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# THE JOURNAL OF AIR LAW AND COMMERCE

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## AIRLINE SELF-SUFFICIENCY AND THE LOCAL AIR SERVICE PROBLEM

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THE problem of the local service carrier in the domestic air transport system of the United States is one of the most troublesome results of the new attitude toward subsidization. The impact on air transportation of the nation's declining tolerance for subsidies to business has led one editor to the opinion that "the promotional stage of air transport in the U. S. has reached an end."<sup>1</sup> Certainly, the freedom with which the Civil Aeronautics Board has promoted in the past, with only minor obligations to explain and justify its actions to Congress, will be limited. Until recently, the policy of the Board was to consider the domestic industry in two parts; the trunk lines, whose progress as a group into self-sufficiency was a source of encouragement, and even concern, as the possibility of excessive profits arose,<sup>2</sup> and the local service carriers, whose financial progress and prospects continued discouraging and who ought, therefore, to be looked on as a secondary air transport system requiring substantial and continuing subsidy assistance.<sup>3</sup> Now, however, the new attitude that the air transport industry ought to be self-sufficient may force consideration of the two parts as one industry only, with very great differences in earning power among its members. Apropos, then, would be Charles Lamb's

<sup>1</sup> American Aviation, August 17, 1953, p. 8.

<sup>2</sup> *In the matter of The General Passenger Fare Investigation, etc.* Civil Aeronautics Board Order Serial No. E-7376, decided May 14, 1953. "The Board has considered the latest available earnings reported by the domestic trunkline carriers, as well as those reported for recent years, and it believes that, looking at these years alone, such earnings must be considered excessive when measured by any reasonable standard applicable to a regulated industry." p. 5.

<sup>3</sup> ". . . the trend since World War II has been in the direction of providing service to marginal points through a secondary airline network which is clearly not self-supporting. The support of this secondary system by the government is based upon an amalgam of political and social considerations rather than on economic justification." Paul W. Cherrington, "Objectives and Strategies for Airline Pricing." 18 JRL. OF AIR LAW & COM. 254-5 (Summer, 1951).

description, in his essay "Poor Relations," of that embarrassingly less fortunate member of one's family as ". . . the most irrelevant thing in nature, . . . a preposterous shadow, lengthening in the noontide of your prosperity, . . . a drain on your purse — a more intolerable dun upon your pride, . . . a triumph to your enemy — an apology to your friends." What shall be done with the poor relations of the air transport industry?

This current problem of the impact of the decline of promotion on that most promoted part of the domestic air transport system is, of course, only an aspect of the larger problem of inequalities in the earning power of a group of companies whose individual survival is important to society. For, since poverty is relative, the relatively poor shall be with us always. The combination of a) differences in cost levels among the companies as a result of market- and route-structure differences, and, b) the more or less uniform fare levels required as a practical matter where the companies compete at a number of points, give rise to large inequalities in earning power which are as difficult to live with as to get rid of, as is demonstrated by the weak-and-strong-carrier problem with which the Interstate Commerce Commission has toiled for over 30 years.

This paper will be concerned with aspects of the general problem of the earning power of our domestic air transport companies (in public utility terminology, the general rate level and its control by regulation) with special emphasis on the weak carrier as exemplified in the local service carriers. It will assume no change in the basic policy of public utility regulation of air transportation in the United States.<sup>4</sup> More than that, it will explore some possibilities for the more extensive use in air transport regulation of regulatory devices well developed in the older public utility industries.<sup>5</sup>

#### INADEQUATE EARNING POWER AMONG AIR CARRIERS

It is appropriate, first, to review the answers to the questions: where, in the domestic air transport industry, is weakness in earning power to be found, and, what have been the causes of this weakness.

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<sup>4</sup> The view that we ought to abandon all economic regulation of air transportation, or those parts of the present regulation which serve to protect the revenues of the existing carriers, has many strong points and many advocates. See, for the most thorough analysis, Lucile Sheppard Keyes, "Federal Control of Entry into Air Transportation," Harvard University Press, 1951. It is the present author's opinion, however, that in view of the impossibility of predicting the performance of the industry if it were free of public utility regulation, our present system, with modifications, offers greater public benefit.

<sup>5</sup> The Civil Aeronautics Act is similar in all important respects to other public utility regulatory statutes, either for transportation companies or the "local" public utilities; it differs from most in its provisions for promotion of air transport development with federal funds. (For a discussion of this point, see Oswald Ryan, "Regulation of Air Transportation under Civil Aeronautics Act. An analysis of the similarities and dissimilarities of air carrier regulation as compared with regulation of older forms of utility service." *Public Utilities Fortnightly*, Nov. 24, 1949, vol. 44, pp. 695-703.) As promotion declines, and as the use of competition as a regulator is relied upon less and less (a possible trend to be discussed later in this paper) the regulatory functions of the Board will become increasingly important and the Board may come to resemble more and more the other regulatory commissions in its actions.

