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DEREGULATION AND LOCAL AIRLINE SERVICE— AN ASSESSMENT OF RISKS

RAYMOND J. RASENBERGER*

I. OVERVIEW

SUBSTANTIAL DEREGULATION of air transportation, such as proposed by the Aviation Act of 1975, risks permanent and serious harm to the domestic airline system, particularly the extensive system of certificated local airline service. The effects of deregulation may be felt in several major respects: (1) increased concentration of air transportation services in the hands of a few very large carriers, (2) less reliable airline service, particularly in smaller air transportation markets, (3) higher fares in many markets, and (4) the indirect cost to the American economy and national economic and social goals of less reliable and less convenient airline service.

These risks of deregulation are admittedly only risks neither proponents nor opponents of deregulation can be certain what will happen until it does happen. That fact, however, underscores what is perhaps the most fundamental weakness of the Aviation Act of 1975. It would substitute the risk of a theory for a certainty of a system which works well and statutory imperatives designed to keep it that way.

The economic provisions of the Federal Aviation Act are a combination of strong policy goals and broad discretion. That discretion is tempered only by the stated goals and conventional require-

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ments for administrative due process. In lieu of this approach, the Aviation Act of 1975 would invest certain regulatory theories with the dignity of policy objectives.¹ In other words, it would convert means into ends.

In so doing, it would also substantially narrow the discretion of the CAB to achieve the basic goals of national policy set forth in the statute. For more than thirty years the CAB has pursued the development of a system of airline service "properly adapted to the present and future needs of the foreign and domestic commerce of the United States, of the Postal Service, and the national defense."² It has done so primarily on the basis of experience rather than theory. Local service carriers were an experiment, and even after these carriers obtained permanent authority³ their service to many points was experimental.⁴ Supplemental airlines grew out of

¹ The Aviation Act of 1975 would amend the statement of policy of the Act to equate "maximum reliance on competitive market forces" and "encouragement of new carriers" with the other policy goals. The full text of the existing declaration of policy is as follows:

Federal Aviation Act of 1958, 72 Stat. 740, 49 U.S.C. 1302 (1970).

Sec. 102. In the exercise and performance of its powers and duties under this Act, the Board shall consider the following, among other things, as being in the public interest, and in accordance with the public convenience and necessity:

(a) The encouragement and development of an air-transportation system properly adapted to the present and future needs of the foreign and domestic commerce of the United States, of the Postal Service, and of the national defense;

(b) The regulation of air transportation in such manner as to recognize and preserve the inherent advantages of, assure the highest degree of safety in, and foster sound economic conditions in, such transportation, and to improve the relations between, and coordinate transportation by air carriers;

(c) The promotion of adequate, economical, and efficient service by air carriers at reasonable charges, without unjust discriminations, undue preferences or advantages, or unfair or destructive competitive practices;

(d) Competition to the extent necessary to assure the sound development of an air-transportation system properly adapted to the needs of the foreign and domestic commerce of the United States, of the Postal Service, and of the national defense;

(e) The promotion of safety in air commerce; and

(f) The promotion, encouragement, and development of civil aeronautics.

² 49 U.S.C. § 1302(a) (1970).

³ Pub. L. No. 84-741, 70 Stat. 591 (1956).

⁴ *E.g.*, the so-called "use it or lose it" policy adopted in the late 1950's. *See* Seven States Area Investigation, 28 C.A.B. 680 (1958).

experimental awards to large irregular carriers.⁵ All-cargo service has been an experiment,⁶ so also the growing role of commuter airlines.⁷ In dealing with fare innovations and charter concepts the Board has also relied heavily on experimentation.⁸ The proposed legislation would substitute economic dogmatism for this empiricism.

Moreover, if the dogma is wrong, more is at stake than the air transportation system. That system is designed to support larger national objectives—the economic development of all parts of the United States and reduction of the geographic and economic isolation of small cities and remote areas.⁹ The risks to such larger objectives are very real, as experience in Canada has taught.¹⁰ In short, if these economic theories are to become national goals, they had better be right. The remainder of this paper will examine the risk—the very real risk—that they may not be right.¹¹

The Air Transportation System Today

Let us acknowledge at the outset that the existing air transport regulatory system, like most things, does not work as well as it

⁵ Large Irregular Air Carrier Investigation, CAB Order Nos. E-13436 (1959), E-14196 (1959). Many "Large Irregulars" eventually became Supplemental Airlines pursuant to Pub. L. No. 87-528, 76 Stat. 143 (1962).

⁶ Air Freight Case, 10 C.A.B. 572 (1949).

⁷ E.g., Part 298 Weight Limit Investigation, CAB Order No. 72-7-61 (July 18, 1972).

⁸ Under the Board policies adopted in the Domestic Passenger Fare Investigation, discount fares must be temporary in nature, their renewal being subject to experience data showing a net benefit to the carrier. See DPFI, Phase 5, CAB Order No. 72-12-18 (Dec. 5, 1972). Many new charter concepts have also been experimental. See, e.g., CAB Special Reg. 85 (Aug. 7, 1975) (one-stop inclusive tour charters).

⁹ One of the reasons given for permanent certification of local service airlines was "the promotion of American commerce and national unity." S. REP. No. 124, 84th Cong., 1st Sess. 5 (1955). See also 81 CONG. REC. 8883 (1937).

¹⁰ The possibilities of adverse effects of deregulation on other national goals are highlighted by a paper entitled *Some Lessons from Transport Deregulation in Canada* delivered by John Heads of the Canadian Transport Commission at a meeting of the Transportation Research Forum in San Francisco, October 10-12, 1974. The paper calls attention to the conflict which has developed between policies adopted beginning in 1967 looking toward easier abandonment and more flexible pricing by railroads and the desire to promote economic development of all geographic regions, especially the Canadian west. Mr. Heads pointed out: "In the years since the 1967 Act in Canada, a major cause of Western complaint has been that transportation is no longer used as an instrument of national policy."

¹¹ This analysis is necessarily limited to scheduled airline passenger service. No views are intended to be expressed herein regarding cargo or charter services.

should. The issue raised by the proposed legislation, however, is not whether some things about the present system of regulation should be changed, but whether they need to be changed by *legislation* as distinguished from agency action under the existing statute. As a point of departure, it may be useful to review how the CAB has operated within the existing statutory framework.

First, as has been noted, the existing statute calls for the development of a comprehensive system of air transportation for the United States, a system which stresses competition and produces economical and efficient service at reasonable charges. These goals are not essentially different from those that appear in the litany of deregulation.

Supporters of deregulation, however, maintain that the Board has not properly employed its broad discretion to achieve these objectives. There is something to this view if attention is focused on the first half of the 1970's when the policies of the Board, or at least a majority of it, were hostile to competition. It is significant, however, that these hostile policies have in fact already come to an end without the enactment of new legislation. Moreover, a longer view of CAB history shows a Board far more receptive to competition than it is given credit for.

The air transportation system which the Board began to regulate in 1938 was essentially a series of adjoining route monopolies. Since that time, as one proponent of deregulation has acknowledged "the proportion of monopoly traffic in trunk carrier operations has steadily diminished."¹² Moreover, contrary to the conventional wisdom of deregulation, the CAB has not been opposed to entry of new carriers.

