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DEREGULATION: THE C.A.B. AND ITS CRITICS

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I. INTRODUCTION

The enhanced possibility that Congress would rewrite the Federal aviation regulatory law persuaded the board of editors of the *Journal of Air Law and Commerce* to devote its entire Autumn 1975 issue to a symposium discussing the logic of proposed changes to the Federal Aviation acts. The highly informative issue stated the positions of the various parties and suggested reasons why change was either necessary or inappropriate depending on the viewpoint of the different authors.

This article is intended first to add some political dimensions to the debate and considerations which will explain some of the differences of opinion aired at the symposium. The political dimensions will provide some background for an evaluation of the logic which underlies the different positions. The second purpose of this article is to identify certain arguments which are manifestly "public relations positions" rather than real positions and other postures which, although superficially attractive, need to be analyzed carefully.

II. REASONS FOR THE ENHANCED PROBABILITY OF CHANGE

The Civil Aviation Acts of 1938 and of 1958 have been extremely stable pieces of legislation. While there have been periodic demands for change by groups within the United States,¹ with minor exceptions, these demands had been ignored. Without strong

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¹ See, e.g., G. EADS, *THE LOCAL SERVICE AIRLINE EXPERIMENT* (1972); F. THAYER, *AIR TRANSPORT POLICY AND NATIONAL SECURITY* (1965); KEELER, *AIRLINE REGULATION AND MARKET PERFORMANCE*; Bell, J. *ECON. & MANAGEMENT SCI.* 399 (1972).

evidence of consumer dissatisfaction or significant lobbyist pressure for change, political realists had accepted as fact that important changes to the basic law were highly unlikely. This static situation, however, has changed remarkably over the past two or three years. There are several reasons for the greater probability that a reform act might be passed. Briefly stated, these can be identified as follows: first, the 1973 cancellation of youth fares; second, the development of excess capacity within the airlines; third, the introduction into the governmental power structure of a new face, the Department of Transportation. I will amplify each of these developments to show why they are important.

Ever since the young, well-educated, and highly mobile segment of the American population discovered their political power, they have been vigorous change agents. The group is unusually powerful not only because of its numbers but also because it is well-educated and accustomed to questioning accepted modes. The power of the group has increased because it has a high success rate. This group quickened the U.S. departure from Vietnam, was a prime mover behind the drive for racial equality, and spearheaded the consumerist and environmentalist movements which have changed the world of the 1970's.

During the late 1960's the Civil Aeronautics Board (CAB) authorized discount fares for youth.² These fares proved extremely attractive to the powerful youth segment, not only on domestic routes, but perhaps more importantly, on international routes as well. Many of the influential members of the group developed a strong taste for travel and a desire to view and review customs and cultures in other parts of the world. This habit of travel, while certainly not universal among youth, became an important status symbol to the better educated, the more thoughtful, and the wealthier students. The 1972 decision by the CAB to cancel these youth fares stopped this movement abruptly.³ The excuses given to the grounded youths did not seem, superficially at least, to make sense. The stated reasons for banning the student fares—that they were discriminations against persons rather than conditions of travel—was hard to accept in view of the probability that those

² See *American Proposes 50% Youth Jet Fare*, AV. WEEK & SPACE TEC., Dec. 20, 1965, at 30.

³ C.A.B. Order No. 72-12-18 (Dec. 5, 1972).

discriminated against were no worse off with the youth fares than they would have been without them. It was not easy to explain why half-empty airplanes could not be filled at cheap fares by students who would not travel at higher fares. This group, in protest, followed the successful strategy they had used in previous causes. They started heavy agitation in the press, with members of Congress, and in influence groups throughout the United States to demand changes in the means of regulating civil aeronautics.⁴ The group is too powerful to ignore and normally will get change of some kind. Whether the change will be major or minor is not certain, but the young have too much political power to be easily frustrated by the opposing forces.

Amplifying the student unrest caused by the abrupt cancellation of a prized perquisite was the concurrent development of a heavy dose of overcapacity within the industry.⁵ This overcapacity resulted from the introduction of wide-bodied jets. Although the academic critics like to say that this overcapacity was an evidence of bad management by airline executives,⁶ it is difficult to see how it could have been avoided. The new wide-bodied jets, highly attractive to passengers, would have been able to steal passengers from competing narrow-bodied jets. In addition, their operating characteristics enabled them to make money at much lower load factors than the jets with which they competed. It is reasonable to assert that any major privately owned airline which did not invest in wide-bodied jets would have found it difficult to stay on many routes during the introductory phase of the wide-bodied jets. It is easy to say retrospectively that over-ordering of aircraft need not have occurred, but the problem was clearly predicted and recognized as inevitable by several students of the industry at the time the jets were being ordered.⁷ With the availability of wide-bodied jets able

⁴ See *Editorial Commentary Aeroflot Capers*, Barrons, Aug. 6, 1976 at 7, col. 1. Among those testifying for change in CAB during the Senate Subcommittee hearings on Civil Aeronautics Board Practices and Procedures, in the 94th Congress (Feb.-March 1975) were Ralph Nader and representatives of Consumers Union.