There is general agreement that inadequate earning power is to be found among the smaller trunk lines, or small regional carriers, and among the local service carriers. For these carriers, non-mail revenues have failed to cover operating costs by the largest margins, year after year, and there is no reason to expect a significant change in this situation. There is not, however, agreement as to the reason for these inadequacies in earning power.

### *The Reasons for Inadequate Earning Power*

The earning power of a company is, of course, the difference between its revenues and its expenses, related to the investment required to produce the service. A firm under public utility regulation is, by its relative freedom from competition, more or less in control of its revenues as well as its expenses; the resulting monopoly profits are, therefore, controlled by the regulative agency in the public interest. Under conditions of competition, the unit revenue or market price is given, and the firm's managers must meet it by control over costs or go out of business.

The rise of competition between air carriers thus emphasizes the importance of the unit cost level of the firm. It has been observed that under the zonal- or regional-monopoly system of routes which the Board inherited from the Post Office, a small company might achieve self-sufficiency because, being free of heavy competitive pressures on most of its system, it could control both its costs and its revenues.<sup>6</sup> With the great increases in parallel competition since then, control over revenue has largely disappeared as a carrier's fare-level was dictated by others, and his share of a market often bore little relation to his own efforts.<sup>7</sup> And, holding one's own, costwise, has become in part a function of the size of the firm.

“. . . effective competition can exist only between carriers who are so constituted that inherently they have comparable unit operating costs. Moreover, since the size and character of the markets served by the carriers—a matter controlled by their route structures—have a primary influence on the unit costs which they can attain, the Board . . . had to keep ever in mind the necessity of insuring to each carrier a system of sufficient size to take advantage of the lower costs of volume operations.”<sup>8</sup>

Although the precise significance of economies of large scale among the medium- and large-sized air carriers is not clear, there is agreement that, by any measures, the very small trunk-line carriers are uneconom-

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<sup>6</sup> Howard C. Westwood, "Choice of the Air Carrier for New Air Transport Routes." *The George Washington Law Review*, Feb., 1948, vol. 16, p. 222.

<sup>7</sup> See F. W. Gill and G. L. Bates, "Airline Competition." Harvard University Press, 1949, pp. 616ff.

<sup>8</sup> Civil Aeronautics Board, "The Role of Competition in Commercial Air Transportation." Report to Subcommittee on Monopoly of the Senate Select Committee on Small Business, Nov. 24, 1952, p. 6.

ically small.<sup>9</sup> The same conclusion must hold true for the local service carriers, the largest of which is comparable in size to the smallest trunk line. The large local service carriers have been experiencing unit cost levels which are similar to those of the smaller trunk lines, and which are the lowest of their local service group.<sup>10</sup>

But is the size of the firm the critical point in an airline's ability to achieve self-sufficiency? Suppose that to an airline which is not self-sufficient at the present time were added additional markets identical in character to the average market presently being served, so that the average traffic generated per station, the average flight distance, and the average passenger haul were unchanged. Would the airline then be any closer to self-sufficiency? According to the analysis of Professor Koontz, its cost level might decline significantly only if it were one of the very small carriers. For those trunk-line carriers not among the self-sufficient Big Four, the answer to self-sufficiency lay in improving the revenue load factor by improving the size and density of the markets facing the carrier, that is, in large traffic-originating cities and in heavy traffic-flow city-pairs.<sup>11</sup> These conclusions would seem to apply with even greater strength to the local service carriers, where the weak markets result in inadequate revenue, and the small size of the firm results in excessive unit costs.

#### COMPETITION AS A CAUSE OF CARRIER WEAKNESS

The creation of competition between air carriers by new route and service certification of the Civil Aeronautics Board has been widely discussed as a cause of inadequate earning power of the industry and of particular carriers. The Board has been forced to defend itself before different Congressional committees against the opposite charges that it had created too much competition and that it has fostered too much monopoly; a former member has recently observed that the Board has had no policy and no administrative "expertise" with respect to the amount of competition necessary to secure sound development of air transportation, and that it has ". . . boxed the compass a dozen times

<sup>9</sup> See Harold D. Koontz, "Economic and Managerial Factors Underlying Subsidy Needs of Domestic Trunk Line Air Carriers," 18 *JRL OF AIR LAW & COM.*, 127-56, and "Domestic Air Line Self-Sufficiency: A Problem of Route Structure," *American Economic Review*, vol. 42, pp. 103-25, March, 1952; especially the latter article at p. 109ff. The conclusions here are in agreement with Gill and Bates, *op. cit.*, p. 617, and with earlier studies of the relation between firm size and operating cost levels. All of these studied have considered only the domestic trunk-line carriers.