It is true that the CAB has not followed a practice of certificating new trunklines.¹³ in addition to the grandfather carriers. That fact alone is misleading, however. In its early years, the CAB certificated over twenty grandfather carriers, a substantial number of participants in an industry that earned less than \$60 million in

¹² Prepared Testimony of James C. Miller, III dated December 15, 1975, CAB Docket No. 27417 (Domestic Load Factor Standards). This substantial increase in the competitiveness of the system is also confirmed and described in the CAB staff study of *THE DOMESTIC ROUTE SYSTEM: ANALYSIS AND POLICY RECOMMENDATIONS* (October, 1974).

¹³ An important exception was Trans Caribbean Airlines, certificated to Puerto Rico in 1957, Service to Puerto Rico, 26 C.A.B. 72 (1957).

revenues that year. Since that time, the Board has concluded that the development of the industry would best be achieved, not by certificating more trunks, but by the encouragement of specialist carriers which had an incentive to develop air transportation in areas where trunklines had shown a lack of interest.

Over fifty new domestic airlines have been certificated since 1938, including over twenty local service airlines, eight all-cargo airlines, twenty-five large irregular (which later became thirteen supplemental) airlines, five helicopter airlines, and a variety of other carriers rendering specialized kinds of service.¹⁴ To a large extent, as the grandfather carriers will attest, these new entrants have been competitive with some or all the services the grandfather carriers were providing.¹⁵

A deeper look into CAB regulation of prices also portrays far more price flexibility and competition than commonly acknowledged. For its entire history prior to its decision in the *Domestic Passenger Fare Investigation* (DPFI),¹⁶ the CAB did not prescribe domestic airline fares. Even under the regime established by the DPFI, the CAB has allowed a substantial amount of price competition through discount fares.¹⁷

Any review of historic regulation by the CAB must also include consideration of what has actually happened in air transportation. The picture that emerges from such an analysis scarcely supports the "dead hand of regulation" theory. This is illustrated by a study recently prepared for a group of local service airlines by Robert R. Nathan Associates.¹⁸ The study compared air transportation with twelve other major industries, regulated

¹⁴ E.g., Resort Airlines, 10 C.A.B. 393 (1949); Aspen Airways, 46 C.A.B. 273 (1967); Wright Airlines, CAB Order No. 72-2-52 (Feb. 14, 1972).

¹⁵ Perhaps the most notable example is Allegheny Airlines, a non-grandfather local service airline, which is now the sixth largest domestic airline in terms of passengers carried.

¹⁶ Domestic Passenger Fare Investigation—Phase 9, CAB Order No. 74-3-82, (Mar. 18, 1974).

¹⁷ E.g., National's "No Frill" discount fare, CAB Order No. 75-3-102 (March 25, 1975); United's Bicentennial Fare, CAB Order Nos. 75-2-124 (Feb. 28, 1975), 75-9-84 (Sept. 24, 1975) and Allegheny's "Liberty Fare", CAB Order No. 75-5-55 (May 10, 1975).

¹⁸ Robert R. Nathan Associates, *The Performance of the U.S. Air Transportation Industry*, a study submitted to the CAB with the Comments of Eight Local Service Carriers, CAB Docket No. 28490 (Jan. 20, 1976) [hereinafter cited as Nathan Study].

and unregulated, and with the U.S. economy as a whole, for the twenty-five year period 1949-1974. It compared growth, output, employment, productivity, prices, and profits. In summary it found:

The performance of the U.S. airline industry has been superior to that of other U.S. industries. By standards of performance expected from vigorous competition or effective regulation, the record of the airline industry in the post-World War II period is impressive: compared with other industries, its productivity has been high and dynamic in terms of growth; its prices have been relatively stable; its rate of return on equity has been modest.¹⁹

The findings of the Nathan study with respect to airline prices are especially significant. They are reflected in the following table from the study:²⁰

AVERAGE ANNUAL RATE OF CHANGE OF CONSUMER PRICE INDEX FOR
ALL ITEMS AND FOR MODES OF PUBLIC TRANSPORTATION
1964-74 AND 1969-74

Item	Average annual rate of change of Consumer Price Index (percent)	
	1964-74	1969-74
All items	4.7	6.1
Public transportation	5.1	5.6
Airplane fares, chiefly coach	3.9	5.9
Local transit fares	5.4	5.3
Taxicab fares	5.6	6.7
Railroad fares, coach	3.1	4.6
Bus fares, intercity	5.8	7.8

Source: BLS, *Handbook of Labor Statistics*, 1975,
Reference Edition.

The study also compared airline fares in the U.S. with those in Europe. The conclusion: "Fares on equidistant routes carrying approximately the same number of passengers are substantially lower in the United States than in Western Europe."²¹

All this is not intended to portray the CAB's regulatory history as an unblemished record of perfection. Obviously, a great deal of

¹⁹ *Id.* at 1.

²⁰ *Id.* at 13-14.

²¹ *Id.*

the progress of air transportation is related to advances in engine and airframe technology. Moreover, even though the CAB has for most of its history been receptive to price competition and has made great strides in eliminating monopolies and certificating new entrants, it is clear with the help of hindsight that some things might have been done better, particularly with respect to encouraging innovation and discouraging concentration. Yet, the fact remains that the CAB has the power, and has generally had the willingness, to allow the forces of competition to play a major role in accomplishing the statutory objectives.²² And the fact remains that the U.S. has today a comprehensive, economical, and efficient system of air transportation. This needs to be remembered when considering the risks of adopting legislation such as the Aviation Act of 1975.

II. THE RISKS OF DEREGULATION TO THE SCOPE AND QUALITY OF AIRLINE SERVICE

Advocates of deregulation of air transportation acknowledge that their proposals may involve a trade-off—poorer airline service in return for lower prices.²³ They see this as only a risk, and a risk worth taking. The discussion below will look separately at each side of the possible trade-off with particular reference to the ensuing effect if the Aviation Act of 1975 is adopted.²⁴

Deregulation theory predicts that lower prices will be the result of the increased competition expected to result from freer entry

²² It is significant moreover that when the Board ignores its obligation to advance competition, the courts are available to remind it of the statutory requirements. The recent decision of the D. C. Circuit in *Continental Airlines v. CAB*, 519 F.2d 944 (D.C. Cir. 1975) which held that, when sufficient traffic exists, certification of competing carriers is mandated by the statute, goes far toward assuring against future lapses in the Board's commitment to competition.

²³ *E.g.*, CIVIL AERONAUTICS BOARD, REGULATORY REFORM: REPORT OF THE CAB SPECIAL STAFF, 173, 278, App. A at 9 (1975).

²⁴ The discussion which follows assumes that the void created by federal deregulation will not be filled by state regulation. This is an assumption and not a prediction. State economic regulation of airlines, including regulation of entry, is already substantial and claims of state jurisdiction are becoming increasingly assertive. (*See, e.g.*: *National Association of Regulation Utility Commissioners v. CAB*, D.C. Cir. No. 75-2133, and *P.U.C. of California v. CAB*, D.C. Cir. No. 75-2070, pending proceedings seeking to narrow the CAB's assertion of jurisdiction over "interstate air transportation.") There is every reason to expect that, in the absence of the firm control of entry and exit at the federal level, a patchwork of state regulation will develop, doing violence to the objectives of both the present statute and the proposed "Aviation Act."

and exit of carriers. The question of whether prices would in fact be reduced by deregulation is discussed later. First, however, it is useful to consider what the effect of freer entry and exit may be on the air service itself. Will it become more competitive? What will be the overall effect on the quality of service, especially at smaller cities?