⁵ Overcapacity was most evident in long range segments. Pan American, for example, was forced to reduce utilization of Boeing 747 aircraft from 10 hrs. 43 minutes per day in 1973 to 9 hrs. 29 minutes in 1974, a loss of 9.4%. PAN AMERICAN AIRWAYS, ANNUAL REPORT XII (1976).

⁶ See, e.g., Miller, *A Perspective on Airline Regulatory Reform*, 41 J. AIR L. & COM. 679, 691 (1975).

⁷ Sir William Hildred, Director-General of the International Air Transporta-

to operate profitably at low load factors, naturally complaints arose suggesting that the accompanying empty seats represented a waste of resources, particularly of fuel when the OPEC oil crisis erupted.⁸ Something was obviously wrong, and the arguments seemed persuasive.

A third factor enhancing the probability of regulatory change was the establishment of the Department of Transportation. Prior to the establishment of the Department of Transportation, the CAB had developed a *modus operandi* with other organizations within the government. Although it was technically an arm of the Congress, it had relatively few differences of opinion with the executive department. There were necessarily heavy overlaps between the Department of State and the CAB when international routes were being considered, yet the CAB came close to being an absolute dictator of domestic air policy, unchallenged by other government agencies.⁹ The Department of Transportation was established in the late 1960's to consolidate transport matters into one department of the executive. The Department of Transportation obviously would come into head-on conflict with the CAB insofar as air transport was concerned. It is not surprising that officials of the Department of Transportation felt that it had primary policy responsibility for air transport.¹⁰ Since the CAB already possessed near-absolute power in this field, a collision was inevitable. Early skirmishes in the conflict between the two agencies were lost by the Transportation Department,¹¹ perhaps because it still lacked the necessary resources, policies, and long service personnel to mount an effective

tion Association, warned, "[T]his [Jumbo Jets] could mean the unleashing of incredible capacity that would make our past overcapacity problems appear pathetic by comparison." *Annual Report of the Director General*, 33 INT'L AIR TRANSP. BULL. 53, 74 (1965). See also R. THORNTON, INTERNATIONAL AIRLINES AND POLITICS 157 (1970).

⁸ See ECONOMIC REPORT OF THE PRESIDENT 154 (1975).

⁹ See Miller, *A Perspective on Airline Regulatory Reform*, 41 J. AIR L. & COM. 679, 682 (1975).

¹⁰ See AV. WEEK & SPACE TECH., Dec. 22, 1969, at 28.

¹¹ Included in these early engagements was an attempt to become coordinator of Policy for the Interstate Commerce Commission, the Federal Maritime Commission, and the Civil Aeronautics Board. A more serious defeat resulted when the Transportation Department attempted to dominate the development of President Nixon's 1969 International Air Transport Policy, a battle won by the Department of State. *Transportation Department Role to Spur Federal Conflicts*, AV. WEEK & SPACE TECH., Sept. 29, 1969, at 31.

tive intra-government war; perhaps, also, because the Department of Transportation chose to fight some of its early skirmishes in the international segment where the CAB and the Department of State had an impregnable position. As the Department of Transportation gained expertise, however, it also sought out allies in other governmental agencies. It found them particularly in the Department of Justice and in the Council of Economic Advisors.¹² The results of the major continuing struggle between these agencies have been to weaken the established positions of all the traditional groups and to reduce the unity which had once existed among regulators.

The CAB, recognizing the new substantially improved quality of its opposition, was hurried into making some decisions which have made it quite vulnerable to criticism. The presence of unused capacity and of a vocal youth group added to the pressure which hastened the CAB into its decisions. The most important of these decisions resulted from the Domestic Passenger Fare Investigation (DPFI). As a result of the DPFI, the CAB gave away much of its traditional flexibility in fare setting.

The CAB had been criticized because fares between cities equidistant apart had varied and because this variance was difficult to explain. In an attempt to protect itself from the severe criticism, the CAB in its 1974 DPFI adopted a rate formula (a fixed charge plus a standard rate per mile) which would minimize such fare anomalies.¹³ It subsequently became obvious that there were many reasons why nonmileage based fare differences were logical and that the "equal fare for equal distance" rule was a force for preventing innovative pricing. Among the reasons were differing costs on different routes due to density, operating difficulties, and differing demand elasticity which made price differentiation more or less successful in maintaining satisfactory load factors. It is unlikely that the CAB would have given away its traditional flexibility in fare setting had it not been defending itself against criticism.

