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Problems in Economic Regulation of Civil Aviation in the United States

Louis J. Hector

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PROBLEMS IN ECONOMIC REGULATION OF CIVIL AVIATION IN THE UNITED STATES

BY THE HONORABLE LOUIS J. HECTOR
Member, Civil Aeronautics Board

It is good to be with you today to discuss some of the problems involved in the economic regulation of civil aviation in the United States. Our airlines are in a period of rapid change and growth, and they face today many complex problems of financing, traffic, and organization. As you know, our carriers, almost without exception, are in the midst of massive re-equipment programs. This is true not only of the trunklines, but also of our feeder airlines who are in the midst of a conversion to larger piston equipment and to turbo-prop equipment.

Speaking broadly, I have the conviction that the managements of our carriers are facing up to these challenges with energy, ability, and imagination. On them rests the major responsibility for solving the problems of the industry. But civil aviation, of course, is a regulated industry, and the regulatory climate in which our airlines operate is vital both to their success and to the maintenance and development of an air transportation system in the public interest.

I understand that this matter of regulatory climate has been adverted to by previous speakers before this group, and not always in the most flattering terms. Both government agencies and the industry, however, profit from full and free discussion; no matter how extreme criticism may be at times, in the long run public bodies profit from the fresh insights which public discussion of their functions engenders. Frankly, I think it would be an evil day if the members of the airline industry ever reached a point where they did not speak out vigorously and candidly on matters which vitally concern them.

To put this matter of regulatory climate into proper focus, let me recapitulate a bit of general recent aviation history. The U.S. trunklines emerged from the Korean War with passenger traffic in the neighborhood of 13 billion passenger-miles a year and load factors around 67 percent. The Korean crisis, as all national emergencies, had simultaneously increased traffic and decreased the availability of equipment. In the four years that followed, new equipment became more readily available and the carriers rapidly added to the size, speed, and comfort of their fleets. The growth of coach service produced a substantial lowering of the general fare level, and traffic continued to grow at an annual rate of about 12 percent. With the exception of a slump in load factors to the low 60's during the 1954 recession, load factors continued at a satisfactory level in the middle 60's up into 1957. Profits remained high.

As a matter of fact, in 1952 the Board became concerned about carrier earnings and the level of rates, and ordered a general passenger fare investigation. Unfortunately this investigation was terminated before it was ever started.

Then in late 1955 a radical new factor was injected into the U.S. civil

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aviation picture—the passenger jet transport plane. It had been clear for some time that both the British and Russians were making rapid strides in the development of passenger jets, and our American carriers and airplane manufacturers had become increasingly concerned that they might be left behind in the jet age. The first dramatic step was taken by Pan American on October 13, 1955 when it announced that it had placed orders for both Boeing 707's and the Douglas DC-8's. It was to be expected, of course, that one of our international carriers would place the first order. Faced with the jet programs of its largest international competitors, Pan Am decided that it had no alternative but to convert to jet equipment.

The next big jet orders to be announced were those of certain of our domestic transcontinental carriers. They decided that a jet transport was not only the quickest and most comfortable, but probably the cheapest way to fly passengers across the United States. From that point, our domestic and international carriers almost in a single voice announced re-equipment programs for both pure jet and turbo-prop equipment. Financing negotiations were started, and a substantial part of the money for the jet programs was raised or committed when carrier earnings began to slump in early 1957.

Then in September of 1957, the rate of traffic growth sharply dropped and load factors started to decline toward the 60 percent level and below. Indeed, in some months in early 1958, traffic was actually below the same month of the previous year—an almost unheard of occurrence in civil aviation. The effect on profits was, of course, very serious.

The extent to which the slump in traffic was caused by the recession of 1957-58 and the extent to which it may have been the result of longer-range trends in passenger growth is a matter on which opinions differ, just as opinions differ sharply on the extent to which the airlines could and should have prevented such a severe decline in load factors by scheduling and equipment adjustments. Whatever the causes, the airlines early in 1958 found themselves with their re-equipment programs still not completely financed, traffic growth at a standstill, declining load factors, and rapidly shrinking profits. This situation was, of course, of just as acute concern to the Board as it was to the carriers and all others interested in their financial health.