A. Effect on Air Service in Larger Markets.

The effects of deregulation on local airline service are best examined by first looking at the potential impact on the larger markets which comprise the bulk of the nation's airline passengers and which function in a symbiotic relationship with the local service system.

There is little question that, at least initially, the airline system as a whole will suffer from deregulation of entry and exit. A recent study prepared by the Stanford Research Institute found:

There seems to be a general consensus, however, except among the most doctrinaire decontrollers, that the transition period to relatively unregulated freedom of entry could be chaotic and devastating to some participants including a number of existing airlines.²⁵

Obviously, airline passengers will not be insulated from these effects. The airline system is a true *system* of interlocking services and arrangements. Because this system works relatively smoothly, the thousand details which make it work tend to be forgotten—computer interconnections, timely schedule publications and coordination, establishment of ticketing, gate, and baggage handling facilities, training of employees, compliance with safety regulations, arrangements for transfers of passengers, interline account settlements and all the rest. In due time, these can be adjusted to accommodate change. But it is foolish to assume that the process of adjustment to deregulation will not disrupt some of these arrangements and all the rest. In due time, these can be adjusted to accompany money lost.

The Aviation Act of 1975 reflects an awareness of the risks of abrupt deregulation; not all of its proposed changes would take

²⁵ 1 STANFORD RESEARCH INSTITUTE, *THE ECONOMIC IMPACT OF FUEL SHORTAGES ON COMMERCIAL AIR TRANSPORTATION AND AVIATION MANUFACTURE* 137 (Study prepared for Federal Energy Administration).

place immediately. The following is a summary of the principal statutory changes with respect to entry and exit and the proposed effective dates.

SUMMARY OF NEW
ENTRY AND EXIT PROVISIONS OF THE
"AVIATION ACT OF 1975"
And Their Proposed Effective Dates

<i>Proposed Provisions</i>	<i>Proposed Section of Statute</i>	<i>Effective Date</i>
1. Any fit, willing and able carrier entitled to certificate in any city pair not receiving non-stop service.	401(d)(4)	Immediate
2. Any air carrier may operate aircraft up to fifty-six passenger capacity without a certificate.	401(d)(5)	Immediate
3. No certificate restrictions may be imposed.	401(e)(1)	Immediate
4. All existing certificate restrictions shall be removed.	401(e)(1)	Not later than January 1, 1981
5. Any carrier may operate non-stop between any points certificated to it on January 1, 1975.	401(o)(1)	January 1, 1981
6. Domestic "fill-up" rights for U.S. international air carriers.	401(o)(2)	January 1, 1981
7. Any carrier may abandon service operated below "fully allocated cost" (including return on investment) after one expense after three months, or on ninety days notice if another carrier will provide the service.	401(j)	Immediate
8. Any carrier may operate in any market where it is not	401(p)	January 1, 1981

certificated as long as the total amount of such operations does not exceed ten percent (or five percent for trunks) of the average of all carriers in its class.

This phasing of deregulation may or may not reduce the impact on passengers. A number of its important provisions would still be effective immediately. Moreover, the proposed phasing will not delay the adverse effects of deregulation on airline capital formation, effects which could turn out to be the most serious of all. In any case, there should be no illusions about where the legislation ultimately leads. Despite retention of the formalities of certification and various other procedural trappings, the bill, by virtue of the interaction of its various provisions, would essentially deregulate entry and exit by the end of 1980.²⁶

Ironically, although instability is risked in the early stages of deregulation, the longer term risks are the opposite. In the larger airline markets especially, the risk is *too much* stability, a stability arising from the control of most of the airline business by a few very large carriers. This is where deregulation can do its greatest mischief.

There have always been strong tendencies toward concentration in air transportation, stronger than in many other industries. This is in part because of the special characteristics of airline traffic. The airline system is more than a collection of unrelated city pairs.²⁷ It is a web of highly interdependent markets. This interdependence has been described by a CAB staff report as follows:

More than half the passengers on the typical flight segment are

²⁶ For example, under proposed section 401(a)(1) carriers would obtain non-stop authority between all points certificated to them as of 1/1/75 and they would be free to extend service to a variety of new cities without regard to "public convenience and necessity" by virtue of the provisions of proposed sections 401(d)(4), 401(d)(5), 401(o)(1), and 401(p). Since no restrictions are permitted pursuant to 401(e)(1), carriers would apparently thereby acquire non-stop authority between each such new city and every other city it served. By the same token, the combination of the provisions permitting exit from unprofitable markets, combined with rate provisions which permit a carrier to make any market unprofitable, leave little realistic control over exit by the Board.

²⁷ E.g., proposed section 401(e)(1) of the "Aviation Act" would have all certificates read in terms of city pairs rather than linear routes.

'beyond traffic.' That is, their trip takes them beyond either the origin, the destination, or both, of the flight *segment* in question. Airlines, therefore, typically schedule their aircraft to include two or more segments or stages per complete flight (*i.e.*, one or more 'intermediate stops'). Two-thirds of all scheduled flights have two or more stages. For the passenger, this sequential staging has the advantage of greatly reducing the number of changes of plane that would be necessary if each flight segment were discrete. For the airline, the sequential staging of flights permits an aggregation of passengers having different origins and/or destinations beyond what would be possible if every passenger origin were to be linked to every passenger destination with a non-stop flight.²⁸

The same staff report also noted: "Only a rather limited number of city pair markets in the U.S. have sufficient 'Local O & D' traffic volume to justify turnaround service, . . ."²⁹

These characteristics of the airline system are of the utmost significance to deregulation. They mean that in most of the U.S. airline system the competitive strength of a particular carrier in a particular market will depend heavily upon the amount of "beyond" or "flow" traffic that carrier can call upon to help support the schedules it offers. The simple fact is that in the vast majority of markets a carrier which does not have access to traffic moving beyond one or both points in a particular city pair cannot compete with a carrier which does.³⁰ Obviously, the larger a carrier's route system, the greater the likelihood that it will be able to call upon flow traffic to support a competitive effort in a new city pair. *In short, without regulation of entry, the bigger the carrier, the bigger it is likely to get!*

The insistent pressure toward concentration in the airline industry is illustrated by its history. In 1950, after certification by the Board of a large number of new carriers, fifty-eight certificated

²⁸ CIVIL AERONAUTICS BOARD, *Evaluation of a Limited Market Experiment in Deregulation of Air Transport* 8 (1975).

²⁹ *Id.*

³⁰ This was one of the reasons the CAB Staff Task Force recommended against a limited experiment in deregulation in certain test markets. The report noted:

For carriers having little traffic flow between the test segment and their existing routes, the test segment provides an opportunity of little worth, unless such flow can be developed or the traffic density on the test segment is such as to justify turnaround service.

Id. at 8-9.

route carriers were in operation. In 1973 there were thirty-nine.³¹ Including supplemental airlines, the Board has certified over fifty new carriers in addition to grandfather carriers. Yet, this has been the experience:

Trunklines: U.S. scheduled domestic and international services are now performed by ten trunks plus Pan American. Ten additional domestic carriers and three international carriers were awarded grandfather certificates for scheduled service but are no longer in existence. Several carriers certificated in the post-grandfather era, such as American Overseas, Trans Caribbean and Resort Airlines have also disappeared. There have been some mergers among trunklines. But a significant number of other mergers which would have greatly increased concentration have not taken place, due in part to the requirement for CAB approval (e.g., American-Eastern, American-Western, Pan American-TWA, Northwest-National).

