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DEPARTMENT OF TRANSPORTATION | NEWS

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REMARKS PREPARED FOR DELIVERY BY SECRETARY OF TRANSPORTATION WILLIAM T. COLEMAN, JR., TO THE WINGS CLUB, NEW YORK CITY, NEW YORK, APRIL 1, 1976.

I read with interest United Airlines Vice-President Andy DeVoursney's recent forecast of the air transport industry in the year 2026 on the occasion of the air carrier industry's 50th anniversary. Andy in his projections looked ahead to United Airlines' - and the industry's - centennial year. There will be planes with 1700 seats, he predicted, each costing a billion dollars. His captains will make $480,000 a year carrying a million passengers a day, with profits in the $11 billion range.

I bow to Mr. DeVoursney's intimate knowledge of the industry and his skill in forecasting. But Andy did begin his look into the future by noting that by the year 2026 the industry would be deregulated and profitable. So Andy is more a maverick than I for I will speak only of regulatory reform, not deregulation.

I hope we do not have to wait 50 years for either profit or reform. In fact, for reasons I shall set forth today, I believe regulatory reform legislation is now both possible and necessary to the long-term economic health of the air transport industry.

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In testimony before Congress earlier this month, United Chairman Ed Carlson posed the right issue -- that this country must decide whether or not it really wants a financially strong airline industry. The answer is simple-- effective and efficient public service is only possible with an airline industry that is strong and financially healthy. Competitive forces must be allowed to work to keep airline companies efficient and to keep fares and rates down.

All of us here are friends of aviation. Our mutual respect for the air transportation industry, and our common concern for its problems demand the development of an action plan which recognizes the changes brought about by 50 years of service.

The DOT has developed a plan and I want to take the next few minutes to discuss it and to answer your questions.

I did not invent regulatory reform. Thirty-four years ago the National Resources Planning Board called for a critical re-examination of regulation. In 1962, President Kennedy delivered a special message on the advantages of competitive rate-making. President Johnson's Council of Economic Advisers advocated less restrictive entry and rate control policies in surface freight transportation. Roy Ash headed an advisory board on executive organization which included reform proposals. There have been repeated Administration efforts to improve the competitive posture of the railroads by relaxing rate inflexibilities. We finally won that one this year!

The Civil Aeronautics Board in its July 1975 Special Staff Report concluded that the airline industry is naturally competitive and-- quote -- "...protective entry control, exit control and public utility-type price regulation are not justified by the underlying cost and demand characteristics of commercial air transportation."

I have detected among the leaders of the airline and aircraft industries, a growing acknowledgment that today's system isn't working well-- that while the productivity gains of past years have offset rising costs and kept fares at sufficiently low levels to attract new passengers, realistic prospects for further economic gains demand fundamental changes in basic policies. The most promising avenue to greater productivity is to give individual carriers the ability to manage their businesses with greater freedom - to use their resources effectively to provide the service that the public has come to expect and demand.

Along with many others, I too am concerned by the reluctance of the financial community to make more loans to the airline industry. The best way to restore lender confidence is for the industry to overcome its chronic inability to make a reasonable rate of return on its investment.

But clinging to the status quo, or implementing only token changes, will add more to the problem than to its solution.

There is little resemblance between the airline industry of today and the industry of 1938 when regulatory authority was legislated. Revenue passenger miles have increased from 533 million to 163 billion; investment in operating property and equipment from $50 million to more than $10 billion. In 1938, the plane in common use was the DC-3. Today, a single Boeing 747 can produce nearly as many revenue passenger-miles as the whole industry did that year. The smallest of our trunk airlines is today more than ten times the size of the whole industry in 1938.

Yet while the technical advances have been extensive the industry's basic structure has changed little. The trunk carriers operating today are the same ones that were in business in 1938, reduced through mergers from 16 to 10. Route-award and ratemaking procedures are still cast from the same mold, and rates and routes are constrained by regulation.