The remedy first proposed by almost all of the carriers was a substantial increase in the level of fares. As early as February 1957, a number of carriers proposed a flat six percent increase. As the crisis grew, larger increases were proposed. The Board recognized that fare increases might be a partial solution to the earnings problem, but at the same time could not ignore the vital necessity of restoring a healthy rate of traffic growth. In a series of decisions during 1958, the Board permitted fare increases and reductions or eliminations of discounts which produced an overall fare increase in excess of 10 percent on an industry-wide basis. At the same time, the Board continued to remind the carriers that the large present capacity and the much larger capacity on order require the most vigorous possible action to stimulate new traffic.

In such times of tension, of course, tempers become frayed, and the air for a while was filled with violent charges and counter-charges. In the last few months I think there has been a considerable change in the general atmosphere. Traffic growth, while not restored to its old rapid rate, shows signs of renewed vigor. This and more careful scheduling has in some cases reversed the trend to lower load factors. Profits have taken a turn for the better. The third quarter of 1958 shows a marked improvement over the second quarter and also over the like quarter of 1957. There is a broad and increasing awareness within the industry of the need for radical new techniques of traffic stimulation in the light of the great increases in capacity still to come with the jets.

Perhaps the most important thing to realize about this recent history is that, in a very real sense, it has all happened once before. This is not the first re-equipment, load factor, earnings crisis for the airlines. They faced much the same crisis in the late 1940's.

The airlines had emerged from World War II with more passengers than they could handle and old inadequate equipment. In the hectic days of demobilization and reconversion to a civilian economy, traffic remained high. As the airlines were able to get DC-4's and then the early Connies and the DC-6's, they enlarged and improved their capacity as rapidly as they could. All of the trunklines had gone off subsidy during World War II and they all looked forward optimistically to a period of growth and prosperity. Load factors during the war had approached the 90 percent mark. In 1946 the average was around 79 percent. In 1947 it dropped to 65 percent—a quite satisfactory peacetime rate. Then with the sudden addition of new capacity and the general business recession, load factors dropped below 60 percent in 1948 and they stayed there during 1949. The airlines, with large equipment programs and vanishing profits, found themselves in a major crisis. Government subsidies were re-established. The Board permitted two general ten percent increases.

But to my mind the most important thing that occurred was a silent but very real revolution in airline management. For the first time the airlines really became interested in scientific management, and they returned, on a more scientific basis, to the careful costing which they had tended to lose sight of during the war. Adequate reservations systems were developed for the first time. The carriers began to realize that planes must be scheduled at times when people want to fly, and to tailor their product to suit the desires of their customers. And they learned to do this while at the same time scheduling their planes and using their other facilities so as to obtain maximum efficiency. Modern airline management really dates from the dark days of the late '40's. It was then that the airlines became a major industry and a basic component of our national transportation system.

These two periods of airline history point some very basic and important questions: Why have the airlines got into the same sort of re-equipment, load factor, earnings crisis twice within a decade? Are such crises inherent in the industry? Why have the carriers placed massive orders for jet equipment which seem in total destined to produce capacity in excess at least of the short run traffic potentials? Why are they replacing equipment which seems adequate to do the job? Have not the carriers taken as a whole been overly optimistic in their total jet orders just as they seemed to have been in the late '40's? Is it not probable that there will have to be some stretch-outs or cut backs in orders, or in the alternative more rapid retirement of some existing equipment than previously planned? And what are the implications of all this for government regulatory policy?