Local Service Carriers: Certificates were issued to over twenty local service airlines in the early stages of the local service experiment. Of these, eight survive today. A ninth, Air New England, was awarded a certificate in 1974.

Supplementals: Sixty-six large irregular air carriers (then operating under a blanket exemption) sought certificate authority in the 1951 *Large Irregular Air Carrier Investigation*. By the late 1950's only twenty-five carriers had survived to become recipients of large irregular certificates. After these certificates were set by a court and new authorizing legislation enacted, thirteen were certificated as supplemental air carriers. Today there are seven viable supplemental airlines³² and a merger of two of them is pending at this writing.

All-Cargo Carriers: At least six domestic all-cargo carriers have been certificated. Two are still operating.

Helicopter Carriers: At least five have been certificated. Two are still operating.

Commuter Carriers: These carriers perform scheduled service with aircraft of up to thirty passengers without a certificate of public convenience and necessity but pursuant to an exemption

³¹ CIVIL AERONAUTICS BOARD, HANDBOOK OF AIRLINES STATISTICS, 1973 (1974).

³² Two of the seven are small domestic carriers offering limited specialized services.

granted by the CAB. There are over 150 such airlines registered with the Board. Statistics recently compiled by the Board show that ten commuter airlines carried forty-two percent of the commuter traffic in 1974.³³ None of the ten were in substantial competition with each other. This amount of concentration among commuters is remarkable in light of the one major respect in which commuters are regulated—the aircraft size limit—which tends to discourage concentration.³⁴

Air Freight Forwarding: A CAB staff study in 1973 noted that, although there were 249 authorized forwarders, the four largest companies in this largely unregulated phase of air transportation accounted for fifty percent of the business.³⁵ The experience in air freight forwarding is particularly instructive. Despite almost total deregulation and minimal capital requirements for entry, the Board recently found:

Lack of meaningful competition [has been] a serious problem notwithstanding the large number of forwarder authorizations. In terms of revenue, the largest forwarder controlled thirty percent of the market, while the ten largest forwarders comprised nearly 73 percent.³⁶

The current situation with respect to the scheduled airlines is as follows. The five largest domestic carriers—United, TWA, American, Eastern and Delta—account for almost seventy percent of domestic revenue passenger miles (rpm's). Internationally, two carriers—Pan American and TWA—account for over sixty-five percent of rpm's. Obviously, this concentration is excessive. Nevertheless, but for CAB actions in resisting some mergers and in fostering new classes of carriers, it is likely that the airline industry would be even more concentrated than it is.

³³ CAB FORMS 298 (1975).

³⁴ This prohibition in effect denies a commuter carrier the main advantage of size—use of larger, more efficient aircraft and the commensurate ability to serve large markets efficiently. Aircraft size limits also are partly responsible for the fact that commuter airlines typically operate hub-spoke services rather than linear routes. Thus a major source of pressure toward concentration found in larger air transportation markets, desire for access to flow traffic, is absent in the commuter industry.

³⁵ CIVIL AERONAUTICS BOARD, *AIR FREIGHT FORWARDING: THE DECADE 1963-1972*.

³⁶ IU and Airborne Freight Corporation Acquisition, CAB Order No. 75-10-14, at 4 (October 3, 1975). See also Motor Carrier-Air Freight Forwarder Investigation, CAB Order No. 69-4-100 at 13 (April 21, 1969).

Without meaningful CAB regulation of entry and exit, the pressures toward concentration will inevitably take a greater toll on competition. In the vast majority of airline city pairs, large carriers with substantial flow traffic support can, when they choose, outschedule smaller carriers without such supporting flow. Result: irresistible pressure toward elimination of the smaller carrier as a competitor.³⁷ This is likely to happen regardless of the antitrust laws, which have failed to prevent concentration in many other industries, or stricter prior restraints contemplated by the proposed new section 408 of the Aviation Act.³⁸ No statute can prevent airline companies from failing or withdrawing from competition as they discover their inability to match the traffic flows of larger competitors.³⁹

B. *Effect on Small City Air Service*

Shortly after completing the certification of grandfather carriers, the CAB turned its attention to the question of how best to extend the reach of scheduled airline service to the less populated areas of the United States.⁴⁰ The local service airlines were the result. Creation of these carriers reflected a judgment by the Board that this development would not be undertaken aggressively by the grandfather trunklines, which still had a lot of growing to do in grand-

³⁷ Many observers believe there is an "S-curve" relationship between capacity and traffic, i.e., when a carrier offers more than half the flights in a market, its share of traffic tends to be greater than its share of flights, and vice versa. To the extent this tendency exists, it augments the ability of large carriers, which can support more frequent schedules with flow traffic, to dominate a market.

³⁸ For example, proposed new section 408 would limit the CAB's discretion to approve mergers and would permit the Attorney General to seek *de novo* review of a Board approved merger.

³⁹ It should be emphasized that prospects of greater concentration do not necessarily mean that effective new competition would never be mounted against a large carrier in a deregulated environment. As noted above, some city pairs do not require flow traffic support. The large transcontinental markets and some of the intra-California markets are examples. Despite the attention focused on such markets, however, they do not account for a significant portion of passengers in domestic air transportation. (For example, the passengers moving between Boston/New York/Philadelphia/Washington on one hand and San Francisco/Los Angeles on the other represent 2.5% of the total domestic passengers.) There may also be other markets where for one reason or another the large carriers will choose not to challenge small competitors. These exceptions, however, do not detract from the probability that, systemwide, domestic air transportation will in time display increasing characteristics of oligopoly, with all the adverse effects on competition that term implies.

⁴⁰ *Cf.* Investigation of Local Feeder and Pickup Service, 6 C.A.B. 1 (1944).

father markets. Through the late 40's and early 50's the local service carriers were granted experimental certification, each certificate containing the explicit statement that its primary purpose was to provide for short-haul local transportation.

Eight of the original local service carriers, or their corporate successors, survive today. In 1975 the eight locals, plus newly certificated Air New England, carried thirty-five million passengers and served 549 cities in the forty-eight contiguous states. Of these, 249 received their only certificated service from a local carrier. The nature of local service operations is illustrated by the fact that, although these carriers collectively account for less than ten percent of domestic revenue passenger miles, they perform one-third of all scheduled airline departures in the United States.⁴¹

It is this portion of the air transportation system that is in greatest jeopardy from deregulation. The impact can be expected immediately and directly in terms of poorer service. Ultimately the interaction of poorer service and other consequences of deregulation can be expected to result in the economic demise of most if not all local service carriers.

1. Non-certificated competition

If deregulation takes the course proposed by the Aviation Act of 1975 it will permit any carrier, new or established, to operate aircraft of up to fifty-five passenger capacity in any city pair without a certificate of public convenience and necessity. Aircraft of this size, such as Convair 580's and F-27's, still form the backbone of certificated services to weaker traffic points. Locals now operate approximately 185 such aircraft and enplane about twenty-five percent of their passengers on them.