<sup>10</sup> Civil Aeronautics Board, *Recurrent Reports of Mileage and Traffic Data and of Financial Data*, 12 months ended March 31, 1953.

<sup>11</sup> John P. Carter, in a critical note on Professor Koontz' analysis ("Domestic Air Line Self-Sufficiency: Comment," *American Economic Review*, vol. 43, pp. 368-73, June, 1953, to which Koontz made a rejoinder at pp. 373-77.) observed that the success of some airlines might be the result of few small markets rather than many large markets and that the inability of other airlines to achieve self-sufficiency was due to their planes being too big and not to their markets being too small. Although this discussion was limited to the trunk lines, Carter's rewording makes the conclusions particularly good descriptions of the problem of the local service carrier.

on the point."<sup>12</sup> Certainly there has been much uncertainty, and Board action could not be successfully predicted.<sup>13</sup>

Experimentation by the Board (or wavering) in the amount of competition was perhaps inevitable under the somewhat conflicting statutory requirements of "competition to the extent necessary" for firms which were restricted in their entry to a particular market by that device for creating legal monopolies in the public utility field — the certificate of public convenience and necessity. The Board had to steer some "in between" course in a situation like the mythological Charybdis and Scylla. On the one hand lay the stern rocks and monster of monopoly; on the other, the treacherous whirlpool of excessive competition. If the course taken has shown wavering, and if it has been dangerously on the edges of the whirlpool, the Board's seamanship was only part of the explanation. The winds of optimism and the currents of unjustifiable pressure on the Board have played their part, too.

### *Regulation by Competition*

In one respect, the growth in competition has special interest for the argument here. The Act, in common with other utility statutes, gives the Board, in Section 404 (a), control not only over the rates charged, but also over the quality of service rendered by, an air carrier. Thus far in the administration of the Act there has been little use of the power over service adequacy, except in the case of the local service carriers where, for example, the requirement of a minimum of two daily round trips over a route segment has been common. But in the case of these carriers, competition has not been available as a device to assure adequate service because the thin market would not support a second carrier.

In general, the Board's attitude has been that competition would achieve far more effective regulation of the quality of service than would its own directives.<sup>14</sup> There is much to be said for regulation by competition, as the philosophy of the relation between government and business in the United States attests. It is automatic and therefore

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<sup>12</sup> Harold A. Jones, "The Anomaly of the Civil Aeronautics Board in American Government," 20 *JRL OF AIR LAW & COM.* 150 (Spring, 1953).

<sup>13</sup> This, however, is no different from any attempt to predict Board action in a certificate case by reasoning by analogy from earlier decisions, as Westwood, *op. cit.*, has detailed. Unfortunately, air traffic predictions, an important part of the data underlying Board decisions on competition, have not had much greater success. The optimism inherent in a new industry's early years is one thing; the expectation of a continuation of early percentage rates of growth measured from a small base is another thing, and unwarranted, of course, by arithmetic alone. A child who, on its second birthday, shows any signs of gloating over a 100% increase in its age in one year ought to be reminded: a) that it can never do it again, as long as it lives, and b) everyone else has done it before,—once. This seems to have been forgotten in some predictions.

<sup>14</sup> "The improvements which flow from a competitive service cannot be obtained by administrative fiat. There is no regulation conceivable which could assure courtesy by a carrier's employees, for example, and it would be extremely difficult to attempt to dictate many other matters affecting the quality of the service rendered." *Colonial Airlines, Inc. et al., Atlantic Seaboard Operation*, 4 C.A.B. 552, 555 (1944).

it economizes in government coercion. But it is ruthless in its assumption that the survival of any one firm is of no great social consequence. Where the individual firm's survival is a matter of importance, as in air transportation today, competition as a regulatory weapon must be used with a light touch — lighter, very likely, than the Board was capable of in the environment of the post-war years.<sup>15</sup>

It would seem that regulation by competition is an attitude more in keeping with the promotional, than with the self-sufficiency, age of air transportation. It makes a permanent alteration in the market structure which, in the event of errors in estimating the competitive impact, will have to be lived with, not covered over with additional subsidy. The Board has recognized the limits to competition as a substitute for its own regulation.<sup>16</sup> The recognition that there is little room for new parallel competition suggests that the Board, in the future, will have to make greater use of its powers over adequacy of service.<sup>17</sup>