Since the airlines must be considered the basic mode of passenger common carriage transportation today, and since they have grown so large that their economic health has a significant impact on the general economy, these are serious questions indeed for both carriers and government alike. And they are difficult questions. Take the matter of fares, for instance. These equipment cycles pose the serious dilemma that just at the time when increased fares seem indicated to restore earnings, lower fares and greater discounts seem indicated to stimulate traffic to fill excess capacity.

I personally tend to believe that re-equipment cycles of this type are in a sense built into the civil airline industry. These cycles will inevitably pose very serious problems, but I am convinced that they can be accomplished successfully by the industry in a regulatory climate which protects both the proper interests of the carriers and the general public.

The airline industry is in many respects different from the usual public utility, and I feel that sound regulation requires careful consideration of its peculiar characteristics. I know of no industry, for instance, where the exact character of the major capital investment is of such critical interest to the ultimate consumer. By and large, people want to ride on the latest and best plane, and it is pretty clear that they will flock to the airline which offers it. This is quite unlike other utilities. The purchaser of electricity cares only about reliability and price. He is not really interested in whether his electricity is produced by coal, oil, water, or atomic reaction. The purchasers of most commodities do not care in what kind of factory they are made so long as the product is satisfactory. Even the railroad passenger is not too choosy what kind of locomotive pulls the train, provided his particular coach is comfortable. But the airline passenger walks out on the loading ramp, looks over the piece of capital equipment that is to perform his service, then climbs right up inside of it—and he wants the latest and best.

In a very real sense the airlines' major capital investment is the very product they sell the public. A carrier with a plane which does not have public appeal has no alternative in the long run but to get rid of it and buy the type of equipment that the public demands.

The practical business logic of the re-equipment program then is easy to follow. It started with the biggest carriers and then spread rapidly to the medium and smaller carriers who believed that they could remain in existence only by offering service in planes like those of their larger competitors. It may be claimed, of course, that DC-6's, DC-7's, and the late and modern Constellations are good enough for the American people. In one sense, of course, they are, because they are very fine planes indeed, but the decisions in a free economy are not made on the basis of what is good enough for the people. Technology produced the jet transport. Our largest airlines decided to shift to the jet and they are almost certainly capable of making it pay. I do not see how we can discourage our other airlines in their efforts to keep up in the competitive race.

Some of the problems could be avoided, of course, if the airlines proceeded at a slower pace in introducing new types of equipment. But here again, the peculiar characteristics of the industry create difficulties. The difficulties inherent in the operation and maintenance of radically mixed fleets, for instance, make it impractical to introduce jets into a system one by one over a long period, in the same way that an electrical power company may build a single new type of plant. But far more important than these factors, and implicit in everything I have said, is the factor of airline competition.

Despite the fact that civil aviation is a fairly-closely regulated industry in which freedom of entry has at least so far been closely restricted, it is certainly not a utility industry in the classic monopoly sense. There are very few monopoly trunkline routes today, and no really major markets in which there is not a vigorous competition. Taking the industry as a whole even, it is in no sense a classic monopoly utility. The airlines must compete with the trains, the buses, and to an ever-growing extent now with the automobile and the super-highway. The airlines could not be operated or regulated as a conventional utility. In the matter of fares, for instance, conventional mechanistic utility formulas are quite inadequate to cope with the complex economic environment in which the airlines operate.

Airline competition, of course, has come in for a lot of criticism in recent months. We have heard many proposals to mitigate or even abolish interline competition: minimum fares, traffic pooling agreements; cancellation of competitive certificates; indeed frank proposals that the airlines be turned into a sort of government regulated cartel with fixed prices and quotas.

Such proposals fly squarely in the face of our American tradition of free competitive enterprise. I think all of us believe that our prosperity and progress in the United States, our inventiveness and our high standard of living are the result of the free play of competitive forces as opposed to the restrictive business regulations of other countries and other eras.

Certainly the airline passenger has benefited from airline competition. The quality of service on a competitive route is almost always far better than that on a monopoly route. Even the commencement of a new proceeding looking toward possible certification of a second carrier on a monopoly route usually produces a dramatic improvement in service from the existing monopoly carrier.