It can be argued that only a fool would acquire these larger aircraft to engage in competition with a local carrier in a market which is already too small to support one carrier without subsidy. That may be, but the history of air transportation suggests that there is an allure to running an airline that seems to drive otherwise sen-

⁴¹ Because locals provide service to more remote and thinly populated areas, with relatively short aircraft hops, many of their operations are inherently uneconomic. For this reason, pursuant to Section 406(b) of the Act (49 U.S.C. § 1376(1)) they are paid federal subsidy. However, with the help of stronger routes awarded by the CAB and more efficient aircraft, subsidy payments have declined from about \$30 per passenger in 1947 to less than \$2 in 1974.

sible people toward economic self-destruction. This is particularly evident in the commuter airline industry, to which the proposed new fifty-five passenger limit would apply. Relatively low capital requirements make new entry easy, but the harsh economies of small city service create the effect of a fast revolving door.⁴²

Thus, it is not unreasonable to expect that a substantial number of non-certificated carriers will acquire fifty-five consistency passenger aircraft and attempt to operate them in competition with local service carriers.⁴³ Conceivably, they may also offer lower fares in an effort to oust the certificated carrier. The result, temporarily, may be a surfeit of good air service. But it will be temporary. In a large number of cases, the certificated carrier, which is likely to have a more realistic view of the economics of serving small cities, can be expected to take quick advantage of the easy exit provisions of the bill. If so, the community in question will find itself served by a non-certificated carrier instead of a certificated carrier. It may then discover, too late, that it did not make an even exchange.

Non-certificated carriers are not required to serve any point.

⁴² CAB statistics show that, of the 152 commuter airlines registered in fiscal year 1972, only 73 were still registered in calendar year 1974, an attrition rate of over fifty percent for the period. During the same period 72 new carriers came into being. This condition has been characterized by the CAB's Office of Consumer Advocate as "unstable, if not chaotic." See Comments of the Office of Consumer Advocate, CAB Docket No. 28048 (December 2, 1975).

A recent study of air freight forwarding, in which entry is also unregulated, suggests a correlation between financial weakness and both higher rates and poorer service. In a study Professor Fredrick Stephenson, Jr. concludes that "it is far from clear that the Board's [free entry] policy is accomplishing its objectives." Stephenson, *Transport Deregulation—The Air Freight Forwarder Experience*, 43 ICC PRAC. J. 39, 54 (1975). The study goes on to find:

In the hub markets, this has resulted in a fragmentation of the traffic base, higher rates to shippers, higher costs to forwarders and carriers, and financial instability for many forwarding firms. Of more importance, the competition resulting from the policy has discouraged many forwarding firms from trying to develop the potential nonhub markets, because the profit incentive is not strong enough for some, and others are too weak financially to pursue the traffic they would like to seek.

Id.

⁴³ This will occur even though the increase in 1972 to a thirty-passenger limit (in lieu of the previous limit—the equivalent of fifteen to eighteen passengers) has not had a substantial impact. The difference is that aircraft which can make effective use of the thirty-passenger standard in typical commuter markets simply do not exist. Such would not be true of aircraft meeting the fifty-five passenger standard. Although a generation old, there are many aircraft of this size available. They offer large cabins, jet-prop power, and other amenities not generally found in non-certificated services.

They are free to cease service at will. Over 100 commuter carriers apparently did just that in a recent two and a half year period.⁴⁴ Moreover, commuter services may be cancelled without notice. Except for certain joint rates, non-certificated commuters are also exempt from the all-rate regulation. They may charge what the traffic will bear; they may offer discriminatory rates; they need file no tariffs.⁴⁵

This is not to say that the substitution of a non-certificated carrier will always produce less reliable or more expensive service. There are notable instances when this is not the case.⁴⁶ But unless it is assumed the existing restrictions against service abandonments and excessive rates by certificated carriers are providing no public protection at all, removal of those provisions will mean poorer, less dependable air service at smaller cities and in more remote areas.

It may also be more expensive service. The theory that free entry and exit will hold down fares is not well supported by commuter experience. In a submission to the CAB in January, 1976, the local service carriers analyzed fares in eighteen leading commuter markets.⁴⁷ The analysis showed that in only two of the eighteen markets did commuters charge less than the CAB prescribed coach fare formula. In ten of the markets the commuter faced no certificated competition; in eight of these the commuters' charges were within the same fare range as permitted local service carriers. *i.e.*, at or above (to a maximum of thirty percent) the CAB prescribed coach fare formula.⁴⁸

⁴⁴ See note 40 *supra*.

⁴⁵ For a list of economic provisions of the Act from which commuters are exempt see 14 C.F.R. 298.11 (1975).

⁴⁶ Notably those where the substitution of a commuter for a certificated carrier is approved by the CAB subject to conditions requiring maintenance of specified minimum services and maximum fares and joint fares. *E.g.*, CAB Order Nos. 75-5-45; 74-11-88 (November 19, 1974).

Moreover, in certain specific cases the CAB has found that operation of up to fifty-six passenger aircraft by commuter carriers was in the public interest. The approval of non-certificated large aircraft operations in a specific case after analysis of competitive effects is very different than the blanket grant of such authority without regard to its effect.

⁴⁷ The markets studied were all which fell within the top fifty in commuter traffic and had a nonstop distance of at least 100 miles. See Comments of Eight Local Service Airlines on the Proposed Aviation Act of 1975, CAB Docket No. 28490 App. B. (January 20, 1976).

⁴⁸ The CAB's DPFI Orders allow locals to charge up to 130% of the coach fare formula. See CAB Order No. 74-12-109 (December 27, 1974).

The prospect that non-certificated fares may be higher than local service carrier fares is increased by two other factors. First, uneconomic local carrier operations generally receive federal subsidy; non-certificated carriers are not eligible for subsidy.⁴⁹ Secondly, local service carriers operate some strong routes which help support their small city services. Commuter carriers typically lack this capability for internal cross-subsidization.

2. Loss of Connecting and Flow Traffic

The impact of the proposed Aviation Act on local airlines service will not be limited to the risks that go with non-certificated competition. Thirty-eight percent of the passengers boarded by local service carriers connect to another carrier, usually a trunkline. Thus, anything that destabilizes trunkline service will affect the interline connections on which so much local service traffic depends.

The effect of this on the local carrier is likely to be far greater than on the trunk. Local carrier traffic, being shorter haul, is far more susceptible to the competition of surface transportation, principally highways. Any loss of public confidence in the reliability of connecting service could take a serious toll on local carrier traffic. Loss of traffic support for a service which is economically marginal in the first place tends to lead to poorer service. This usually means poorer traffic and, in turn, further cuts in service quality—a downward spiral that seldom stops short of total suspension.

The last resort is of course subsidy, either external, in the form of higher federal payments, or internal, in the form of profits from stronger routes. Historic CAB policies give little hope for the former. Deregulation is a major threat to the latter. Locals do operate a number of relatively strong routes, often in competition with trunklines. But the free entry provisions of the bill expose all such routes to new competition. While locals would also be free to enter new markets, in such a competitive free-for-all, for the reasons noted above, the survivors will almost certainly be the very large carriers. The competitive problems of the locals will also be compounded by inroads on their own flow traffic as a result of non-certificated operations at small cities or, as permitted by the pro-

⁴⁹ See *Air Line Pilots Association, International v. CAB*, 515 F.2d 1010 (D.C. Cir. 1975).

posed legislation, operation by new carriers of non-stop services in markets served one-stop by locals.⁵⁰

In sum, deregulation is likely to reduce the amount of flow traffic that locals can develop from their smaller points, and decrease the possibility of retaining existing strong routes or acquiring new ones. The combination is as good a formula for the extinction of these carriers as can be imagined. With their demise will go the commitment which local service airlines represent to the preservation and development of rural America.

