necessary and justified. The advantages of the contract proposal have been extensively discussed elsewhere by its inventors. In essence, the advantages are that the need for subsidy can be precisely determined for each individual case, costs can be made explicit and minimized by competitive bidding, and the mechanism for subsidy is not dependent on the willingness or ability of any particular certificated carrier to serve the points involved. The proposal also frees the regulatory system from any need to protect a carrier's ability to generate excess revenues from passengers traveling in unregulated markets since no such funds will be needed for cross-subsidy.

I have presented the preceding sketch of a regulatory regime for domestic and overseas transportation that makes maximum use of competition not only for any intrinsic interest it may have as a "pure" alternative to the proposed Aviation Act of 1975 (the proposed act), but also because its rationale and desirable features provide a standard by which to judge the reforms proposed in the Administration Bill. Virtually all the advantages possessed by the proposed Act flow from its resemblance to the alternative proposed above, that is, from the *elimination* of regulation. Virtually all its defects stem either from failures to eliminate regulatory provisions whose effects are adverse to consumer interests or from doomed attempts to devise politically acceptable alternatives to known regulatory evils. In no respect is the proposed act superior to a system of unregulated domestic markets with antitrust enforcement and

³⁴ See Swaine, *A Proposal for the Control of Local Service Subsidies*, 31 J. AIR L. & COM. 181 (1965); G. EADS, *THE LOCAL SERVICE AIRLINE EXPERIMENT* (1972); C.A.B. BUREAU OF OPERATING RIGHTS, *SERVICE TO SMALL COMMUNITIES* (1972).

³⁵ C.A.B., BUREAU OF OPERATING RIGHTS, *supra* note 34.

contract subsidy. In a few important respects, it is much worse. It also contains a few technical ambiguities worth correcting.

Procedurally, for example, the proposed act is extremely well conceived. The proposed revisions reflect not only an excellent understanding of the Board's present use of procedure to affect substance but a subtle appreciation of the incentive structure of a bureaucratic agency. Take as an instance the time limit for decision on new entry, proposed as an amendment to § 401(c)(1).³⁶ The Board has repeatedly refused to set new entry applications for hearing, pleading the press of more important business in applying "priorities"³⁷ For hearing or deciding whether to "expedite" hearings on other route applications. Applications not expedited languish at the Board for three years, after which time they are dismissed as "stale."³⁸ This *Catch-22* procedure is particularly effective because the failure to make a decision to expedite is arguably not an action, and hence is extremely difficult to characterize as a final "order" subject to judicial review.³⁹ Since the Board has not set the matter for hearing, the applicant does not get a decision; since the Board has not *refused* to set it for hearing, arguably there can be no review. The Board disposed of World Airways' 1967 application to provide transcontinental service for \$79 in this way, ultimately dismissing it as stale.⁴⁰

The proposed act requires that the decision not to set an application for hearing be in the form of a dismissal on the merits, which is explicitly made a reviewable final order.⁴¹ More importantly, the "sanction" imposed on the Board by the proposed act for failure to dispose of an application on the merits within approximately one year is *granting of the application*.⁴² For an agency which has been unable for nearly forty years to find merit in a new trunkline application, this is truly "punishment" to fit the

³⁶ Proposed Aviation Act of 1975 § 5, *amending*, 401(c) of the existing act.

³⁷ 14 C.F.R. § 399.60 (1975).

³⁸ See REPORT OF THE C.A.B. ADVISORY COMMITTEE ON PROCEDURAL REFORM 1 (1975).

³⁹ Federal Aviation Act of 1958, § 1006, 49 U.S.C. § 1486 (1970); Administrative Procedure Act, 5 U.S.C. § 551(6) (1970).

⁴⁰ C.A.B. Hearings, at 537-38, 565 (Testimony of William A. Hardenstine, World Airways).

⁴¹ Proposed Aviation Act of 1975 § 5, *amending*, § 401(c) of the existing act.

⁴² *Id.*

"crime!" More seriously, imposing action rather than inaction as the consequence of delay is very likely to produce expedition by an agency whose justification for continued existence is to shape events in its industry.