From the airline point of view competition by this very improvement of service seems in many cases to increase the traffic over a route. The competitive spur between carriers provides that extra attention to scheduling, passenger convenience and services which are certainly in substantial part responsible for the dramatic growth of airline traffic.

It must be admitted that there may be cases where the Board has certificated competition which has proved somewhat excessive in the short run. Government agencies are no more omniscient than any other groups, and they have at times over-estimated future traffic potentials; but this has not happened often in an industry which has grown as rapidly as civil aviation. Even if a route does receive slightly too much competition at first, it must always be remembered that certificates have to be issued with an eye to the future; certificates cannot be issued and cancelled from week to week as demand fluctuates.

And we must always remember one other important fact about airline competition. Every time that one airline is subjected to new competition from a second carrier, the other side of the coin is that the second carrier simultaneously acquires from the new award a new market and new traffic potentials. With few exceptions, no new airlines have entered the field. The Board rather has permitted the existing carriers to enter each other's monopoly markets. While there is plenty of airline competition, it is still restricted to a small number of competitors.

The most important aspect of airline competition, however, seems to me to be its effect on the regulatory climate in which our airlines operate. As you know, all of our airlines were on subsidy for many years. During that time the Civil Aeronautics Board and its predecessor agencies examined with meticulous care all phases of airline operations. This was required because subsidy could be paid only to the extent required by honest, economical, and efficient management. Thus the Board in effect had to pass judgment on the business wisdom of all phases of airline operations.

As the trunklines have gone off subsidy, the controls of the Board have become considerably less detailed and stringent. We do not look into every aspect of the operations of a carrier which is not subsidized. More and more areas have been left to the free play of management discretion.

There are certain duties, of course, which the government must always enforce under the statute. First, the carriers must give adequate service to all communities to which they are certificated; second, carriers must not charge rates which are discriminatory or preferential; third, carriers must not engage in unfair competitive practices; and fourth, carriers must not charge rates which are unjust and unreasonable, or in other words, rates which are unfair to the traveling public.

Each of these duties involves complicated factual situations and policy judgments which must grow and develop as the industry and public needs grow and develop. Each of them is the type of duty customarily imposed upon a public utility by law and policed by a regulatory agency. It is my firm belief, however, that the amount of detailed government regulation of the airline industry required in the public interest is in almost exact inverse proportion to the amount of inter-carrier competition within the industry.

Massive, gigantic complicated systems of rate-making and control may well be part of the reason for some of the grave difficulties of other forms of transportation within the United States. The effort to protect one type of transportation from the competition of other types; the tendency to protect the inefficient operator from the efficient operator; the desire to fit all rate patterns into a preconceived plan; the tendency to discourage promotional fares and discounts as technically discriminatory—all of these are substitutes for the play of competitive forces. Whenever I hear someone suggest that we put tight floors under airline fares, the thought immediately occurs to me that tight regulatory price floors are almost inevitably followed by tight price ceilings.

Many spokesmen for the trunklines have pleaded in various rate cases that they should be subject to less rate control because they are now competitive. In a general way I agree with this argument, but I think the argument must be pushed through to its logical conclusion. A carrier cannot argue for freedom from rate-making one day and come running to the Board the next because one of its competitors has lowered fares or introduced a new, more comfortable type of service. Government regulation in the public interest is not a one-way street. Controls cannot be relaxed just in the interests of the industry or any particular section of it. They can be relaxed only if competition increases sufficiently to insure that the public interest will be fully protected by the forces of competition rather than by detailed government regulation.

I spoke earlier of the general passenger fare investigation which was started in 1952 and then terminated a year later. That investigation was reinstituted in 1956. It is commonly known in the industry as the GPFI, the General Passenger Fare Investigation.

Just exactly what does the GPFI purport to do? Its most important purpose is, or to my mind should be, to establish clear guide-lines and policies—procedures and standards—for the future determination of whether rates are just and reasonable. Its main value is certainly not just a one-shot determination of whether fares are reasonable today.