III. THE ECONOMIC RISKS OF DEREGULATION

As noted, the prime objective of deregulation is to lower the cost of airline service to the public. This is usually expressed in terms of lower fares. Obviously, however, the true cost of airline service to the public involves more than fares. Although more difficult to quantify, time and energy also have economic value. Hence, lower fares at the cost of poorer service may be a bad bargain. A city which has lost its only air service is hurt economically even if air fares are lower at a point 100 miles away. A city which keeps its air service but loses flights or connections which are convenient to its business community may also be worse off, even with lower fares.

As shown above, there is a substantial risk that not only small cities, but the entire nation will get poorer service as a result of deregulation. Where then is the offsetting benefit in terms of lower fares for scheduled service, especially for local airline service? Consideration of that question as it pertains to local service best begins with an attempt to assess what may happen to scheduled fares on an industry-wide basis.

A. *Industry-wide Fares*

The threshold question is this: Is it appropriate to assume that the United States can maintain a system where airline fares do not cover fully allocated costs on a long-term basis? Such a system can

⁵⁰ The provision of the proposed Aviation Act authorizing non-stop operations by any carrier on a blanket basis in markets not receiving such service reflects a fundamental lack of understanding of the nature of traffic flows. A city pair too small to support non-stop service may be able to support one-stop service and at the same time offer traffic support necessary to permit non-stop service in adjoining city pairs. Diversion of the one-stop traffic to an uneconomic non-stop service could adversely affect non-stop service in the adjoining markets.

be projected. As noted previously, there is an attraction about the airline business which seems to transcend economic sense. Even without unregulated entry, the number of business failures in the industry has been impressive. Yet there has also been a steady stream of new companies seeking fortune where others have failed. Thus, it at least is conceivable that in an environment of unregulated competition, the air transportation system could be sustained indefinitely by an unending flow of unprofitable enterprises replacing each other.

However realistic or unrealistic this possibility may be, anything which contemplates an airline industry supporting itself indefinitely on improvident private investment must be rejected. Not only is there an undesirable relationship between marginal financial condition and marginal safety practices,⁵¹ but the American economy is simply too dependent on air transportation to gamble its future on an assumption of rotating corporate suicides. Limited as was reliance on airline service in 1938, the need for financial stability was an important reason for adoption of the Civil Aeronautics Act. Today, with the vast bulk of intercity transportation of passengers dependent on airlines, it is unthinkable. That being the case, it follows that any fare savings projected as a result of deregulation must be related to cost savings which deregulation generates.⁵² The following analysis examines the prospects for cost savings and commensurate fare reduction, under two opposing models: increased concentration and increased competition.

Assumption No. 1: Increased Concentration

According to theory, in a deregulated environment carriers will set their prices so as to recover no more than costs. That result, however, cannot be predicted if the airline industry evolves into a tighter oligopoly. As one experienced observer has pointed out:

The economic reasons which have led the courts to impose stringent checks on individual monopoly power are in most respects

⁵¹ FAA safety regulations, while comprehensive, still rely on carrier compliance for their effectiveness. As the Stanford study pointed out: "It is not certain that the FAA resources would be capable of assuring adequate safety in a vastly expanded air transportation system except after a period of adjustment or enlargement." (Vol. 1, p. 137.)

⁵² Since airline industry profits are, and for some time have been, minimal or non-existent, fare reductions through profit reductions is not a realistic possibility and is not considered here.

applicable to the shared monopoly power of a tight oligopoly. *Both situations are characterized by an absence of vigorous price competition, wider price-cost margins than would exist under effective competition, protection of inefficient firms, and a consequent misallocation of economic resources (emphasis added).*⁵³

A well-known economic text concludes as follows:

Industries in which the 8 largest sellers control more than 70 per cent of sales seem to run higher profit rates than industries with lower concentration. Possibly this level of concentration marks the point where firms start seriously to take account of their influence on one another—where oligopoly really comes into its own.⁵⁴

Under this definition—seventy percent of the business controlled by the eight largest companies—oligopoly has already now “come into its own” in the airline industry. All that stands in its way are the provisions of the Federal Aviation Act.

Ironically, the proposed rate provisions of the Aviation Act of 1975 could facilitate the further development of oligopoly. Under the present statute the CAB can, and does, exercise a tight rein on increases in fares. Under the proposed bill carriers making up the oligopoly would be free to increase fares ten percent a year without the fares being suspended by the Board.⁵⁵ The bill would also substantially eliminate the CAB's power to require that fares conform to costs by mileage block. This is meaningful because the cost of long-haul operations tends to be substantially lower per mile than short haul operations. The proposed bill would facilitate the historic practice of large carriers, which ended only with the CAB's *DPFI* decision⁵⁶ to establish a fare structure in which long-haul passengers pay substantially more than cost. Other forms of price discrimination between cities and regions could also flourish in an oligopolistic air transportation industry since the Board's power to suspend a fare on grounds of discrimination alone would be eliminated.

⁵³ Turner, *The Scope of Antitrust and Other Regulatory Policies*, 82 HARV. L. REV. 1207, 1225-6.

⁵⁴ Caves, *AMERICAN INDUSTRY: STRUCTURE, CONDUCT, PERFORMANCE* 107 (2d ed. 1967) (footnote omitted).

⁵⁵ See proposed new section 1002(g).

⁵⁶ *DPFI*, Phase 9, CAB Order No. 74-3-82 (March 18, 1974).

Assumption No. 2: Increased Competition

Cost savings stimulated by deregulation will occur either by virtue of savings in costs directly caused by regulation, or indirect savings related to elimination of economic constraints associated with regulation.

Direct costs of regulation: Proponents of the Aviation Act of 1975 will not seriously argue that the bill would lower the direct costs of regulation to the carriers. The major costs of government regulation of air transportation relate to safety. The bill does not propose less safety regulation. The major costs of economic regulation relate to such matters as accounting, reporting, and tariff requirements. These would not change. Provisions relating to entry, exit, and rates would change, but would not necessarily be less complex procedurally and hence probably not generative of substantial cost savings. New provisions relating to mergers, control, and agreements are intended to be more restrictive and another agency, the Justice Department, is injected more fully into the approval process, thus raising the possibility that regulatory costs related to these provisions may actually increase.

Costs related to regulation: The principal areas where cost savings are possible for airlines are: (a) labor costs, which amount to almost one-half of operating costs; (b) costs related to investment in flight equipment and its productivity; (c) costs of wasted production, *i.e.*, excess capacity and other kinds of non-price competition.

(a) *Labor costs:* Advocates of deregulation appear to regard lower labor costs of new carriers as a major reason deregulation will result in lower fares. It is assumed that new entrants will not face the same demands from organized labor and therefore will pay lower wages and less expensive "duty rigs" and fringe benefits than established carriers. This will not only permit carriers to charge lower fares, but will require established carriers to find a way to reduce their own labor costs or risk being driven out of business. There are weaknesses in this theory on both practical and policy grounds.