The skepticism concerning the Board's motivational structure implicit in the proposed procedure is warranted not only by the Board's own past history of creative inaction, but by recent developments in the theory of bureaucratic behavior. It is now fairly clear that setting up an expert agency—allowing it to control entry, prices, and, directly or indirectly, technological or managerial innovation—and then telling the agency to do the best it can in promoting the public interest in its area of regulation, does not free high-minded commissioners from petty concerns of private interest, but rather encourages them to develop a utility calculus of their own. Commentators disagree on the question of just what is maximized in the behavior of commissioners so instructed, but they pretty much agree that general public welfare is not a leading element.⁴³

Of course, if one takes the view that restriction of entry cannot be justified in the public interest and is skeptical of the Board's willingness to allow it, the proposed legislation, for all its ingenuity, can at best only approximate the workings of an open market. At worst, if skepticism about the Board's motivation is justified, the legislation will simply force the Board to develop court-defensible rationales with which to deny entry on substantive grounds. Given the deference to agency expertise which has become a part of administrative law, such determinations, if supported by substantial evidence in the record of a proceeding, are virtually unreviewable.⁴⁴ Since even a finding which is "clearly erroneous" may be supported by substantial evidence,⁴⁵ an opponent of a finding made by an agency careful not to be arbitrary will find reversal difficult to accomplish. Since there will always be opponents to new entry, and since those opponents will always produce at least some data

⁴³ For an excellent survey of the literature on bureaucratic motivation and behavior, see R. Noll, *Government Administrative Behavior: A Multidisciplinary Survey*, Social Science Working Paper No. 62, Oct., 1974 (available from Division of Humanities and Social Sciences, California Institute of Technology, Pasadena, California).

⁴⁴ See K. DAVIS, *ADMINISTRATIVE LAW TEXT* § 29.02 (1972).

⁴⁵ *Id.* at 528.

and expert testimony to support their position, a Board inclined to curtail entry will virtually always be able to do so.

This highlights a general problem with the proposed act. It may correct, by explicit prohibition (as in § 12 of the new act which amends § 412 of the Federal Aviation Act by prohibiting capacity agreements, pooling, or agreements on agents' commissions) or by ingenious incentive design,⁴⁶ existing Board tendencies toward suppressing competition. But as long as the Board's existing power remains, and as long as it is inclined as it has been in the past, there is no reason to expect future decisions on questions other than those specifically addressed in the reform act to be much better than past ones. Indeed, given the history of creativity exhibited by the General Counsel's office in the past and the time to invent new stratagems, the new bill if enacted might produce less change than a cursory examination of its provisions would suggest.

The bill's drafters seem to have attempted to take this possibility into account. On rates, for example, the principal strategy is simply to reduce drastically over time the Board's discretionary authority in this area. By and large, the rate provisions of the proposed act⁴⁷ are excellent. To the extent that they work, they will produce an approximation of free market levels. But, again because the drafters apparently felt constrained to work within the framework of the existing legislation, some possibility exists that the rate provisions might not accomplish their intended purpose.

The bill retains the tariff mechanism. In oligopolistic markets, which will continue to exist under the partially constrained entry provisions of the proposed bill, tariffs reduce the opportunity of a firm to increase market share by offering discounts to some of its customers. Since announced price changes in such markets will elicit a response from rival firms, a firm contemplating offering a discount may, under some circumstances, tend to refrain from doing so if it expects response to be rapid. If it can offer the discount suddenly or gradually and quietly, it may experience temporary profit increases and an improvement in market share, some of which it hopes to keep even after the price level has been eroded to the dis-

⁴⁶ *E.g.*, the procedural deadlines contained in the proposed Aviation Act of 1975 § 5, amending, § 401(c) of the existing act, discussed in the text at notes 42-43 *supra*.

⁴⁷ Proposed Aviation Act of 1975 § 13, amending, § 1002 of the existing act.

counted level, as it will tend to be in the long run.⁴⁸ Many real-world markets do not move costlessly and instantaneously, but rather in a series of price experiments, some open and some covert. Tariffs require that a firm announce in advance the amount and applicability of proposed price reductions. The notice provisions ensure that rivals will have adequate time to respond. In addition, tariffs reduce the risk to the firm of raising prices, since the advance notice provisions ensure that a firm will be able to gauge the response of its rivals before the increases actually go into effect. Indeed, iterative tariff filings can be a kind of "negotiation" between rival firms.⁴⁹ It is no accident that when railroad cartels failed to "stabilize" rates because of the common-law unenforceability of their price-fixing agreements, the carriers turned to the device of tariffs enforced by a government regulatory agency to accomplish the job.⁵⁰

A minor problem with the provision of proposed § 1002(d), which allows the Board to require that fares be equal to direct operating cost, stems from the fact that certain flight segments are operated to position equipment for another segment or as a means of serving more than one city on a long-haul flight. If a carrier flies from Portland to Seattle as part of a flight continuing on to New York, it may well be efficient to permit the carrier to charge very low fares to attract "fill-up" traffic between Portland and Seattle. The principal reason for operating the Portland-Seattle leg is to serve Portland-New York traffic. The carrier can be relied on not to operate flights primarily for traffic that does not cover direct operating costs, but both the carrier and the public are better off if some traffic can be attracted to fill empty seats on a positioning leg or trip extension which would operate anyway.