#### THE SPECIALIST DOCTRINE AND SELF-SUFFICIENCY

A decade ago the Board embarked upon its largest promotional program: the planned development, on an experimental basis, of air service in the small-city, short-haul market.<sup>18</sup> An essential part of the experiment was the doctrine of the specialist, that is, that a new type of service requires a new type of operator, one who will offer only some of the services, or serve in only some of the geographic markets, which the trunk-line carrier had been serving. The thinking behind the doctrine is illustrated in the following quotation:

"The type of service we here visualize involves *an entirely new type of service* gauged to meet the needs of smaller communities and relatively short hauls. In view of the limited traffic potentialities of the points on the new system, an unusual effort will be required to develop the maximum traffic. Greater effort and the exercise of managerial ingenuity may be expected from an *independent local operator* whose continuation in the air transportation business will be dependent upon the successful development

<sup>15</sup> A whip may be an effective way to increase the output of a horse, but the horse must understand and he is being urged on to greater achievement, and not beaten to death. Also, of course, the right horse must be whipped. In the 1949 Air Freight Case, where the Board thought the certification of cargo specialists would provide a continuing spur of competition to the non-specialists. Member Jones criticized the argument because the spur was applied most sharply to the very carriers who needed it least. (p. 41 of the Jones dissent in *Air Freight Case*, etc. Order Serial No. E-3085, decided July 29, 1949.)

<sup>16</sup> To the contention of a feeder carrier that a trunk line's service had been inadequate, the Board stated, "In the event the present service does not adequately care for the needs of the interested cities, United could increase the number of its schedules. If it fails to meet its duty in this respect, there are appropriate measures provided by the Act. Certainly the remedy for inadequacy of service does not lie in the creation of new routes where the traffic volume is insufficient to support competition." *Additional California-Nevada Service*, Order Serial No. E-2935, decided June 15, 1949, pp. 9-10.

<sup>17</sup> The decision in *Southern Service to the West Case*, Order Serial No. E-5090 contains implications of this approach.

<sup>18</sup> *Investigation of Local, Feeder, and Pick-Up Service*, 6 C.A.B. 1 (1944).

of traffic on the routes and the operation of the service on an adequate and an economic basis."<sup>19</sup>

This doctrine has been the justification for the selection of new companies in preference to trunk-line applicants throughout the period of the creation of the local service industry. The Board apparently has not abandoned the doctrine,<sup>20</sup> and those carriers whose existence rests on the doctrine naturally support it today.<sup>21</sup>

The specialist doctrine, however justifiable for an era of almost unlimited promotion, is a highly questionable concept for an era when self-sufficiency is the goal, for it seems to demand a high price for some meager benefits. The purpose of the doctrine was to get the greatest possible development in a market which was admittedly inadequate. It seemed that the more of a specialist a firm was, the better a specialist it would be. That fact, together with the clear need for minimizing the competitive impact of the local service carrier on the trunk line, has led the Board to impose many restrictions on the local service carriers which have had the avowed purpose of keeping them different. For example, they must serve intermediate points whether the traffic demands such service or not, for in the absence of such an obligation, they would be little different from, and often directly competitive with, the trunk lines. Or, the attempt of a local service carrier to equip its fleet with a post-war, trunk-line-type, plane had to be disapproved because among other reasons, such a step would eliminate a difference between a local service carrier and a trunk line carrier and endanger the local service experiment.<sup>22</sup> Thus, a substantial part of the difference between the two types of carriers has been created. The local service carriers have argued, quite correctly it seems, that these many and various restrictions have hindered their progress to self-sufficiency; they are thus put in the unhappy position of arguing that they deserve to exist because they are different, but that they cannot continue to exist unless they are made the same.<sup>23</sup>

#### THE DISTINCTIVENESS OF THE LOCAL SERVICE CARRIER

The result of being created different and kept different is that the local service carrier shows a number of characteristics different from the trunk line. It originates its passengers in smaller cities and hauls them, on the average, shorter distances than the trunk-line carrier. It

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<sup>19</sup> *Rocky Mountain States Air Service*, 6 C.A.B. 695, 736-7 (1946). Italics supplied.

<sup>20</sup> See, *Service to Fargo, North Dakota, Case*, Order Serial No. E-7547, decided July 10, 1953, p. 12.

<sup>21</sup> See, for example, Leslie O. Barnes, "The Case for the Local Service Airlines," 20 *JRL. OF AIR LAW & COM.* 199 (Spring, 1953). "There is a vast difference between a trunk line operation and a local service operation. Different techniques are employed, different equipment is required—both in the air and on the ground. The two types of operation do not mix in an operational sense, and the concept is growing that an airline must specialize in either one or the other."

<sup>22</sup> *Pioneer Air Lines, Inc., Mail Rate*, Order Serial No. E-7225, decided March 13, 1953.