First, it assumes that new entrants will not only start out with lower labor costs but will maintain lower costs even when they have reached a large enough size that their fares will have a significant impact on the system. It is true that small new carriers, such as commuter airlines, can and do engage in air transportation while paying

lower wages than larger carriers. Local service carriers enjoyed such status at one time. That advantage disappeared, however, as the locals and their aircraft grew to competitive size. Thus, new entrants whose operations and flight equipment become substantially competitive with established carriers are likely to find themselves subject to intense pressure from organized labor to conform to the labor costs of the established airlines.

The fact that there will be a time lag before new entrants reach the labor costs of established carriers will probably not be significant in terms of systemwide air transportation costs. During the period a new carrier is behind in its labor costs, it is also likely to be behind other carriers in terms of economies of scale, access to flow traffic and public acceptance. By the time the carrier catches up in these respects, its labor costs are likely to have also caught up.

The theory that labor costs will be forced down also raises substantial policy and political questions which by themselves may frustrate its realization. In the sense that deregulation is an effort to lower airline labor costs, it is a collateral attack on historic government policies toward organized labor, in air transportation and in general. Wages and working conditions in air transportation today are not caused by the indifferent acceptance of labor's demands by regulated airlines. They are to a large extent the result of the federal policies embodied in the Railway Labor Act and other statutes and regulations designed to encourage protracted bargaining, minimize strikes, and otherwise advance the health, welfare, and safety of airline personnel. The proposed legislation is nothing less than a repudiation of those policies and penalization of carriers that have been subject to them. If it is believed that airline labor costs are excessive, a more straightforward approach would be to put the focus of regulatory reform where it belongs—on the agencies and policies which directly affect airline labor costs.

This is surely a matter which will not escape the attention of Congress. Any realistic assessment of what deregulation will accomplish must therefore take account of the fact that, whatever other advantages Congress may see in deregulation, it is unlikely to agree to its major premise—substantial reductions in airline wages and benefits.

(b) *Aircraft operating costs*: The second major cost element re-

lates to flight equipment. The most important force working toward low air fares for the American public is not a particular kind of regulation or non-regulation, but aircraft and engine technology, which has held down unit costs remarkably in the face of inflation. Any change in regulatory approach which reduces the ability of the airline industry to support new technology will cost the public far more than any regulatory action or inaction possibly could.

There is good reason to ask whether the proposed legislation may not discourage the development of new technology. On one hand, if concentration becomes serious enough, competitive incentives to pay for new technology may be jeopardized. The development of new aircraft requires the investment of enormous sums by the aircraft industry and a commensurately high price for the product. On the other hand, if the airline industry is weakened by un-economic competition, the chances of heavy capital investment in new technology are weakened also—another self-defeating result.

Even if technological advances in engine and air frame manufacture continue, the benefits will not necessarily favor new entry. The capital costs of aircraft are substantial, and tend to be higher for the newer, more efficient models. Typically, new entrants will have to go to the same sources of capital as established airlines. Even in today's regulated environment, established airlines are discovering that capital for new equipment is expensive and hard to find. If the existing serious shortage of capital for airline financing is any indication, deregulation will produce a total drought from institutional sources.⁵⁷

By the same token, it is not reasonable to assume that new entrants will be able to compete by using cheap obsolescent equipment. Where jets are available at lower prices, it generally has to do with their high cost of operation or lower passenger appeal. Hence, the kind of aircraft a new entrant could acquire at lower capital cost would in all likelihood involve higher operating costs, aggravated by more frequent overhaul requirements⁵⁸ or marketing disad-

⁵⁷ Equipment leasing is sometimes mentioned as an alternative. However, leased aircraft must be owned and financed by someone. That someone must go to the same money markets as established airlines and, like established airlines, must show a likelihood that the equipment will be able to pay for itself. The prospect that the leased aircraft will go to a new and unproven airline will not make it any easier for the lessor to obtain the financing than the lessee carrier.

⁵⁸ Airline maintenance cost are affected greatly by the time between overhauls

vantages tending to offset lower wage scales. Moreover, even obsolescent aircraft could become expensive. If the proposed legislation did succeed in developing a number of new entrants, the supply of appropriate aircraft would not be sufficient to support the increase in competition. Hence, new entrants would find themselves paying inflated prices for less efficient aircraft.

(c) *Costs of unused capacity*: One of the principal areas of airline cost—and hence possible savings—is wasted capacity, *i.e.*, seats not sold. Deregulation theory appears to assume that one of the major benefits of added competition will be fare savings associated with higher load factors. Higher load factors are unquestionably an important means of permitting lower fares. And experience with promotional fares shows that a properly designed fare reduction can increase load factors and not adversely affect profits. Such fares must, however, be designed to stimulate more net new revenue than they divert from normal fare traffic after taking account of cost savings in handling the lower fare traffic. These conditions are most likely to exist in dense markets with a substantial amount of pleasure travel (*e.g.*, New York-Florida “no frills” service).

Obviously there is a place for promotional innovations which permit lower fares by reducing wasted capacity. The question is whether deregulation is necessary to get them. Although not all innovations have received quick Board approval, there have been a great many, and they continue today under the *DPFI*.⁵⁹ Even if it were concluded that an effort should be made to speed up the CAB’s reaction time to innovation, it is questionable whether the proposed legislation is appropriate. Indeed, it would seem that successful innovation in fares and services is more likely to occur in an environment which favors a large number of strong established competitors, while still providing for the new entrant with a better idea, than in the kind of highly concentrated system deregulation is likely to produce.

Normal fares: To the extent deregulation theory assumes that load factors will be improved by a lowering of normal fares on a broad scale, it encounters a heavy burden. First, by taking away much of the CAB ratemaking power it necessarily assumes that a

(t.b.o.’s) of engines and airframes allowed by the FAA. These t.b.o.’s are traditionally low for new carriers, increasing only as justified by experience.

⁵⁹ See note 16 *supra*.

systemwide raising of load factors and lowering of fares will be the result of market forces alone. The CAB has the power to prohibit fares based on load factors which it believes are below those reasonably allowable, and it is actively exercising that power.⁶⁰ Deregulation would deny the Board that power.

Nor is there any factual basis for assuming that market forces will do the job. Carriers who lower normal fares on the assumption they will raise their load factors confront the virtual certainty that their reductions will be matched by competitors. Airlines will because they must, match each other's fare reductions. Therefore, a carrier which introduces lower normal fares (and continues to provide the same passenger services) must assume that the entire market will be stimulated enough to produce a compensating increase in its load factors and those of its competitors. Long experience⁶¹ and informed judgments as to the price elasticity in scheduled air transportation⁶² suggest that this is not likely to happen.

The assumption of extensive reductions in normal fares is also at war with certain other provisions of the statute. For example, section 404 of the Federal Aviation Act embodies a fundamental policy prohibiting rates which unjustly discriminate against, or unreasonably prejudice, any "person, port, locality, or description of traffic."⁶³ As that provision is now applied, carriers may not charge less for a longer haul than a shorter haul even if otherwise justified by traffic density or competitive factors. Nor, with a few exceptions, may a carrier charge the same for markets of substantially different distance. If fares must maintain a reasonable relationship with distance,

⁶⁰ A CAB proceeding looking toward possible upward revision in load factor standards is now in progress. Domestic Load Factor Standards, CAB Docket No. 27417 (Dec. 31, 1975). See CAB Order No. 75-10-107 (October 24, 1975).