A more important problem with the proposed legislation is that its entry provisions are insufficiently liberal. While any move toward freer entry will almost certainly improve things, and while the proposed bill greatly liberalizes restrictions on entry into new markets over time by existing carriers, the legislation is seriously deficient in its failure to provide a more realistic prospect of new

⁴⁸ Stigler, *A Theory of Oligopoly*, 73 J. POL. ECON., 44-61 (1965).

⁴⁹ See, e.g., *C.A.B. Hearings* at 1155, 1225-26.

⁵⁰ P. MACAVOY, *THE ECONOMIC EFFECTS OF REGULATION*, esp. Ch. 5, 6 (1965).

entry by carriers not currently in business. This has important implications not only for new service proposals but for the prospect of lower fares through competition.

There are three principal classes of benefits from new airline entry:

- 1) provision of new capacity in markets not now served or insufficiently served;
- 2) lowering of fares in existing markets as a result of increased competition; and
- 3) innovation, either in the form of identification of new price/quality options, new marketing ideas to expand travel markets (the inclusive tour is an example of this), or managerial or technical innovation to lower costs (in particular, indirect costs of management and operation).

The proposed legislation should certainly help bring about new service in city-pair markets not now receiving nonstop service. Section 6(b) of the proposed act amends § 401 of the existing act to provide for issuance of a certificate without reference to public interest, convenience, and necessity to any fit, willing, and able applicant offering to provide nonstop service in a market not receiving such service from a certificated carrier. This should certainly have the effect of encouraging existing carriers to offer at least five roundtrips per week⁵¹ in any market which they are authorized to serve nonstop and which they think can support such service over the long run. Indeed, such service might be offered prematurely to prevent a new carrier from gaining a certificate toe-hold which could be used as the basis for additional new service under the expansion provisions contained in § 9 of the proposed act. The possibility of route expansion by another certificated carrier should also provide incentives for increased service in markets now receiving some, but insufficient, nonstop service. And the removal of certificate restrictions contained in § 9 of the proposed act should provide still more potential nonstop authority.

There is one interesting problem for would-be new entrants, however. Since the bill is ambiguous with respect to the point in time at which the existence of service is to be determined for the

⁵¹ The proposed Aviation Act of 1975 § 9 containing the definition of "scheduled service", adding § 401(r) to the existing act.

purposes of certificating a new carrier, even this limited provision for new entry could be circumvented by the Board if it decided that service initiated *after* application by the new carrier but before completion of a hearing on its fitness, willingness, and ability negated the applicability of § 6(b) of the proposed act. Under such an interpretation, an existing carrier could squelch a new entrant simply by initiating service after the new application was filed, an outcome which should make new applications very unrewarding, and hence rare. The likelihood of such an interpretation by the Board is speculation, but a skeptical observer would not be reassured by the restrictive construction the Board recently put on § 401(d)(3) in dismissing World Airways' application for transcontinental low-fare service authority.⁵³

Whether the legislation will bring about lower fares in existing markets depends upon the predicted nature of new entry under the expansion⁵³ and certificate reorganization⁵⁴ provisions. These provisions limit most new entry to existing trunklines and local service carriers who are members of the certificated "club." It is entirely possible that years of accommodation to the regulated environment and mutual recognition of interdependence have produced a situation in which entry would occur largely without new price competition, much as it does now when the Board adds a certificated carrier to a market. Whether adding a few intrastate carriers (which now operate in rate-regulated environments) to the list of eligible competitors or changing from introducing new competitors into a market one at a time to the simultaneous multiple eligibility made possible by the bill would replace existing capacity competition with aggressive fare competition is difficult to predict. If vigorous fare competition followed from route expansion, many of the benefits of free competition would have been achieved by the proposed legislation.

There is historical cause for concern that liberalized fare competition without free entry by new firms will not produce competitive price and output conditions. The major examples—California, Texas, New York-San Juan transcontinental coach service—of vig-

⁵² C.A.B. Order No. 76-1-88 (Jan. 23, 1976).