A second example which gave critics a basis for objection was

¹² James C. Miller III served as theoretician and spokesman for the Council of Economic Advisors. *Hearings Before the Subcomm. on Administrative Practices and Procedures of the Senate Comm. on the Judiciary*, 94th Cong., 1st Sess. (1975). Thomas E. Kauper served as spokesman for the Antitrust Division, Department of Justice. *Hearings Before the Subcomm. on Aviation of the Senate Comm. on Commerce*, 94th Cong., 2d Sess. (1976).

¹³ C.A.B. Order No. 74-3-82 (Mar. 18, 1974).

the informal decision by the Board to place a moratorium on all new route awards rather than acting through formal procedures.¹⁴ The decision to stop new awards might have been justified as a policy (most routes were considered "over competition"), but the manner in which it was done permitted outsiders to complain, plausibly enough, of unfairness.¹⁵

III. CRITICISMS—WHEAT AND CHAFF

The *Journal of Air Law and Commerce* symposium provides a set of criticisms of the regulatory system as well as a second set of opposing opinions which favor the status quo. As is to be expected in an environment in which political action is an important objective, the criticisms and opinions are of varying quality. Some are outright absurdities. Some are half-truths or propositions which need supporting evidence. Others are defensible statements. It is worthwhile breaking down some of them to place the criticisms and opinions into one of the above categories.

A. Some Absurdities.

The most obvious set of absurdities are those which criticize the airline for providing unnecessary amenities on flights. Among those mentioned as unnecessary amenities are the following:

The airplanes are painted a wide collection of gaudy colors.¹⁶ The airplanes could theoretically be left aluminum colored but it is foolish to presume that unregulated airlines would not paint their airplanes. Once the decision to paint has been made it costs no more to paint an airplane purple or pink than it does to paint it dark blue or gray.

The airlines are criticized for having attractive stewardesses.¹⁷ The stewardesses are required for safety reasons and for control of passengers in flight.¹⁸ Once stewardesses are required for safety

¹⁴ See Kennedy, *Airline Regulation by the Civil Aeronautics Board*, 41 J. AIR L. & COM. 607, 616 (1975) [hereinafter cited as Kennedy].

¹⁵ "Outsiders" included the airlines who were not permitted new award because of the delay; for example, World Airlines' Transcontinental application (1967); North Central Airlines' Detroit-Boston application (1972).

¹⁶ Snow, *Aviation Regulation: A Time for Change*, 41 J. AIR L. & COM. 637, 642 (1975) [hereinafter cited as Snow]. See also, Miller, *A Perspective on Airline Regulatory Reform*, 41 J. AIR L. & COM. 679, 685 (1975).

¹⁷ Snow, *supra* note 16, at 642.

¹⁸ Letter from the Federal Aviation Authority to the author (Feb. 15, 1977).

reasons there is no reason why they should not be attractive.

The airlines are criticized for providing free drinks.¹⁹ There have been rare instances where alcoholic beverages have been provided without cost to coach customers. In the vast majority of cases, however, the only free drinks provided coach customers are four ounces of soft drink. Any other drink is normally paid for by the customer at a price which, given the necessity of a stewardess for other reasons, is probably economically justified. If the free drinks objected to are the four ounces of soft drink, the criticism approaches the absurd.

The airlines are criticized for lavish meals.²⁰ The meals provided have, on very rare occasions, been of unusually high quality, usually exotic sea food or steak, but these have been of extremely limited duration. The meal provided on most flights, including those on competitive routes, is attractive and reasonably palatable, but a long way from lavish.²¹ This criticism is intended to suggest that the consuming public would be better served if they bought their tickets without a meal included and meals were provided at an added cost. While this proposition is superficially attractive, there are major administrative problems with it. First, if free meals were not provided at times when meals are taken by custom, the airlines would have difficulty in preventing customers from "brown-bagging" their meals. "Brown-bagging" a meal represents a major problem both in interference by one passenger with another and in clean-up and control of waste resulting from the meal. If a meal were not provided for free, one passenger who wished the airline meal might be sitting beside another passenger eating a brown-bagged meal which created a nuisance and a mess which would be difficult for the stewardess to clean up.

The provision of a "no added cost meal" may be essential if the airlines are to prevent highly unsatisfactory meal arrangements. Consumers who doubt the truth of this statement should observe transportation facilities in which meals are not provided. The procedure to prevent fouling the passenger bus compartment with

¹⁹ Snow, *supra* note 16, at 642.

²⁰ Kennedy, *supra* note 14, at 610.

