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**AN ASSESSMENT OF DEREGULATION AND
ITS EFFECT ON THE INTERNATIONAL AIR
TRANSPORTATION COMMUNITY**

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COMMUNITY -- A 1981 UPDATE

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Professor Cary tells me that you have all received a copy of my remarks of a year ago so my presentation today will take that paper as a starting point. I have not changed my mind as to anything I said then and will today update some of the facts and intervening events, leaving time for questions and discussion.

Quite frankly, I was among those who opposed deregulation initially and for what I still believe were the right reasons. The prior approach to economic regulation of airlines, whatever its faults -- and there were many -- had built up a strong, extensive, highly-competitive, and low fare airline system in this country. It was without a doubt the best in the world and it offered more frequencies and lower fares by far than anything in Europe or elsewhere. The major concern about deregulation was that if the regulatory system were to be changed drastically and, as a result, the airline system deteriorated substantially, there would be public and political clamor to re-regulate -- and in an even more burdensome form. That was the concern originally

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expressed back in 1977 to the Congress by Richard Maurer, now Vice Chairman of the Board of Delta Air Lines as is set out at pages 20-21 of the monograph of my remarks last year.

Mr. Kahn while Chairman of the Civil Aeronautics Board once said that if the Board got the structure of the airline industry changed, "you are going to have one hell of a time getting it back to where it was." At least in that respect he was right. The domestic U.S. airline industry will never again be the same as it was before nor can it be restructured to its former condition. So it is too late to talk about whether we should have deregulation. And while I still believe that intelligent modification of the old system would have been preferable, deregulation is here.

My concern now, and that of the airline industry, is that we do not want re-regulation. We do not want even the seeds of re-regulation lying around. And that is why the industry is united in seeking quick abolition of the Civil Aeronautics Board as well as the statutory provisions pursuant to which it severely burdens domestic air transportation.

Let me read to you from the testimony of Paul Ignatius, President of the Air Transport Association of America, as given to the Senate Aviation Subcommittee just last Tuesday:

"While there were understandable differences of view within the airline industry in 1978 on the question of deregulation, there is broad agreement today -- agreement: that deregulation is a fact of life; that there can be no turning back to a tightly regulated regime without completely disrupting public air service; that the airline industry cannot and

should not be expected to operate part free and part regulated; that the economic problems facing the airline industry over the past two years would have been much more severe in the absence of the management decision-making latitude made possible by the Deregulation Act; and that the time has come to complete the action taken by Congress in 1978 to free the airlines from unnecessary and burdensome economic regulation.

"It is for these reasons that the airlines support the proposal to advance CAB sunset."

And he continued a bit later:

"The primary interests of the airlines concerning sunset related legislation are:

"To broaden and accelerate the process of removing unnecessary and burdensome federal regulatory activity consistent with the goal of Congress for a substantially more competitive, less regulated free enterprise airline industry;

"To prevent the adoption of new or replacement economic rules, regulations and regulatory functions not common to other industries, or the transfer of such functions to other government agencies; and

"To assure the continuation of the interline system under which the full range of individual airline services and connecting airline services are made available on a freely interchangeable basis to the public here and around the world, through thousands of sales outlets, on a unique, simple one-transaction basis."

In short, the U.S. airline industry is anxious to have true deregulation domestically. We have not had it yet and will not have it so long as the CAB or a successor agency is around meddling with management prerogatives and interfering with the action of the free market.

Of more direct interest to you, however, is the fact that U.S. international aviation is not on the block for complete deregulation -- nor can it properly be. The difference, and the reasons for it, were summarized by Knut Hammarskjold, Director General of IATA in his testimony last Tuesday to that same Senate Aviation Subcommittee:

"Regulatory sunset domestically will reduce governmental control to the minimum required to preserve essential services. Internationally, while it is also desirable to reduce governmental bureaucracy to a minimum, a greater measure of government involvement is inevitable. It is inevitable because the U.S. has responsibilities under international agreements and because foreign nations insist on retaining their sovereign powers. The national laws and regulations of each country must be sufficiently compatible to allow the system to work effectively. One challenge as you develop legislation for domestic sunset is to ensure that you do not create serious problems for the international network."

One thing you as non-Americans can be particularly thankful for from our last national election is that the new Administration has a more realistic recognition that bilateral negotiations involve a balancing of the needs and aspirations of two sovereign states. It is truly a negotiating process. By way of example, I presume you are all familiar with the CAB's IATA show cause proceeding wherein it proposed to disapprove the IATA fare setting arrangements and thus withdraw antitrust immunity from them. When the matter was recently up before the Board for approval of a final order in the proceeding, both the Department of State and the Department of Transportation sent written requests to the CAB for postponement and deferral of any further action, not only to

allow the new Administration an opportunity to review the foreign policy and foreign relations considerations but also because it was of concern in connection with upcoming discussions between the U.S. and other countries. This was clearly a recognition by the new Administration of the desirability of working with foreign governments to try and resolve differences between the highly pro-competitive policies of the United States and the often far less-competitive policies of other countries.