⁶¹ Although normal fares were not fixed by the CAB for over thirty years, the Board was forced to conclude that during the period: "Price competition in normal fares has been virtually non-existent." DPFI, Phase 9, CAB Order No. 74-3-82 at 116 (March 18, 1974). The absence of such competition reflected in part the almost certain knowledge that competitors would meet any reduction in normal fares.

⁶² See DPFI, Phase 7, CAB Order No. 71-4-59, at 54-69 (April 9, 1971), CAB Order No. 72-8-50, at 34-39 (Aug. 10, 1972). To the extent that CAB action, or the provisions of the proposed bill, may result in a shift of price sensitive traffic to charter services, the elasticity of scheduled service traffic will be less than that estimated by the Board in Phase 7.

⁶³ 49 U.S.C. § 1374(b) (1972).

a carrier's ability to make substantial reductions in selected markets is obviously more limited than deregulation theory seems to contemplate.

The proposed Aviation Act would also leave undisturbed section 1002(h) of the Federal Aviation Act⁶⁴ which empowers the CAB to fix divisions of joint rates between carriers. Under that section the CAB has ordered domestic carriers to divide joint fares in relation to their respective costs for their portion of the passenger haul.⁶⁵ If the Board adheres to cost-based divisions, carriers who reduce fares in a market may find that, under a division formula which looks at relative costs not fares, a higher proportion of a lower yield will have to be paid out to connecting carriers. This may tend to discourage reductions, especially by carriers who depend more heavily on other carriers for connecting traffic.⁶⁶

If, as it appears, widespread reductions in normal fares cannot be predicted, competition from new entrants will tend to fall into the traditional mold—service competition. Unable to gain price advantages, airlines usually seek improved load factors by non-price behavior. This may be reflected in various attempts at product differentiation—advertising, cabin services, etc. But the most significant form of such behavior involves adding capacity, *i.e.*, out-scheduling the competition with bigger aircraft or more flights.

Such behavior is not only inconsistent with the attainment of lower costs, but poses special problems for the new entrant. In non-price competition, established carriers have several major advantages:

(1) Better public identification. As any airline which has tried to break into a new market can attest, the American public has a great affinity for familiar names in air transportation.

(2) More beyond traffic flow to support schedule frequencies which the local market will not support.

(3) Stronger financial resources to weather a competitive struggle.

In sum, while the odds are great that a new entrant will not be able to underprice an incumbent's normal fares, they are equally

⁶⁴ 49 U.S.C. § 1482(h) (1972).

⁶⁵ DPFI, Phase 4, CAB Order No. 72-4-42 (April 10, 1972).

⁶⁶ Carriers with extensive route systems would be affected less since they could rely more on their own system for traffic support.

great that it will not be able to compete effectively in non-price terms.

Lower mail revenues: A carrier's ability to offer lower fares would also be inhibited by a provision of the proposed Aviation Act which would encourage rates for mail below fully allocated cost. Currently, mail payments to scheduled airlines, which amount to approximately \$200 million per year, are based on rates fixed by the CAB. Section 15 of the Aviation Act of 1975 would amend the Postal Reorganization Act to permit the Postal Service to contract for mail wherever it (not the CAB) determines that the service by certificated carriers between one or more pairs of points "is not adequate for its purposes." No standards are established for such a determination, and it is apparently non-reviewable.

Upon making such a determination the Postal Service would then be empowered to institute competitive bidding, or negotiations, for mail rates. Quite apart from the questionable policy represented by the bill,⁶⁷ the effect of this will be to encourage the pricing of mail on an added, instead of fully allocated, cost basis. The resulting loss in mail revenue will have to be made up, largely by passenger fares.

B. Local Service Fares

If, as the foregoing analysis suggests, deregulation is unlikely to result in the predicted price competition, and is likely to lead to the gradual extinction of local service carriers, the fares paid by small city passengers will tend to be set in one of two ways: (1) in larger markets, by the members of the oligopoly, or (2) in markets of no interest to the oligopoly, by non-certificated carriers.

In either case it is difficult to predict benefit for the small city passenger. In smaller markets short-run price benefits may result from increased competition and turnover, but in the long run the fares in these markets will have to cover costs. As noted previously, without subsidy support, such fares could well be higher than charged by local carriers.

For small city passengers whose fares are affected by oligopoly pricing, and this would include the large number of passengers connecting to oligopoly services, the prospects for lower fares are

⁶⁷ One of the principal purposes for adoption of the Civil Aeronautics Act of 1938 was to eliminate the abuses stemming from competitive bidding for mail prior to that time.

no brighter. Systemwide, oligopoly prices will have to cover costs. For reasons already noted, they may actually exceed costs, especially in smaller, less competitive markets. In short, either way the local service passenger is likely to lose.

IV. CONCLUSION

Although it takes the form of legislation, the Aviation Act of 1975 is no less an experiment than many others the CAB has embarked on in pursuit of the same goal—a comprehensive, economical, and efficient air transportation system. The difference is that if this legislative experiment fails, there will be no quick turning back. Hence, the risks of this experiment require more cautious and careful evaluation.

The risks are substantial. Obviously, not all those risks identified above will be, or could be, realized; some are mutually exclusive with others. But not all risks need to be realized to result in serious and permanent harm to the air transportation system. Moreover, it must be remembered that it is an air transportation system that is at risk. Few other industries are more essential to the functioning of commerce, the conduct of personal lives, and the achievement of larger national purposes.

The paradox of the proposed Aviation Act is that it acknowledges this. Were air transportation just another industry, it could be deregulated in the true sense. But in seeking to preserve much of the regulation provided by the existing statute, advocates of the legislation acknowledge that this industry is really too important to deregulate. If air transportation is important enough to regulate, it is too important to risk on a theory which says in effect that whatever the public happens to get in terms of service, competition, and rates is what it deserves.

This is not to say that nothing can be done better. The perception that something needs to be changed comes in large part from the apparent success of intra-state airlines offering low fares in certain markets. As emphasized above, markets where such operations have survived are characterized by high traffic density and little dependence on flow traffic. Such markets are, of course, highly unrepresentative of the system as a whole, and it is utter foolishness to attempt to advance a regulatory theory for the national system based

on the experience in such markets. Nevertheless, there is enough to be learned from that experience to suggest that a separate regulatory strategy should be considered for large independent markets, one which is not inconsistent with the preservation of a national system of thousands of interdependent markets.

Similarly, it seems clear that the growth of airline oligopoly needs to be checked with firmer and more clearcut policies. Including the local service airlines, there are now twenty established and experienced certificated domestic carrier airlines. Even without new entrants, that number is more than sufficient to provide for a vigorously competitive system if an effort is made to reduce size disparities between carriers—rather than, as now, allowing them to increase.

While such objectives could be addressed in legislation, they do not require it. In the past, the CAB has often shown a willingness to act forthrightly in developing new policies required by the statutory goals. It should be recalled, moreover, that the existing system of regulation involves not just the CAB, but an effective system of legislative and judicial oversight. Within the recent past we have seen that system succeed in helping to refocus the Board's attention on the statutory requirements for competition and economical air transportation.⁶⁸ Admittedly, it still is an imperfect system. But it has one advantage the proposed Aviation Act lacks—the assurance that it will not destroy that which it is supposed to regulate.

⁶⁸ E.g., *Hearings Before the Senate Subcomm. on Administrative Practice and Procedure on Oversight of Civil Aeronautics Board Practices and Procedures*, 94th Cong., 1st Sess., pt. 1-3 (1975).