²¹ "The average cost per passenger for food is \$3.12," according to Howard D. Putnam, Group Vice President, Marketing, United Airlines. *Advertising Age*, Sept. 13, 1976, at 6, col. 5.

garbage and obnoxious odors is to make appropriate stops where meals may be taken or where "brown bag" lunches may be eaten outside the passenger compartment. This, of course, is not appropriate for airlines. In Europe, where trains are much more heavily used and where people of limited means are commonly accommodated, "brown bagging" is normal, and the result for many people is revolting. It should be noted that even in circumstances where price cutting is a primary selling tool, such as charter flights and in other non-regulated circumstances, a meal is almost universally furnished free. This criticism will not stand inspection. It is superficially attractive, but upon examination it is administratively and economically irrational.

The biased nature of many of the above criticisms is most easily brought out by examining the unregulated situation, referred to throughout the symposium as the example of the way things ought to be done or would be done in the absence of regulation. These examples are Pacific Southwest Airlines and Southwest Airlines. The provision of some of those things criticized as being a result of regulation has become the trademark of both Pacific Southwest Airlines and Southwest Airlines.²² The sexiest stewardesses in the business are said to belong to Pacific Southwest Airlines; their uniforms are unquestionably the most exotic.²³ Southwest Airlines is notable for the gaudy painting of its airplane,²⁴ and both airlines are in the forefront of the move for trendy decorations not only of the stewardesses but of the airplanes as well.²⁵ Neither provide meals, but then neither do certain of the regulated carriers at comparable flight distances.²⁶

²² See Gottschalk, *High Flyers Fall*, Wall St. J., July 20, 1976, at 1, col. 8.

²³ The President of Pacific Southwest Airlines decked out P.S.A. stewardesses in pink, orange, and red hot pants outfits. *Id.* at 31, col. 3.

²⁴ "Hi. It's Us, Southwest Airlines. Us with our brand new, candy colored rainbow powered Boeing 737 Jets." Telephone greetings to callers (June 10-18, 1971).

²⁵ "He (President of Pacific Southwest Airlines) painted widely grinning mouths under the noses of P.S.A. planes." Gottschalk, *High Flyers Fall*, Wall St. J., July 20, 1976, at 31, col. 3.

²⁶ Industry practice varies depending on the total routing of a flight. Piedmont Airlines, with similar route distances generally limits service to snacks; Pacific Southwest Airlines, however, also serves snacks. See appropriate Official Airline Guides.

B. Propositions Needing Supporting Evidence.

Several propositions made by contributors to the *Journal of Air Law and Commerce* symposium need more evaluation before they can be accepted as valid. Some propositions of contributors are well-criticized by other contributors. For example, the airline apologists fear the abandonment of small city service without regulation,²⁷ critics of regulation adequately discuss the weaknesses of the airline proposition,²⁸ and the "abandonment" argument gets a reasonably balanced treatment. Certain other propositions, however, are stated by contributors but are not fully critiqued by other participants.

Perhaps the most superficially persuasive argument used against regulation is that without regulation fares would be driven down by competition to the point at which no more than a normal profit would be possible. Since regulated airlines do not and have not averaged more than a normal profit,²⁹ this argument needs the support of an ancillary theorem, namely that airlines voluntarily reduce their profits to an unreasonably low point through overscheduling. An airline obsessed by "share of market" objectives adds unneeded capacity to a route until it is making below acceptable profits. At this point the regulators bail out the airline through fare increases, proceeds from which are used to add capacity, restarting the cycle. Presumably, this would not happen without regulation. Unregulated airlines, knowing they would not be bailed out, would only schedule enough capacity to insure adequate service. Some critics represent this amount as load factors of sixty to seventy percent; that is, averaging sixty to seventy seats occupied out of every hundred available.

In spite of a sprinkling of comments about relative managerial efficiency between regulated and unregulated airlines, the basis of the "price reduction" argument for deregulation lies almost exclu-

²⁷ See, e.g., Rasenberger, *Deregulation and Local Airline Service—An Assessment of Risks*, 41 J. AIR L. & COM. 843 (1975).

²⁸ See Snow, *supra* note 16, at 660-62.

²⁹ Since 1968, domestic trunks have averaged well below "all manufacturing organizations" in "return on equity." They have not approached the CAB recommended "Return on Investment" since 1967. *Hearings Before the Subcomm. on Aviation of the House Comm. on Public Works and Transportation*, 94th Cong., 2d Sess. (1976).

sively in load factor.³⁰ Load factor problems, therefore, need to be reviewed at some length. Before discussing load factors, however, it is important to put the under-use of available capacity exemplified by low load factors into perspective. Unused capacity is widespread in the United States in unregulated industry. It is not necessarily regulation which produces low utilization. It can be a variety of things. Your local supermarket, so busy on Friday evening, is near empty on Tuesday morning. Ski lifts stand idle and silent in August, and Carolina Beach is visited principally by sea gulls in February. Your friendly local barber works at top speed Friday night, but spends Monday morning gazing out his shop window. The correlation between unused capacity and regulation is highly imperfect.