<sup>23</sup> See, for example, the list of obstacles to feeder line progress in the statement of Robert J. Smith, in "Separation of Air Mail Pay from Subsidy," Hearings before the Senate Committee on Interstate and Foreign Commerce, June-July, 1951, pp. 449ff.



operates two-engine pre-war equipment, not two- and four-engine post-war planes. There are other, less striking, differences. But, are these differences of the kind that make the services mutually exclusive in a business sense? Are the differences of the sort which would characterize a baker who also operates a dancing school, or of the sort which characterizes a baker of bread who also bakes cakes, or who operates a small grocery store in the front part of his bakery? Are the two operations such, that if combined in one organization and performed by the same persons, success in one would be wholly independent of, or prejudicial to, success in the other? That, clearly, is the question, and not the mere fact of differences in service or operation.<sup>24</sup>

Accepting the arguments above that the differences in the two services are forced and insignificant, it is still possible that the local service carriers have, by reason of their concentrated efforts, achieved such significantly better results in generating traffic at small points that they ought to be preserved despite their diseconomies. This is a point which could be proven by an historical study of traffic generation at a homogeneous group of cities served exclusively by each type of carrier.<sup>25</sup> If the local service carriers have not been able to generate a substantially larger amount of traffic than a trunk line develops in the same type of small city, then one of their reasons for being is destroyed.

There can be little doubt today about the absence of any economic basis for local air service. The fears of the Board, when it first examined the problem in 1943, concerning the thinness of the small-city, short-haul market have since then been fully documented. Public transportation in the United States is mass transportation, except for the irregular contract taxi services. It is difficult to imagine technological conditions in aviation which will make the boarding of one passenger per flight, for flights over relatively short distances, economical in comparison with the more flexible forms of surface transportation, except in a handful of isolated communities in the United States. The re-

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<sup>24</sup> In the record of the *Air Freight Case* where the freight specialist argument was accepted by the Board, Member Ryan has been quoted as follows: "The refrigerators made by the General Motors Corporation, I imagine, are not any less efficient refrigerators because the General Motors Corporation happens to be engaged in the manufacture of automobiles. . . . There may be other reasons why you should be certificated but it seems to me that that kind of a reason is not sound economics." *Supra*, p. 27 of the Jones dissent.

<sup>25</sup> The author has attempted a comparison of traffic generating powers (from the C.A.A.'s *Enplaned Airline Traffic by Community, 1951*) for all small communities receiving service from a single carrier in 1951. Cities receiving service for less than one year, and the five tourist cities with passenger indexes (number of passengers enplaned per 1000 population) in excess of 1000 were excluded. The results do not suggest significantly better generative powers for the specialists. Thus, for 51 cities under 10,000 population served exclusively by a local service carrier, the median passenger index was 215; for 25 cities of similar size served exclusively by trunk lines, the median index was 121. The average passengers per plane departure were 1.0 and 1.9, respectively. For all cities under 25,000 population, local service carriers had a median passenger index of 111 for 106 cities and trunk carriers 117 for 65 cities. Other measures for this larger group showed, respectively for local and trunk carriers; average passengers per departure of 1.14 and 2.18, mail tons per 1000 population of 0.44 and 0.39, and cargo (including express) tons per 1000 population of 0.33 and 0.56.

sponse of residents of small communities to high quality air commuter service with their trade centers, at a fraction of the full social cost of such service, proves only that consumers still know a bargain when they see one. When consumers have enjoyed a so-called public service, it is commonplace that they do not happily forego it, even when it was not supported by the public treasury as in the case of railroad service. The problem then, is not the abandonment of air service at all points which cannot now bear the full cost thereof. Since the justification for such service rests on political and social considerations, the question becomes how such service can be provided at minimum social cost.<sup>26</sup>

### A POSSIBLE SOLUTION

The discussion thus far has attempted to show that certain policies of the Board were more appropriate for the promotional stage of domestic air transportation than for the self-sufficiency stage on which we are now embarked. The use of direct competition as a device for the regulation of rates and services can be relied upon less when the federal funds for easing the temporary or permanent pains of competitive excesses are strictly limited. Similarly, the specialist doctrine, by which local service carriers have been made different and kept different for the purpose of maximum concentration of effort on a minimum-sized market, must be reappraised. And the revision or abandonment of these policies must be carried out against the background of the broad problem of the entire industry — the financial stability of every one of its members.

There are a number of steps which can be taken by the Board, which follow somewhat different paths, but which all move in the direction of industry-wide self-sufficiency. The decision to attempt to correct disparities in the earning power of trunk-line carriers by a policy of mergers of the weak with the strong has received wide support. It may be that a somewhat similar move with respect to the local service carriers would likewise find acceptance, when the special problems involved have been explored and the special techniques required have been worked out. The remainder of this paper will be devoted to some of the questions which would arise if such a policy were adopted.