Unfortunately, the Board ignored the requests of the Department of State and DOT and proceeded to issue its final order -- merely deferring the effectiveness of its order for some four months. I may be naive, but it seems to me that negotiating options are severely constrained after the Board has issued its final determination rather than before those determinations are set in stone. (Parenthetically, I might note that all five Board members were appointed by the previous Administration.)

I would be very unfair, however, if I did not recognize that Boyd Hight who was the last Deputy Assistant Secretary of Transportation and Telecommunications in the Department of State under the previous Administration, was at least one person who had a real appreciation for the problems. In a speech entitled "Deregulation Abroad: A Game Without Rules" given at the International Aviation Club on November 18, 1980, he said:

"Internationally, it doesn't work quite that simply, there is no broad international agreement as to the rules of the marketplace. There are the American rules, the antitrust laws, and then there are the rules of other countries or organizations. These other rules

range from no rules at all to those such as Australia's maritime regulation of the outbound but not inbound trades, from rigidly controlled markets in the planned economy countries to the emergence of antitrust thinking in the European community. Nobody, however, has rules like ours. Many other nations don't understand our rules very well. Those of us who have worked with the antitrust laws sympathize with this difficulty. Most of those foreigners who understand our rules don't like them. They believe in market structure, stability and harmony. That's a wonderful word by the way. Harmony ... the placid market. The placid market is achieved by market division and pricing by agreement -- ways of life abroad. Price competition threatens stability and the health of the enterprise. Without our experience in the large, unfettered domestic market with its multiple participants, our colleagues abroad shake their heads at our commitment to competition. They believe either that we are a little bit crazy or, more likely, that we are trying to open up international markets so that big American companies can exploit them. Whatever their view of our motives, there is no international agreement that competition is desirable, let alone a body of rules promoting it.

"Moreover, we control only our end of the international market. We can deregulate ourselves but not our partners. We can, but it isn't very sensible. Unilateral deregulation exposes us naked to the elements. We can therefore deregulate internationally only by agreement, and only by agreement which articulates the rules of the marketplace."

I think that is as clear a recognition of the need to negotiate international air transport rights as you could want. And with all due deference to what Mr. Cohen told you a couple of weeks ago, it is my impression that the CAB at least, has operated under the domino theory. That is, if the U.S. can get a liberal bilateral with one country in one area of the world, the other countries in the area must of necessity fall into line. It is also my recollection that Mr. Cohen's predecessor, Mr. Kahn, in a sunshine meeting which considered route awards pursuant to

the more restrictive Bermuda II agreement, commented that he would like to "stick it to the British" and suggested that the Board should consider encouragement of alternate gateways to Europe, by-passing London.

As you know, the opening of alternate gateways did subsequently occur and, I think it was good for all concerned. For example, the encouragement of direct service to Germany from several U.S. gateways, but overflying the traditional London gateway, had two beneficial effects. First, it freed up seats on the U.S.-London segment that used to be blocked by thru passengers to Germany and secondly, it resulted in the promotion of services from non-traditional U.S. gateways direct to Germany. As Mr. Cohen told you a couple of weeks ago, passenger traffic between the U.S. and Germany -- already a well-developed market -- increased substantially. But at the same time the U.S.-U.K. market increased both in absolute numbers of passenger and in percentage growth in excess of that with Germany. For the period September 197⁷~~9~~ through September 1980 there was a growth of 689,300 passengers or 44.3% for the U.S.-Germany market as compared to 1,653,575 passengers or a 47.2% growth for the U.S.-U.K. market. What I read from that comparison is that Bermuda II as it has been expanded and applied is at least as good an arrangement as the so-called liberal bilateral between the U.S. and Germany. Furthermore, reference to the tabulations attached to Mr. Cohen's lecture paper lead me to believe that strong growth is related to the number of carriers actually providing

service and points served whether pursuant to a so-called liberal or a restrictive bilateral. And U.S. participation appears not so much a function of the relative number of carriers but, rather the source of the traffic -- i.e., U.S.-originating or foreign-originating.

I should like to spend the rest of my time updating my last year's comments on whether deregulation is working.