⁵³ Proposed Aviation Act of 1975 § 9.

⁵⁴ *Id.* at § 6(c), *amending*, § 401(e)(1) of the existing act, and § 9, *adding*, § 401(o)(1) to the existing act.

orous fare competition and new price/quality options have occurred when, due to lack of entry controls or a regulatory agency receptive to entry, new firms not already operating in the Board-controlled environment have entered the market. Indeed, in the California and Puerto Rico examples, statutory authority for fare regulation existed and was occasionally exercised.⁵⁵ This suggests the seemingly paradoxical possibility that ease of entry is more important as a factor in fare competition than rate freedom. If this is true, it may be because air transportation is a relatively non-product-differentiated service, so that price competition is the principal means available to a new entrant trying to establish itself in the marketplace. Lack of interdependencies with existing firms operating in other markets may also be a factor. And an agency faced with repeated low-fare proposals by applicants may find it difficult to refuse new entry (although the Board's treatment of the large irregular air carriers and World Airways suggests caution in accepting the last explanation).

This brings us to the last benefit to be achieved from freer entry, namely increased management innovation. In this respect, we must take seriously the possibility that new firms not now adapted to the regulatory environment may be the single most important source of new managerial and marketing ideas. Since aircraft operating costs are limited by technology and tend to be relatively similar from carrier to carrier operating the same type, the principal opportunities for innovation available are probably in the areas of control of direct labor costs, indirect costs and imaginative marketing. PSA's and Southwest's operating efficiency have often been noted⁵⁶ and are difficult to explain in terms unrelated to their operational specialization due to lack of a prior regulated history.⁵⁷ Many of the most significant marketing innovations of the postwar era—the Laker Airways Skytrain proposal, Southwest Airlines' peak/off-peak price structure, transcontinental coach service, and Trans Ca-

⁵⁵ For an example in California, see Levine, *supra* note 2 at 1430, n.60. In the New York-San Juan market, of course, the CAB has full regulatory jurisdiction over rates.

⁵⁶ See, e.g., *C.A.B. Hearings* at 480 (Testimony of W. A. Jordan), 1244 (Testimony of M. Lamar Muse).

⁵⁷ Not for lack of effort along those lines by CAB-certificated carriers. See, e.g., Levine, *supra* note 2 at 1442-43; *C.A.B. Hearings*, 587-600 (Testimony of James L. Mitchell, Continental Airlines).

ribbean Airways' very-high-density thrift service—have been introduced by “outsiders” trying to break into a market. While it is possible that the existing regulated firms who would be the principal source of new entry under the proposed act would find themselves forced to innovate by increased competition among themselves, it does seem odd and unfortunate that the proposed act provides far more flexible pricing freedom than entry freedom. If the drafters felt the political environment permitted them to choose only one degree of freedom in deregulating air transportation, there is reason to believe that they should have focused their primary efforts on entry by completely new carriers.

Assuming the Board must be retained in the form contemplated by the proposed act, the antitrust provisions of §§ 11-13⁵⁸ are a major improvement over the present arrangements, although they do not involve quite as comprehensive an overhaul as I proposed earlier in this article.⁵⁹ The principal antitrust defect of the proposed act lies in its adoption of the liberalized Clayton Act standards adopted for banks in the 1966 Banking Act amendments.⁶⁰ As proposed, this would permit the Board to approve a consolidation, merger, purchase, lease, operating contract, or acquisition:

[W]hose effect in any section of the country may be substantially to lessen competition, or tend to create a monopoly, or which in any other manner would be in restraint of trade . . . [if] *the Board finds that the anticompetitive effects of the proposed transaction are outweighed in the public interest by the probable effect of the transaction in meeting the transportation convenience and needs of the community or communities to be served*, and unless it finds that such transportation convenience and needs may not be satisfied by any less anti-competitive alternative (emphasis added).⁶¹

While such flexibility may be desirable in the abstract, its inclusion here represents another example of a general tendency, al-

⁵⁸ Proposed Aviation Act of 1975 §§ 11-13, *amending*, §§ 408, 412, and 414 of the existing act.

⁵⁹ See text accompanying notes 31-33 *supra*.

⁶⁰ 12 U.S.C. § 1828 (1970).