1. *Low Load Factors.*

Low load factors are caused by several considerations. Most importantly, load factors are affected by demand variability. Demand varies in several patterns, each idiosyncratic to particular markets. The first variable is seasonal. Across the North Atlantic, for example, February demand is only one third of August demand.³¹ Few people go to Europe for pleasure in February. People will not go to an undesirable place for pleasure at any price, so price reductions do not help much.

The second problem is weekly variation. Most business routes are travelled heavily on Friday and Sunday, with half as many customers on Wednesdays. What do we do on Wednesdays if personal travel is unimportant to the route?

A third problem is directional imbalance. In tourist markets, for example, everyone flies south in early winter and back in late winter, or before and after holidays. If so, presuming we have taken a load in one direction, how do we get the airplane back to the "from which" point to pick up a new load of "to whiches"? Repositioning can be done only at very low load factors.

The last problem is that of "no shows." Outsiders are frequently unaware of the severity of the "no show" problem. For example, a major airline station manager at Tallahassee, Florida, stated to the author that one of every four reservations he receives becomes a

³⁰ Kennedy, *supra* note 14, at 621.

³¹ AV. WEEK & SPACE TECH., Aug. 29, 1977, at 30; *id.*, Nov. 28, 1977, at 24.

"no show." This factor alone would make the absolute maximum load factor seventy-five percent, before corrective action. "No shows" are normally willful acts, done by an individual, unsure of the time his business will let him leave a city, who safeguards two or three different times by separate reservations. Of course, he is a "no show" on all the nonused times. Corrective airline action is by "overbooking," a risky practice complained of by Senator Kennedy's subcommittee in one symposium paragraph;³³ not, however, the same one as that in which it castigates the airlines for low load factors.³³

Critics of regulation seem to suggest that load factor problems resulting from poor matches between the size of an available airplane and the expected demand on a specified route are due to regulation.³⁴ The argument suggests that the airlines have been unwilling to demand certain sizes of aircraft, particularly the smaller ones, from manufacturers. Presumably, without regulation, all competitors would have a wide variety of aircraft types in each stable and could choose the right one (as a craftsman chooses a tool) for a particular route on a particular day. Presto, there would be no scheduled overcapacity. This argument may be valid, but it does raise credibility problems.

2. High Load Factors.

Given the above uncertainties, very high load factors are still possible under particular circumstances.

Underscheduling: If the low point for demand is 100 per day across a time period and the high is 200, schedule only 100 places across the period. The peak travelers smooth out the high-low disparity either by not going or by shifting their travel into valley periods. This method is used in Europe where very high load factors (seventy-five percent) are commonly achieved.³⁵ This solution is not practicable without regulation. Without regulation, competition would schedule preferred times, reinstating the peaks.

Matching cycles: If counter-cyclical demand can be developed which reduces demand variability, load factors can be enhanced.

³² See Kennedy, *supra* note 14, at 631.

³³ *Id.*

³⁴ See G. EADS, THE LOCAL SERVICE AIRLINE EXPERIMENT 129 (1972).

³⁵ U.S. Civil Aeronautics Board, Bureau of Economics, *Recent Growth of Air Traffic, Intra-European Compared to U.S. Domestic*, Sept. 1971, at 8.

The most attractive device would be discriminatory pricing, cheaper for "low point" travelers, more expensive for peak ones. This could be achieved either by lowering valley fares, by raising peak fares, or by both. In this way, day-to-day demand would be smoothed out and load factors improved. Practical usefulness of this approach depends on demand elasticities on a day-to-day basis. Where tourism travel is important on a route, "within the week" demand shifting is probably possible: from and to San Francisco, Miami, New York, or New Orleans. When most travel is business-oriented, extreme daily inelasticity is likely to frustrate the differential pricing approach. No unregulated airline will voluntarily reduce prices into an inelastic zone on its demand curve (*i.e.*, the price reduction produces a total revenue less than that before the price cut).