Just last Friday the Board released a staff study entitled "Developments in the Deregulated Airline Industry." From a quick review over the weekend, my impression is that it is -- as are most of the recent studies I have seen -- shallow and self-serving. I say that because it appears to attribute any positive movement from 1978-onward to deregulation, yet tempers recent adverse movements with the assessment that they were contributed to by industry action that would have taken place even absent the Deregulation Act.

Now I would be equally guilty of bias if I said the facts to date prove deregulation is not working. Certainly there are indicators pointing both ways. Rather, I think all fair minded observers believe that it will be necessary to wait until deregulation has gone through a full cycle of both good and bad times before a valid assessment can be made. That has yet to happen.

So the problem today, as it was a year ago, is we still really do not know. To start with, the facts are not all in, and secondly, we still do not have complete economic deregulation. I limit that to economic deregulation because no one has suggested

-- nor would they -- that safety regulation either be abolished or weakened. But in the economic field, we still have the same burdensome so-called consumer regulations involving denied boarding compensation, smoking and no smoking regulations, baggage liability rules, and the like. In his statement to the Senate Aviation Subcommittee last Tuesday, Mr. Cohen presented the Board's "sunset" proposal as including:

"transfer explicitly the Board's authority over the carrier's duty to provide safe and adequate service, which is a primary source for public protection, to DOT."

So long as rules such as those are on the books, carrier managements lose considerable flexibility in running their airlines. Indeed, if air carriers are like the corner drug store or lumber yard as Congress has now said they are, the carriers should no more be subject to such rules than any business concern.

Similarly, while we have much greater pricing flexibility than we did a year ago, the Board still has a ceiling on how much normal economy fares may exceed what is commonly known as the Standard Industry Fare Level. That, incidentally, is quite comparable to the so-called Standard Foreign Fare Level by which the Board manages what it considers proper fares in the international field. And it is worthy of note that insofar as the Standard Foreign Fare Level is concerned, the Board allows considerably greater flexibility on the upside for fares to/from countries with which the U.S. has so-called liberal bilaterals as compared to those where it does not. That, of course, is just one example

of the way the Board brings pressure on foreign nations to fall into line with its idea of international air transportation economics.

Now as to the specifics of how domestic deregulation is working at least to date. I shall cover the points I did last year in response to the article by James Miller in the Wall Street Journal of March 26, 1980, namely, fares, productivity gains, profits, service to small communities, labor, subsidy, industry concentration, the airline network and safety.

First, fares. A year ago the so-called deregulation economists were pointing with pride to a lower rate of increase in fares than in airline costs and consumer prices. As I noted a year ago, fares were low because the CAB kept the lid on increases. This year the statement is "... a lower rate of increase in fares than in airline costs" -- they left out the consumer prices bit because fares have now risen faster than consumer prices. But if you look at the General Accounting Office report on the airline industry dated June 1, 1981, you find that while for the deregulation period (that is, 1978-1980) airline costs on the average increased more than fares on the average, for the year 1980, fares increased 29.5% over 1979 levels whereas costs rose only 23.2% in the same period. Quite clearly, last year's fares rose well in excess of the increase in costs -- as well they should, because the carriers had to recoup the losses earlier caused by the Board's artificial ceiling on fares.

Next, productivity gains. Last year I questioned whether productivity gains would not have occurred in any event to meet sharply increasing fuel costs as would higher average daily utilization and higher load factors brought about by a temporary tight new equipment situation. Well, as of today, the equipment situation is far from tight, load factors have dropped sharply and the General Accounting Office report summarizes that "significant 1978 and 1979 productivity gains, severely eroded in 1980 by declining load factors." As with the situation a year ago, I do not believe this can be used either pro or con deregulation because of the concurrent general economic recession in the United States.

Profits. Last year the bottom fell out and it was probably the worst year in history for the U.S. air transportation industry. It was also a disaster for U.S. carriers internationally. The Aviation Daily's summary of U.S. international airline revenue and expenses shows a total operating profit for the industry of \$86,428,676 for the year 1979 but a loss of \$195,572,273 in 1980, or a turn for the worse of \$282 million in one year.

More recent figures are no less dismal for the U.S. international air transportation industry, with the first quarter going from a net operating profit of a little over \$13 million in 1979 to almost \$111 million operating loss in 1980 and \$127 million operating loss in 1981. I must note that I think those quarterly figures are subject to some correction because they do not include the results from the transatlantic services of

carriers such as World or Capitol although they do include Air Florida. But the trend is there and it is not a happy one.