#### *The Johnson Proposal*

In April, 1953, Senator Johnson suggested to the Board a possible use for the profits of the larger trunk-line carriers, if the General

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<sup>26</sup> It is important to observe that a criticism of the local service experiment and of the specialist doctrine does not imply a criticism of the local service industry or of the individual firms of which it consists. The Board on many occasions has commended individual firms, and the industry's record of innovation in the technology of air transportation has been widely publicized. (See, for a discussion of the many achievements, Josh Lee, "The Planned Promotion of Feeder Air Transportation." 17 JRL. OF AIR LAW & COM., 356-60.) Public recognition and approval of the efforts of these firms means they have substantial good will and going concern values; this fact argues against any solution to the local service problem which would destroy these values.

Passenger Investigation then underway showed such profits to be excessive:

"Instead of looking toward a reduction in the rates of these large carriers, it would be far more sensible for the Board to compel such carriers to utilize these profits by assuming the operation obligations of the local-service lines and smaller trunk lines that now require subsidy. The big railroads are compelled by the regulatory bodies to operate branch line passenger service at a terrific loss. Instead of reducing the rates of the strong air carriers, the strong air carriers should be required to take the bitter with the sweet, as have the railroads."<sup>27</sup>

The phrase, "taking the bitter with the sweet" refers to a concept better developed in the public utility regulation of other-than-transport companies, where it is often referred to as "taking the lean with the fat." Generally, the concept embraces two ideas, only one of which has thus far had any use in air transport regulation. In the first place, the phrase refers to the fact that, for a multi-product, multi-market firm, there is no reason to expect uniform rates of profit for all the firm's products or in all its markets. This idea has been expressed by the Board as applying to air transportation when, in the *Transcontinental Coach-type Service Case*, it said:

"Our national air transportation system must of necessity provide service at cities showing varying degrees of attractiveness from a traffic-generating standpoint and individual route segments must include some points that are below the optimum in profitability. These variations exist not only in the system as a whole, but in the system of each individual carrier."<sup>28</sup>

And in the same decision, the Board referred to ". . . the traditional public service obligation of serving communities which can only be served at a loss."<sup>29</sup> Such a reference to the public utility obligation for air transportation would seem to refer to the abandonment of an existing service simply on the showing that that service provides less profit than other services, or incurs a loss. In the second meaning, the concept may refer, in "local" utility regulation, to the way in which the firm expands within the market area in which it "holds itself out to serve." Thus, in the process of introducing service to new sections of the territory (a territory which has been delineated by the firm's actions in offering service as well as by the terms of franchises) the

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<sup>27</sup> Senator Edwin C. Johnson, "Utilizing Trunk-Line Profits to Support Local Air Service," Letter to the Chairman of the Civil Aeronautics Board, reprinted in 20 JRL OF AIR LAW & COM. 203, 204. The analogy to main- and branch-line railroad service is similar to an analogy used by Board Member Young in the *Southeastern States Case*, 7 C.A.B. 863, 911-12 (1947) where he advocated the broadening of the feeder experiment to include trunk line carriers. There, he argued that in the electric industry, ". . . the regulatory agencies have not assumed that the public interest would be served by licensing one power company to serve consumers at distant points and another to serve those nearby, thus segregating the high- and low-cost services." In air transportation, the analogy means that ". . . the operating entities . . . should be so constituted as to provide, to the fullest extent practicable, a balanced volume combination of the low-cost, high-value services on the one hand and the high-cost, low value services on the other."

<sup>28</sup> Order Serial No. E-5840, decided Nov. 7, 1951, p. 7.

<sup>29</sup> *Ibid.*, p. 5.

firm is not free to select areas solely according to the test of immediate profitability.<sup>30</sup> Since the certificates of convenience and necessity in air transportation define the carrier's service obligation by reference to points, and not areas, this second meaning of the phrase "taking the lean with the fat" does not apply in our present regulation of air transportation.<sup>31</sup> However, since Senator Johnson was referring to the expansion of trunk line operations into the "bitter" or the "lean," it would seem that his proposal bears a relationship to this second meaning.

No method was described for carrying out the proposal that the large trunk lines assume the operation obligations of the weaker lines. Conceivably, there could be gradual transfer of points presently served by the local service carriers to the trunk lines carriers; such a policy would be related to that of the Board in recent years when it has transferred feeder-type points from trunk line routes to local service routes in an attempt to strengthen the latter. It would be possible to transfer the poorer local service points from local service carriers to trunk lines, thus improving the earnings of the former and at the same time utilizing the excess profits of the latter. But for such a policy to do substantial good, it would probably have to be carried to such lengths that the local service carriers would emerge as small regional trunk lines with new duplicative route patterns, while the trunk lines would be performing, in addition to their present services, those services now being rendered by the local service industry.<sup>32</sup>

Preferable methods for implementing the Johnson proposal would be the transfer of route segments or entire route systems, or the mergers of the weaker companies into the strong. How might such actions be taken, so that the losses on the federal investment in the promotion of local air service would be minimized at the same time that the greatest possible progress toward total industry self-sufficiency was being made? One possible program which the Board might adopt is sketched below, in very broad lines.