⁶¹ Proposed Aviation Act of 1975 § 11(b)(2), *amending*, § 408(b) of the existing act.

ready noted,⁶² of this legislation to correct specific past problems in the Board's administration of the Federal Aviation Act while leaving the Board with the power to recreate an anticompetitive regime through specific decisions. Since the Board has already interpreted the existing act in more anticompetitive terms than most scholars think is required by its language (for example, the act did not require the Board to refuse all new trunkline entry or to eliminate proposed new competition by delay), it is difficult to see why the Board should be given any more opportunity than absolutely necessary to interpret and administer the new statute in a manner contrary to its intent.

An additional minor antitrust problem arises from the exemption of agreements allocating landing "slots" among carriers operating into high traffic airports from the prohibitions of pooling or capacity agreements contained in the proposed amendments to § 412 of the existing act.⁶³ Since these agreements can easily be used as a vehicle for tacit divisions of markets at the high traffic airports and as *quids pro quo* for reductions of competition elsewhere, such agreements could only be justified if there were no available alternatives. A competitive alternative more efficient than intercarrier agreements is readily available, so this exemption should be deleted. The alternative is competitive bidding for "slots" at congested airports, as has been suggested by numerous commentators.⁶⁴ Absent a kind of collusion which would be clearly illegal under the antitrust laws, such bidding should efficiently allocate the existing facilities and generate revenues for expansion. Outlawing the "slot" agreements would encourage airport authorities to adopt this approach. There is no reason to give special treatment to a less desirable solution.

Relaxation of the equipment restrictions on Part 298 operators (commuter carriers) is a welcome change.⁶⁵ As with the antitrust exemption, however, there is no special reason to expect the

⁶² See text accompanying notes 44-45 *supra*.

⁶³ Proposed Aviation Act of 1975 § 12(c).

⁶⁴ Levine, *Landing Fees and the Airport Congestion Problem*, 12 J. LAW & ECON. 79 (1969). See also R. ECKERT, *AIRPORT AND CONGESTION: A PROBLEM OF MISPLACED SUBSIDIES* (1972).

⁶⁵ Proposed Aviation Act of 1975 § 6(b), amending, § 401(d) of the existing act.

Board to further relax the restriction, as the proposed act allows if circumstances seem to warrant it. Of course, as long as there is to be entry limitation, there must be some limit on the Part 298 exemption, but this is another example of possible less-than-efficient market organization resulting from the decision not to propose "pure" deregulation.

The route transfer provisions of § 7 of the proposed legislation offer the principal significant possibility for entry by a new firm. As such, its liberalized standard limiting the Board's approval authority to finding the transferee fit, willing and able is a welcome amendment. If the liberalized competition rules and rate freedom do not have the desired effects, however, this provision will require any prospective entrant to pay an existing certificate holder for any market power it possesses by virtue of holding a certificate. This will tend to capitalize and make permanent any anti-competitive effects remaining in the system. Of course, to the extent that the new holder is more efficient or more innovative than the old, benefits may be made available to the public. It is a peculiarity of regulation that it creates value in a firm beyond its asset or going-concern value. In a competitive or properly regulated (perhaps not possible) environment, a license to operate should be worth no more than the legal fees entailed in getting one. This fact might help in any effort to monitor the success of any statutory changes adopted. The extent to which a change reduces the value of CAB certificates will be a partial surrogate measure for the amount of monopoly power a new regulatory scheme has destroyed.⁶⁶

Two longstanding issues involving the Board—postal contracting and local service subsidy—are also addressed by the proposed legislation. The postal contracting issue was last addressed in the debate over the Postal Reorganization Act of 1970. At that time, the Postal Service and the Administration failed in their efforts to remove CAB protection of carriers from the airmail procurement process.⁶⁷ The proposed act's attempt⁶⁸ to authorize contracting

⁶⁶ Of course, the same effect might be observed if the changes simply made the industry less efficient, but this would presumably be accompanied by rising prices and other changes which would enable the analyst to distinguish the two situations.

⁶⁷ See Levine, *supra* note 28 for a history and analysis of these efforts.

⁶⁸ Proposed Aviation Act of 1975 § 15, *amending*, 39 U.S.C. § 5402(a) (1970).

deserves support. In view of the likely intensity of carrier opposition, it is understandable that the proposed bill creates a hierarchy of eligibility for such contracts, starting with carriers certificated between the points involved, then other certificated carriers, and finally any other air carriers. But certificated carrier opposition to this entire bill is likely to be so strong that any coalition powerful enough to overcome their opposition at all may well be strong enough to pass it in a form which does not limit airmail contract eligibility. This would increase the number of available bidders for any contract, but without eliminating the normal economic advantage of a carrier already providing service in combination equipment over a route proposed for mail contracting. The increased number of bidders should ensure procurement at the lowest possible cost to the Postal Service.