Variable scheduling: In this approach, daily flight schedules are not symmetrical across a week or season. Only that which will be used on a particular day is scheduled, and load factors are thus high. Here, the most likely saving will come with seasonal variations, and this practice is widely followed even under regulation. On a weekly basis, extra sections are frequently added for peaks and omitted in valleys. It is a logical practice in all industry, however—regulated or unregulated—to operate capacity in the very short run at any time that revenues are expected to cover variable costs. On a "within a week" basis, a much larger percentage of costs are fixed than is normally admitted to by academic theorists.³⁸ Unregulated airlines, therefore, would be expected frequently to do as poorly as their regulated brethren. They would fly at load factors as low as twenty or thirty percent during short-term valleys in demand, presuming severe demand variability exists.

Development of a differential advantage: This is perhaps the approach most revelant to the discussion reported in the *Journal of Air Law and Commerce* symposium. It does not change industry load factors in a market; it merely shifts the burden of demand variability from one carrier to another competing one. In this approach, one carrier, by some device, becomes the carrier favored

³⁸ For a carrier to operate on a route, a certain minimum "presence" is important, and flights at least daily during the week need to be scheduled if their services are to be successfully marketed. Theorists tend to ignore the importance of this "presence" in calculating fixed costs.

by most customers on a route. Customers will always take the favored carrier when available. The favored carrier then schedules only enough to serve all passengers wishing to fly at the lowest demand period, abandoning the peak surpluses to its competitors. If successful, the favored carrier can become extremely profitable, flying at eighty or ninety percent full, and, if it wishes, further exacerbating the problem for its competitors by using its increased revenue to cut prices. Obviously, no carrier can afford to become the victim of such a favored competitor; it would bear the entire burden of demand variability. Much of the service competition results from defensive moves to prevent a competitor from becoming the most favored. Of course, the favored competitor cannot afford to drive its competitors off the route; should that happen the survivor will be reduced to dealing single-handedly with normal demand variability again.

Considering the highly unfavorable results ensuing to any carrier permitting a rival to develop a differential advantage, it would seem that no company would allow it to happen. It has happened, however, quite frequently, for a variety of reasons. Loftleider, the Icelandic carrier, has long enjoyed differential advantage on the North Atlantic. It maintains it through its ability to coerce the United States into permitting it to be the only scheduled cut-rate carrier on the route. The CAB permits rate cutting for external reasons (the United States needs Iceland's military bases) and protects Loftleider's price differential by preventing other carriers from violating the higher International Air Transport Association floor prices.³⁷ Loftleider enjoys very high load factors, winter and summer, recession or boom, in a market notorious for its cyclical and seasonal variations. Laker Airways' North Atlantic "skytrain" proposal and World Airways' low price transcontinental idea³⁸ were both feasible only if load factors could be kept high through differential advantage. If potential competitors were wholly unfettered, neither of them would seem to have any particular basis for differential advantage. Without an advantage, the presuming competitors matched their moves, they would have had to deal with

³⁷ The author worked in NATO as a planner for three years, and is personally aware of the very hard bargaining Iceland did on the subject of base rights.

³⁸ Levine, *Alternatives to Regulation: Competition in Air Transportation and the Aviation Act of 1975*, 41 J. AIR L. & COM. 703, 718-21 (1975).

seasonal and cyclical variations of the same kind which prevent current carriers from increasing load factors.

Differential advantage need not rest solely on price, although price moves may be the initial cause of a differential advantage which continues long after the price advantage has disappeared. Pacific Southwest Airlines was permitted to build a "consumer franchise" originally by price cutting. Their customers stayed loyal long after price differences had disappeared. Consumers scheduled with the competition only after Pacific Southwest was fully booked.

Southwest Airlines, the Texas intrastate carrier used (probably accidentally) a different tactic to develop a successful "consumer franchise." Their long legal battle to gain the "right to fly" against entrenched regulated carriers was well-publicized. A sharp reduction in fares occurred on all carriers coincident with Southwest's legal victory—applicable to all carriers.³⁹ In the mind of the consumer, however, Southwest Airlines was responsible for the price cuts; they deserved the prized differential advantage.⁴⁰

Another kind of basis for differential advantage could be used, as an added example, if only one carrier was allowed to use a highly favored airport. Imagine Eastern Airlines' Washington-based load factor if only it could use Washington National Airport while the competition had to use Dulles! Only if Eastern were full would anyone call in the others.

A reasonable hypothesis can be made that a differential advantage would be hard to achieve against alert, unregulated competitors, and would be even harder to maintain. A loser in such a situation would probably withdraw, destroying the favored carrier's protection against traffic uncertainty.

"Unscheduled" schedules: One other theoretically attractive way to achieve high load factors might be possible on extremely high density routes such as Chicago-New York or Washington-New

³⁹ Fares prior to inauguration of services on June 18, 1973 by Southwest Airlines: Dallas-Houston \$27; Dallas-San Antonio \$28. Fares afterwards: \$20, both city pairs. See Official Airline Guide, appropriate issues.