#### A MERGER PROGRAM FOR THE LOCAL SERVICE CARRIERS

Basic to the program for narrowing the disparities in earning power would be the adoption of a merger program, by the statement that the Board would view favorably certain kinds of mergers made under

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<sup>30</sup> For example, the following is a typical statement: "Corporations which devote their property to a public use may not pick and choose, serving only the portions of the territory covered by their franchises, which it is presently profitable for them to serve, and restricting the development of the remaining portions. . . ." *People ex rel. New York & Queens Gas Co. v. McCall*, 245 U.S. 345, 351 (1917).

<sup>31</sup> In the *Air Freight Case*, *supra*, Slick and Flying Tiger requested certificates worded in terms of geographic areas rather than points. The Board, however, after stating it was not deciding whether the Act gave it the power to award area certificates which omitted any mention of specific points, named groups of specific points. It appears that the difference in practice between the two types of certificates need not be great.

<sup>32</sup> Such does not seem to have been Senator Johnson's intent, for he did not state that the trunk lines should assume only *some* of the operating obligations of the weaker carriers.

specified assurances and restrictions.<sup>33</sup> The mergers ought to be between a trunk line and one or more local service carriers with whom that trunk line has some substantial service areas in common; perhaps the trunk-line's choice should be limited to the local service carrier or carriers with whom it competes in the largest number of (or most important) city-pair markets. While the existing temporary certificate for the local service route might be made permanent, the existing minimum flight-frequency requirements should be retained for a further experimental period, except insofar as their purpose was to limit the competitive impact of the local carrier on the trunk line. It might be expected that the mechanics of a merger would transfer the fleet and much of the personnel of the local service carrier to an operating department of the trunk line. However, the local system should be retained as a separate rate-making unit for mail pay purposes, with separate accounts and reporting requirements, as was used in the transfer of a local route to Mid-Continent in 1950.<sup>34</sup> Subsidy would, of course, be required for an initial period, but the amount could be expected to be reduced almost immediately for a number of reasons; the economies available from the merging of duplicate plants and operations, the economies from elimination of operating restrictions on the local service system intended to prevent excessive competition with the trunk line, and increases in revenue from system traffic growth and from the higher local service fare levels made possible by the reduction of competitive city-pairs.<sup>35</sup>

After an initial period of operation with continued but substantially reduced federal subsidy, and as excess earnings developed for the trunk line, consideration should be given to the transition from externally-supplied subsidy to internal or intra-firm subsidization. Perhaps for an interim period, an earnings offset system would be desirable whereby some portion of the excess earnings on the trunk line routes, when there were such, would be used to offset the subsidy on the local service route. Ultimately, the use of separate rate-making units should be abandoned and the distinction between the two parts of the firm's system would disappear in accounts and reporting.

It is perhaps worth noting again that under this proposal, the restrictions hitherto imposed on the local service carriers, and which were the cause of operating diseconomies, could in large part be relaxed. In addition, what has in effect become an obligation on the local service carrier to operate with pre-war equipment would disap-

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<sup>33</sup> This discussion will exclude the smaller trunk lines who are also in the category of weak carriers, and whose problems would not be solved by a merger with a local service carrier but probably rather by a merger with a large trunk line.

<sup>34</sup> *Parks Investigation Case*, Order Serial No. E-4472, decided July 28, 1950.

<sup>35</sup> Board action to maintain higher fare levels on local service routes is indicated by the following statement: "We shall also look with disfavor on any action of Mid-Continent whereby it would attempt to equalize its fares for such circuitous services with the fares for the direct services of the existing carriers, or to resort to any other device for providing competition which we do not intend either to authorize or permit." *Parks Investigation Case*, *supra*, p. 24.

pear.<sup>36</sup> Some small cities would very likely receive service with newer equipment. It is also possible that that most unfortunate obstacle in the local service experiment, the lack of an economical local service plane, would be overcome; certainly, the stronger resources and permanent certificates of the trunk lines would lead the manufacturers to examine again the market for the successor to the DC-3.