Many basic policy matters are at issue in the GPFI. Should we judge airline rates solely on the basis of return on investment in the classical utility fashion, or should we use some other formula taking into account factors such as earnings as a percentage of income? How much profits should the airlines be permitted to make during good times to tide them through bad times? What is proper policy on accumulation of earnings in the light of the seemingly inevitable cycles of massive re-equipment programs? To what extent can we let fares go up because of equipment increases and the consequent lowering of load factors and profits, or in other words, to what standards of load factors can or should we hold the carriers?

Unfortunately the Board has never before held a general investigation to look into these questions, and the Board has consequently lacked some of the refined tools it has needed in its rate proceedings.

I was very pleased recently to hear the president of one of our biggest airlines say that it was a tragedy that the 1952 investigation was called off, although he at the time had been strongly in favor of terminating it. I think a great majority both in government and the industry today agree.

The General Passenger Fare Investigation, however, has given rise to a sort of disease which might be called GPFItis. This is a certain tendency on the part of government and industry alike to think that the GPFI will somehow solve all of our rate problems for the indefinite future. Being very skeptical that any one proceeding or piece of legislation can bring about the millennium, I have been disturbed by the exaggerated importance sometimes attached to this one case.

All of us, of course, hope that out of the General Passenger Fare Investigation will come new guide-lines and clearer basic policies for the future. But we must always remember that the day after the GPFI is decided the world will be the same as it was before. Traffic and equipment problems will be just as difficult, and the problem of setting fares and rates, even with better tools, will be just as intricate as ever. Neither we nor the industry can let our preoccupation with one investigation prevent us from tackling vigorously on a day-by-day basis all of the multitude of immediate problems which must be solved.

I have said that the great revolution in the airlines in the late '40's was in the field of scientific management and operations. Today it seems to me the airlines are entering on a new, and just as important, job—that is the job of attracting and serving the mass traffic market which will be required to support jet operations. It will not be an easy task. Common carrier passenger traffic seems to have been relatively static for some time. The airlines have been getting a bigger and bigger slice, but the pie has stayed the same size. It may well be that the airlines will soon have pulled about as many passengers off the trains and the buses as they can. The normal growth and increased prosperity of the country will provide a steady increase in traffic, of course, but not as much as the carriers have projected. They must, therefore, develop and serve new sources of traffic.

In other words, the new revolution in airline management must be the conversion of their sales and servicing techniques to a mass market, with a product carefully tailored and priced to meet a mass demand. Basically, of course, their product is one of the finest and most reasonable ever offered to the public. The speed, comfort, and convenience of air travel today is a miracle of business accomplishment. It bears almost no similarity at all to air travel twenty years ago. And yet, so efficient are the new planes and our present carrier organizations that the price has risen hardly at all.

There are many avenues which the carriers must and will explore—attracting the medium and long-haul automobile passenger; persuading the man who has never flown that he should try it; convincing the man who spends his two-week vacation at home that he can now enjoy a holiday thousands of miles away at reasonable cost. The carriers must consider more institutional advertising, more market research, more specifically tailored discounts and services. The new generation of Americans who have grown up entirely in the air age should certainly respond readily to such appeals.

It may be that radically simplified reservations systems will be more appropriate for very high density markets. I am convinced that even under present laws there is ample flexibility for many new discounts and special price experiments. I feel that some fares will have to be lowered to attract new traffic, but it may well be that others can appropriately be raised.

And then, of course, there are the great unexplored frontiers of air cargo, where the traffic is unlimited if the price is right.

All of these problems are the responsibility of airline management. I would not pretend to offer any definitive solutions. The job of the government rather, it seems to me, is to provide a regulatory climate within which airline managements can solve their own problems with due regard to the public interest.

Our carriers have shown amazing resourcefulness and ingenuity in the past. I am amply confident of their future.