The outlines of local service subsidy reform have been articulated and the general principles agreed upon in two academic studies⁶⁹ and two CAB studies⁷⁰ and the outline was the subject of a CAB proposal to the Senate Aviation Subcommittee.⁷¹ All these efforts agreed that a low-bid competitive subsidy program was feasible and desirable. There seems to be little reason to require a new study, and the proposed bill should include authorization for such a program.

A technical ambiguity in the language of the bill as introduced into the Congress in October 1975 ought to be resolved. Section 6(c) of the bill states that the Board should reissue certificates as an unduplicated list of *city pairs* that each certified carrier is authorized to serve. Section 9, in its commendable attempt to eliminate artificial restrictions on the service that carriers can provide in certificated markets, states that on or after January 1, 1981, each air carrier engaged in air transportation may engage in non-stop scheduled air transportation between any United States *points* named in its certificates on January 1, 1975. This would be very much broader authority than that conferred by authorizing transportation between named city pairs and, indeed, for a carrier serving many different points would be broader authority than that

⁶⁹ Swaine, G. EADS, *supra* note 34.

⁷⁰ C.A.B. BUREAU OF OPERATING RIGHTS, *supra* note 34; REGULATORY REFORM at 333.

⁷¹ REGULATORY REFORM at 90-91.

contained in the route expansion provisions of the bill. While I certainly would have no objection to conferring the broader authority, I doubt that such a result was intended. In any event, the ambiguity should be resolved.

While the proposed act falls well short of the degree of deregulation that could be justified by the present state of knowledge concerning air transport regulation, it is a major step in the right direction and should be supported. The degree to which it will fall short of the benefits that could be obtained from more comprehensive deregulation depends largely on the performance of existing carriers operating in a relatively free rate-setting regime with increasing, but not total, freedom of entry. If such carriers can exhibit fully competitive behavior and greatly increased levels of managerial and operational innovation, the benefits to the public could be very great indeed. One must wonder, however, whether managements adapted to survival in a quasi-cartelized environment demanding great sophistication in dealing with a government agency are likely to be flexible enough (or will be *forced* to be flexible enough) to behave like innovating competitors. If the bill passes, time will tell.

This brings up the final and perhaps most important problem. What chance is there that this bill, or any bill reasonably like it in concept, will pass? There is little evidence that the relevant committees of the Congress are at all sympathetic to deregulation. When the Postal Service succeeded in getting a bill providing for a more competitive environment for a relatively small proportion of airline traffic⁷² (mail accounted for less than five percent of industry revenues in 1970) to the floor of the House by bypassing the Commerce Committee (which was opposed), the proposal was badly beaten.⁷³ If postal contracting for airmail was unable to survive in an environment in which reducing postal costs was politically important, how well will much broader deregulation do on its own? Whatever the defects of the present system, it provides relative security for airline managements.⁷⁴ They have been well organized politically since 1938, and the cohesion created by the regu-

⁷² Mail accounted for less than five percent of industry revenues in 1970.

⁷³ Levine, *supra* note 28.

⁷⁴ REGULATORY REFORM at 131-33.

latory regime which has limited their numbers makes them even more formidable today. Carrier testimony in the 1975 hearings before the Senate Subcommittee on Administrative Practices and Procedures suggests that the certificated airlines understand very well how much is at stake.⁷⁵ Only the sheer magnitude of the costs of regulation to the public and growing public awareness of those costs militates politically in favor of passage. I do not think that they will be enough.

An interesting question of political strategy is raised by these grim prospects. If one thought that by ignoring some of what we know could be achieved by total deregulation, a bill could be enacted, one might well be prepared to make the compromises contained in the proposed bill. But if the congressional climate (especially in the relevant committees) is hostile to deregulation, should not a bill designed to maximize consumer benefits be introduced in an effort to create pressure for some limited kind of reform? Such a bill would have the outline suggested in the earlier part of this article and would leave a lot of room for watering down. Or would it simply be so incredible to the Congress (ironically, considering its congruence with the current state of scholarly knowledge) as to damage even further the prospects for a consumer-oriented regulatory scheme? I leave the answers to such delicate problems of Congressional politics to those more expert in dealing with them.

⁷⁵ *C.A.B. Hearings*, certificated carrier testimony *passim*. See, e.g., *id.* at 512-23, 629-37.