#### A NEW POLICY STATEMENT OF THE DIMENSIONS OF PROMOTION

An essential part of any program for the future development of air transportation, and a second part of the program for reducing disparities in earning power, would be a statement of policy by the Board as to the direction of future growth. The decision of the Board in dismissing *The General Passenger Fare Investigation* contains some parts of that kind of a program. The Board's comments there on the need for measuring profits over a long period, and of the desirability, in the regulation of profits, of providing an economic climate conducive to managerial risk-taking manifests a more advanced view of regulatory responsibilities than many utility commissions are capable of, and promises a strong future for the air transport industry.

In this decision, the Board recognized, and offered encouragement to, one dimension of growth — the expansion of coach-type service — in favor of growth in another dimension — a first-class passenger rate reduction. Profits could be used in either direction: to reduce prices of one service or to expand the scope of another type of service in those markets where it has been considered marginal. Losses, of course, might give rise to the opposite actions.

There are a number of other possible uses for profits (or losses): a reduction (or increase) in all rates, the introduction of new equipment (or the retardation of its introduction), the expansion (or contraction) in the intensive scope of service as by increased schedule frequency, and the expansion (or contraction) in the extensive scope of service as in the introduction of service to new cities or in new city-pairs. It cannot be assumed that each of these methods of plowing excess earnings back into the business would serve the nation's air transport needs equally well in all instances, nor that they would be equally useful ways of absorbing the excess earning power of any one firm when that firm's principal competitors lack such earnings. There is no assurance that, in the absence of the restraint of the Board's hand or voice, a carrier might not choose to spend excessive earnings exclusively on those competitive weapons for altering existing shares in a market — overscheduling and equipment innovation, at greater public cost than public gain. It would seem then that the Board will have in the future the responsibility of indicating desirable directions of growth and rates of growth, just as it has done in its recent encouragement of coach service. Under a regime where the service to the marginal small-city, short-haul markets in a region is the exclusive

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<sup>36</sup> See *Pioneer Air Lines, Inc., Mail Rate, supra*.

responsibility of one unsubsidized firm with only a limited incentive to expand into more of the same thinness, the Board must, it seems, announce a doctrine of "taking the lean with the fat" — that in exchange for control over this market, the firm has some responsibilities for developing it.

It may be that this type of program would satisfy the many conflicting interests involved in the local service problem. It provides for a continuation of local air service at its present extensive and intensive level, and attempts to assure the future expansion of such service at an economic rate.<sup>87</sup> The communities involved can have no objections if such aims are achieved, and the issue is thus kept out of the political arena where local interests often emerge above the national interest. The national transportation policy of Congress will be furthered and the Administration's aim of economy will also be served. The trunk-line carriers know that their status as a regulated industry gives them certain protections and also imposes upon them certain responsibilities. From the past record, there is no reason to expect trunk-line managements to argue: a) their legal right to more than a reasonable return on the investment plus limited rewards for managerial efficiency and incentives for future risk-taking, or, b) their freedom from responsibility for the development of a great national asset and a highly essential service.<sup>88</sup>

Air transport in the United States has arrived at the point of transition from heavily promoted childhood, under the logic of support for an "infant industry," to self-sufficient maturity. It may be that the present form of the Act poses some obstacles to the transition; if so, alteration is certainly possible in the present environment. More important, it would seem, is a recognition by the regulators and the industry of the new meaning of *promotion* for a self-sufficient industry — the creation of an environment conducive to the largest balanced growth which is economically justifiable to the investors whose confident support is essential.

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<sup>87</sup> It has recently been argued (Leslie O. Barnes, *op. cit.* pp. 198-99) that the proposal that trunk-line carriers be required to provide local air services "makes absolutely no sense for a number of unassailable reasons." The reasons offered are: 1) that the trunk lines could render identical service to that now being offered by local service carriers only at greatly increased costs and larger subsidy. Such an assertion, without proof or even indication as to why a result would occur which is contrary to all that might be expected, cannot be dealt with; 2) that the trunk lines have offered only "token service" to small cities and can neither be expected to change or forced to change by the Board. A comparison between the two types of carriers is meaningless here, for a few small cities on a long route do not make a local route pattern. In this instance, a synonymous phrase for "token service" may be "economically justifiable service." And the Board would not agree to the suggestion of its impotence, as shown above; 3) the statement quoted above in note 21, that the local service operation is distinctly different and hence requires a specialist, an assertion that has already been discussed.

<sup>88</sup> Air transport lies in that group of businesses to which resort to nationalization has been easily and frequently made. In this connection, Sir Leonard Isitt in "Air Transport in New Zealand and the South Pacific," *Journal of the Royal Aeronautical Society*, Nov., 1951, observes that a case for nationalization can be made on five grounds, of which two are, ". . . cut-throat competition is eliminated . . ." and ". . . it becomes more practicable to use profits on main lines to absorb losses on lateral routes." p. 709.