Airline regulation has served its intended purposes - one, to promote and foster the growth of civil aviation; and, two, make air travel accessible to the public. Yet in denying the airlines the freedom to compete in price as well as in service, regulatory policy has prevented air carriers from offering their passengers a legitimate choice between service amenities and lower fares. It was a favorite doctrine of the late inventor Charles Kettering that "if you have always done something a particular way, it is probably wrong." There seems little doubt that in transportation regulation something is "probably wrong."

Our airline industry is all that its loyalists claim it to be - "The best air transportation system in the world." But that is no guarantee that this status will continue. I believe that through selective, orderly and carefully time-phased reforms, fares can be lower, creating new demand; carriers can operate more productively - reducing costs; and efficiently managed companies can earn a better return on investment - providing the capital needed for growth and the replacement of older equipment.

I want to stress two points - (1) we are <u>not</u> proposing total deregulation, and (2) we realize the necessity for a transition period to maintain stability and avoid any disruption in service.

What is the substance of our program?

First, we favor a policy of easier market exit.

Under the proposed legislation, an airline could stop service at any point already served by another scheduled carrier upon 90 days notice. Or, where alternative service is not provided, any carrier not meeting its fully allocated costs for one year, or direct operating costs for three months, could leave that market.

There is no reason to believe that this would result in wholesale abandonments. Regional and local service airlines have been quick to fill any markets opened by a cessation or reduction of trunk carrier service. The emerging pattern of today's three-tier air service reduces inefficiencies. It eliminates high subsidy costs; and it provides levels of service well tailored to the market. It makes little sense to schedule a stream of jets in and out of a market that may enplane only 20 or 30 passengers a day.

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Fifteen years ago the commuter airline was virtually unknown. Last year the nation's more than 200 commuter carriers reported an eight percent increase in passenger traffic for a total of 6.7 million passengers, and a 33 percent increase in cargo business.

This pattern would continue under the amendment we proposed earlier this week, providing a subsidy program to ensure that small communities are not deprived of air service.

In just the past 15 years, the general taxpayer has subsidized regulated airline service to small communities, yet the regulated air carriers have dropped nearly a third of the points they once served because it just hasn't paid. The commuter airline is more efficient in these markets, and even with the subsidy program we propose, the cost would be small in comparison to the large amounts that will be saved through more efficient routing, scheduling and equipment-use.

Second; we favor a policy of flexible fares. Some of my friends who consider me over-zealous on the subject of regulatory reform point out that there is nothing in our proposal which will bring the <u>costs</u> of air transportation down. Fuel and labor and food costs, and all the rest, they maintain, would not diminish. This is true, but what my friends know - and perhaps aren't saying - is that air transportation is extremely sensitive to load factors, in that profits rise rapidly when load factors exceed the break-even point. The CAB's present rate-making policies, and prohibitions against true price competition, tend to tolerate and even reward mediocrity and inefficiency.

Today's uniformity does have a certain appealing simplicity and may aid industry stability, but the cost of such comfort is high. Rates become unresponsive to cost or competition, either artificially high, protecting inefficient operators; or artificially low, sapping the financial vitality of the industry.

Where carriers have offered lower fares in special markets, in the case of intrastate operators in Texas and California, service has improved and demand has grown. The central conclusion of the SIMAT report on state regulation of intrastate air carriers issued last January is that millions of additional passengers would use air transportation if fares were lower.

According to the best estimates available, only 40 percent of the people in the United States have flown, and many of those only once or on rare occasions. If there is a lesson to be drawn from the California and Texas experiences - and I believe there is - it is the tremendous opportunity awaiting the air carrier industry, in terms of new business, new markets and potentially larger profits.

There are, of course, reasons other than the absence of federal regulation why these intrastate carriers can charge lower fares - higher density markets, no interline costs, and the ability to schedule high yield turnaround service - but studies show that such factors account for less than half the difference. The key to intrastate carrier profitability has been their higher load factors, induced - in large part - by lower fares; fares that have not compromised safety or service.

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We are not urging complete rate freedom, only greater flexibility. Our proposal would not condone or permit predatory practices. The Aviation Act preserves intact the present authority of the CAB to declare unlawful any rate which would be discriminatory, prejudicial or preferential.

The third of our reform proposals is liberalized entry.