I guess what concerns me most about Mr. Cohen's presentation to you of a couple of weeks ago is that while traffic has indeed grown as he told you, he made no attempt to correlate the traffic results with the economics of the operation. But my compilation from the Aviation Daily summary is that over the North Atlantic, U.S. carriers combined had a total operating loss for CY 1980 of almost \$117 million and for just the first quarter of 1981 (admittedly a low quarter for traffic) an operating loss of over \$111 million. I have no reason to believe that foreign airlines are any better off and, while in an utopian world with no barriers or differences of aspirations as between nations, we might accept survival of the fittest, I question whether that can be a viable approach at this time in international air transportation. But again, our assessment of deregulation must await further facts and a full consideration of the effects of the soft economy on airline results.

Service to small communities. Last year while Miller and others were pointing to increased numbers of departures and frequency of service as a result of deregulation, this year the General Accounting Office tabulates fewer weekly departures than the previous year for all sizes of communities as well as fewer available seats. But again one cannot tell whether the reductions are because of a recession economy or because of carrier management decisions facilitated by deregulation. We shall have to wait and see.

Airline labor. This is a very difficult aspect to assess for the reason that many airlines have been reducing service with an attendant layoff of employees. Many of the layoffs are clearly due to belt tightening in an attempt to become more lean and efficient -- certainly a laudable goal in any economic regime and some are due to unbelievably poor earlier management decisions. Here again it is wait and see.

Subsidy. This may be an argument in deregulation's favor because the current pending legislation appears to relegate subsidized service to a thing of the past. There will, of course, be subsidy for service to small communities until 1988 at which time it is programmed to terminate so that the U.S. air transportation industry will have to sink or swim on its own. Certainly, it puts all carriers on an equal competitive footing.

Industry Concentration. This, too, is a mixed bag. The Republic-Airwest merger was consummated during the past year, and a Continental-Western or Continental-Texas International merger is at least theoretically possible. And right now Air Florida is seeking authority to acquire up to 50% of Western Air Lines' stock.

On the other hand, a number of new certificated air carriers have sprung up under deregulation. These include such carriers as Air Florida, Midway, Southwest and, within the past year, New York Air and People Express -- with still others on the brink of certification -- not to mention the numerous smaller certificated carriers, many of which were formerly non-certificated commuter carriers. Several of these new carriers have commenced business

with small twin-engine jets such as the Boeing 737 and Douglas DC-9 which have become surplus to the larger carrier fleets and therefore were relatively inexpensive to purchase. These carriers neither are unionized -- at least as of now -- nor have they experienced the cost increases attendant on long term seniority with the company. If these carriers can avoid unionization and the necessity of buying brand new more fuel efficient and less noisy -- but much more expensive -- aircraft, they may be able to hold their own on a competitive basis. We are, however, already seeing these newer carriers seeking Government guaranteed loans -- a clear form of subsidy. Again, the facts are not all in and only time will tell.

Insofar as the airline network is concerned, we are still in a period of shakedown and do not know what the ultimate effect will be. It may well be that there is a need for point-to-point low cost service with no interlining or thru baggage checking. In my opinion, however, the maintenance of a good on-line and inter-line connecting service network is essential. Again, wait and see.

And finally safety. There is certainly no evidence that safety has been affected adversely by deregulation and we all fervently hope and pray that it will not be. My own view is that the FAA has done an outstanding job of monitoring air carrier operations and practices to ensure the highest degree of safety. So long as a strong surveillance continues, I think we are probably in good shape.

A year ago I quoted and disagreed with Mr. Miler's conclusion of May 1980 that: "The evidence thus far is overwhelmingly on the side of the proponents of deregulation."

This year I agree with the General Accounting Office's statement that it is too early to judge the ultimate success or failure of deregulation because it is a gradual process (which has not yet been completed) as well as with their caveat that their comparisons "... require a word of caution. They reflect changes which have also occurred from other than airline deregulation, such as those attributable to changing economic conditions." So this year even more would I disagree with any claim that the evidence thus far is overwhelmingly on the side of the proponents of deregulation. We just do not know.

I leave you with a thought which I heard expressed on television by Senator Paula Hawkins, the new Republican Senator from Florida and a former member of the Florida Public Service Commission. She said, and I quote: "I rarely agree with economists. When I was on the Public Service Commission they'd come to our commission and tell us exactly what would happen two, three and four years from now. Two, three and four years from now they'd come back and tell us why it didn't happen that way and charge us a tremendous amount of money."

In international air transportation it is an open question as to whether it is in any particular nation's interest to gamble on the outcome of unfettered competition. Certainly if they are wrong, the economists are not going to pay damages. The best you

can expect is an explanation as to "why it didn't happen that way" -- and they'll probably bill you for the opinion. And so I leave you with the same thought I did last year. Your government must ask and is entitled to a definitive answer, "What if it doesn't work? Is the U.S. willing to pick up the tab?"