⁴⁰ Southwest Airlines made certain that consumers knew who had started the price war. A three page brochure on the theme "Remember what it was like before Southwest Airlines" was handed out in downtown streets of Dallas and Houston Feb. 1-5, 1973; the same theme was used in Dallas and Houston newspapers on Feb. 5, 1973, along with copy such as "You'll lose if they win. If Braniff succeeds you'll again be at the mercy of a single dominant airline on major Texas routes."

York. Presuming decisions to take off were made by airport authorities rather than by airlines and were made only when the airplane was full, the airport authority could see to it that 100 percent load factors were achieved. Such a system would have to deal with the businessman's desire for certainty—passengers might have to wait appreciable periods of time for the last few fill-in customers. On very high density routes, waits and uncertainty might be manageable. On less dense routes, the scheme would probably be unacceptable.

A thoughtful evaluation of the above analysis of ways by which high load factors might be achieved does not suggest that the absence of regulation is a prerequisite for load factor efficiency. A better prescription would have to be based on demand elasticity conditions, or the presence of substantial personal travel interest in the market in question. The most persuasive cases used by the deregulators—the California and Texas cases—can be explained, partially at least, as due to the presence of both regulated and unregulated carriers in the same market. The unregulated carriers use differential advantage, stemming from unwise dependence on the CAB by regulated airlines, to cream off the stable demand base, while the regulated carriers are stuck with the cyclical excesses. In both these cases the local experimenters were able to make their deep fare cuts from concomitant reasons. They struck pay dirt in an important pocket of demand elasticity.⁴¹ Other unregulated carriers have had less success; intrastate carriers in Florida, another long, thin, populous state, have not been able to make an impression, in spite of the California and Texas examples.⁴² On the other side, pay dirt was struck in spite of CAB regulation in the Puerto Rico-New York markets.⁴³ This pocket of elasticity was

⁴¹ Demand elasticity is defined as a market in which the increased volume from price cuts will generate significantly more revenue after the cost of serving the added passengers than the lower volume at higher fares produces.

⁴² The only current effort at emulating the Texas and California examples is by Air Florida, which had not been profitable through 1975, and had suffered a traffic decline 1974-75. At the time, it had 3 Lockheed Electras versus Pacific Southwest's 30 aircraft. Air Florida was in the process of ordering different aircraft at time of writing.

⁴³ See Prepared Statement of Rafael Hernandez-Colon, Governor of the Commonwealth of Puerto Rico in "Oversight of Civil Aeronautics Board Practices and Procedures." *Hearings Before the Subcomm. on Administrative Practice and Procedure of the Comm. on the Judiciary*, 94th Cong., 2d Sess. (1975).

exploited by the regulated carriers with effects quite similar to those achieved in California and Texas—lower prices.

The most telling criticism of the CAB is of a recent innovation. The "Formula Pricing" coming out of the Domestic Passenger Fare Investigation inhibits the search for pockets of elasticity to which the price cut tool should be applied. Formula pricing ignores varying elasticity situations. It will take an unregulated experimenter to ferret out the pockets as long as formula pricing is a CAB policy. The Puerto Rico pocket was discovered before "Formula Pricing" was adopted as CAB policy.

3. *Price Competition.*

Load factors aside, the major premise of the assumption that deregulation would result in lower prices is that an unregulated airline industry would engage in vigorous price competition. The theoretical basis for this assumption is arguable. An examination of the nature of the airline industry suggests that in any relevant market, it is totally unrealistic to presume that more than eight or ten airlines would simultaneously offer service under free competition. In the vast majority of markets within the United States it is highly unlikely that more than two or three airlines would be viable at the same time on the same route. At this number of competitors, economic theory does not support an assumption that price competition would occur. The theory of oligopoly, instead, would suggest that price competition would be the exception. The statements made by the proponents of free competition in domestic airline operation are generally made as if the market consisted of an undifferentiated national market. At the operating level, that is, the specific market (*e.g.*, Birmingham-Atlanta), it is highly probable that the scale of operations is always well below the minimum cost point because of limitations on available demand. Arguments denying this are based on overall operations rather than on operations in specific markets, and therefore are unrealistic.

Secondly, the assumption that because there are low fixed costs in airline operations, freedom of entry is easy, is also suspect when the market under consideration is recognized as being the local one rather than the national one. For a new carrier to break into an existing route will require a significant investment, primarily in marketing, but also in station opening costs. Most studies of the

cost of entry in airlines tend to be production-oriented and do not recognize that the cost of reaching the market can be very significant.⁴⁴ A new competitor would have to displace an entrenched opponent before he could successfully invade a market. If the logic behind this argument is to stand up, it would require that the aggressor, a new carrier, be confident that he could recoup the cost of entry into a market after he entered it successfully. If we accept that prices will be kept down by fear of other new entries, then this new competitor would not be able to make the excess profit that is necessary to recoup the cost of entry. While the circularity of both lines of reasoning is obvious, the price competition argument is not totally persuasive.