My economists tell me that with pricing flexibility, the only way to protect those caught in a monopoly market is through liberalized entry.

Liberalized entry, under the Aviation Act, will have the effect of curbing any excesses under a competitive price system. The threat of potential -- and I emphasize the word potential -- entry will police carrier behavior and keep prices at a level which is low enough to forestall entry by competitors.

Increased reliance on competitive market forces will not necessarily bring more carriers to every route. Increased competition does not, therefore, equal excessive service. If competition is allowed to work in this industry as it works elsewhere in the American economy, then service in individual markets will be provided at efficient load factors, and will be priced to reflect the cost of providing the service, while insuring a fair return on investment.

In this country an efficient and effective transportation system has always been primarily the responsibility of private industry. Our commercial air transportation system, of course, involves three partners -- the Federal Government which owns and operates the airways;local governments, which own and operate the airports; and the private companies that own and operate the airlines.

There is no desire or intention on the part of the Federal Government to gain a "controlling interest" in that partnership by acquiring the airlines outright as many foreign governments have done, or indirectly through regular subsidies. I believe the proper role of the government is to stimulate private sector solutions to economic problems, not to impede or hamper the ability of efficient companies to operate profitably. Government policy should foster a climate conducive to adequate capital investment, enabling private firms to earn reasonable returns on their invested capital. If the industries do not generate the capital they need -- and I include the airlines among these industries -- no amount of government subsidy will suffice.

While forecasts vary, traffic growth during the next five years should be above the five percent rate of the past five years. Economic studies I have seen predict a six to nine percent annual growth in air traffic, bolstered in the later years of the next half-decade by the shedding of restrictions and the stimulation of competitive rates.

Even without the increased demand regulatory reforms would bring, the airline industry will need significant numbers of new aircraft in the years ahead -- to replace aging airliners, to secure a new generation of quieter and more efficient aircraft, and to provide the additional capacity the normal growth in air travel will require. Some industry sources estimate the need over the next 10 years at a thousand or more new aircraft, representing an investment of $20 billion.

To finance this kind of capital investment, the industry must reverse the unsatisfactory earnings record of the past 20 years. For U.S. businesses as a whole, debt has become an ever increasing burden -- raising break-even levels and eroding profits. Interest payments as a percentage of profits for non-financial U.S. corporations now average 29 percent, compared to less than nine percent 10 years ago and under four percent 20 years ago.

The capital-intensive airline industry is particularly vulnerable to the debt-burden problem, which forecloses service options by severely limiting a firm's financial flexibility. This passes excessive business risk on to debt-holders and other business creditors.

The economic salvation of the airline industry, in my judgment, depends on the ability of the industry to earn reasonable profits consistently. The bill we propose would help, not hinder, the industry in meeting that test.

In summary, the basic need today is to address and correct the deficiencies causing poor performance in the airline industry, while allowing time required for orderly transition from one set of regulatory policies to another.

A legislated transition toward greater reliance on market forces will establish long-term general policy principles for the guidance and use of all affected parties. For the financial community, it is important to provide regulatory policy that will be consistently applied through all economic cycles, in such a way that lenders and investors have a reasonable idea of what to expect over the life of their commitments to, and investments in, the industry.

In looking to the future, we cannot evade the certainty of change. It will be necessary to leave the refuge of the comfortable and the familiar to pursue the untried and the uncertain. Economic regulation has served us well in the past, and may do so in the future. But only if we have the wisdom as well as the courage to adjust regulatory policies to today's times and tomorrow's objectives.

Let us remember that the Supreme Court has ruled that "regulatory agencies do not establish rules of conduct to last forever -- they are neither required nor supposed to regulate the present and the future within the inflexible limits of yesterday."

"The art of progress," in the words of Alfred North Whitehead, "is to preserve order amid change, and to preserve change amid order."

That is our course and our purpose. As I said at the outset, I am as desirous as any of the leaders of this industry to see it prosper. I am confident the prospects -- and the potential -- for consistent profitability are there. It is our obligation to do all we can to usher in a new era of airline prosperity, and make the industry's second 50 years more exciting, more dynamic and more fulfilling than its first.

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