A glance at other unregulated industries where only a modest number of competitors are involved provides us with some insight into the competitive ways of an oligopoly. Automobile companies, for example, do not compete with price. Instead, "bare bone models" are neither available nor particularly sought after by the public. Breakfast food manufacturers, an industry with low fixed costs of production and superficially easy entry, are currently under Federal Trade Commission attack for failure to price-compete.⁴⁵ In the motel trade, with far fewer entry problems, price competition has occurred in certain areas of the United States, the Southeast perhaps most obviously. It has occurred less obviously in most markets. In supermarkets, rapidly degenerating into an oligopoly, price competition is not the way to succeed, in spite of lurid price ads in the newspapers. Indeed, potential supermarket profits are more likely to be used, of necessity, in "trading up" the services provided, an interesting parallel with the airline case.

Predicting the behavior of oligopolies has been an academic nemesis for years. The academicians who have so confidently assumed that unregulated airlines would engage in price competition may be right, but likewise may be wrong. The most likely result of total deregulation is one of a group of unexpected developments, one which would completely reorganize the industry. There is a remote possibility that total deregulation would shift

⁴⁴ Included in the costs are terminal and gate space costs, local advertising costs, promotion with local travel agents, minimum level of flights per city pair per day, maintenance, servicing, and baggage handling services.

⁴⁵ See *N.Y. Times*, April 25, 1976, § 3 at 1.

power within the travel industry from the airlines to the travel agents and wholesalers. The flying companies would be reduced to mere subcontractors to powerful national travel agencies who control the trade through controlling access to the market. In Europe, for example, this has already occurred in the charter market. There, one does not ride Dan Air or Monarch Airlines. One rides with Cosmos Tours, or Thompson's Travel, or Cook's. Dan Air or Monarch, technically airlines, are mere subcontractors.

IV. THE KEY CRITICISM OF REGULATION

The above discussion suggests that the critics of regulation have failed to make their point. It is not established that the drastic step of deregulation would offer advantages large enough or probable enough to justify the risks involved. There is, however, one key remaining criticism which is hard to deny and is damning of important segments of the regulatory system. Whether it is called "overprotection of the scheduled routes" or "overconstraints on charter travel," it amounts to the same thing. The CAB has prevented the development of low cost, vacation-oriented, widely attractive travel. For the traveling public, which will settle for inconvenience to hold personal costs down, the alternative has not been provided.

How Much Scheduled Travel?

Scheduled, dependable, and available air travel between localities is an important public need. It is the CAB's most basic charge that it be provided. But, how much should be offered? What does business need? Let me suggest. Business needs an available, short notice, secure, and dependable flight between major cities usually no more than three times per day—morning, perhaps noon, and night. Once this frequency has been provided, and a high probability of short notice reservation guaranteed (say, ninety percent two hours before), the public necessity has been met. Greater frequency is not a need, it is a luxury. If a system could be devised, for example, which would guarantee Chicago-New York scheduled availability three times a day, the CAB should cease to worry about the conditions under which any other passengers travel. The CAB can make two kinds of error, Alpha and Beta.

Alpha error is failing to insure adequate schedules to meet public need. Beta error results from actions so protective of scheduled travel as to inhibit the development of alternatives.

Until very recently, the CAB had been most fearful of making an Alpha error. For the vast majority of markets within the United States, protection of scheduled routes left no room for alternatives. Demand was not adequate to go beyond three flights per day. For the really large markets, however, those currently offering nearly hourly flights, the CAB had until recently failed to try innovative approaches which would permit the very great savings possible with high load factors. Recently the CAB has been much more relaxed in its control of price and conditions of service. Most of the resulting new innovative approaches have called for significantly lower prices with some modest form of capacity or timing control on the low priced fare. Whether this experiment in meeting the need for low cost fares within the framework of regulation will succeed or not is at the moment difficult to predict. It is worthy of note, however, that experimentation is possible without deregulation and that deregulation is not a necessary prerequisite to innovation. Indeed, as was suggested earlier and as European experience has shown, strong regulation may be a requirement for some innovative forms.

V. A SUMMARY

The *Journal of Air Law and Commerce* symposium did an adequate job of making the point that the current regulatory system was not providing all the results it should. Given that, it only examined one way to solve the problem—deregulation. The symposium did not persuade the thoughtful student that deregulation would solve the problem. The problem remains, but because of the heat which reregulation has generated, a solution by less drastic means may not be adequately studied.

