STATEMENT OF BROCK ADAMS, SECRETARY, UNITED STATES DEPARTMENT OF TRANSPORTATION, BEFORE THE SUBCOMMITTEE ON AVIATION OF THE SENATE COMMITTEE ON COMMERCE, SCIENCE AND TRANSPORTATION, CONCERNING AVIATION REGULATORY REFORM, APRIL 1, 1977.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss with you the question of aviation regulatory reform. The President has set as a major goal of this Administration the freeing of the American people from the burdens of over-regulation. He has committed the Administration to an analysis of the values and costs of regulation.

Fortunately, in the area of aviation, the Congress has already done much of the hard ground work. Thanks to your leadership in the Senate, Mr. Chairman, and the assistance of Senators Kennedy and Pearson and the leadership of Chairman Anderson in the House, the issues are being clearly drawn and I hope we can now reach a proper solution.

As you already know, the President issued a statement concerning aviation regulatory reform. I participated in the development of that statement and I support it. It is a bold statement calling for the reduction in the extent of federal regulation of our nation's air carriers.

In 1938, the Congress in its wisdom created a very comprehensive regulatory system for the aviation industry. The industry was young then, and there was a need to improve safety and to nuture the industry so as to create the best aviation system in the world. Today, we do have the best aviation system in the world, one which provides a nation-wide system of superior-quality air service. The state of the industry has changed dramatically since 1938 but the C.A.B.'s regulation and decisions have become too static and have made the whole system too inflexible and cumbersome.

As an economist, I understand the development of the economic arguments that have been presented to the last six Presidents. As a legislator, I have participated in oversight hearings of the C.A.B. As a lawyer representing the Federal Government, and as a private attorney involved in transportation work as long ago as the early 1960's, I have seen the regulations and decisions in their practical application lose touch with the real world of airline operations.

I believe in a regulatory system designed to protect the consumer. The economic regulatory system has been used as a middle point between an absolutely free market and the slow moving, antitrust laws. I have repeatedly said I believe in consumer-oriented regulation to protect the public. On

September 17, 1975, in response to the former Administration's comments on national transportation policy, I said with regard to the regulatory agencies (referring specifically to the ICC but it applies here):

> "The Nation's transportation policy should be directed toward creating and maintaining a privately-owned and operated ... interstate system regulated by the Federal Government in the public interest. The . . . degree of regulation should vary with the degree of monopolization existing at any particular point in the system . . . . with competition allowed to set individual prices above cost where neither shippers nor the industry have power to control rates and quality of service. Otherwise the rates will all be set publicly by Governmental regulation."

I therefore agree with the opening statement of Chairman Cannon that "total deregulation" of the aviation industry "would create chaos out of order," but I also believe that we should remove regulation where it is unnecessary, where it is not serving the public interest, and where competition could do a better job. The time has come to reform the economic regulation of the aviation

industry. This will mean that C. A. B. regulation will be removed from many rate and route decisions and the C. A. B. will become more an adjudicatory body than a regulator. There must also be a decision made on whether the C. A. B. should administer the subsidy grant program when it does not totally control the system and determine the entire route structure.

I do not intend these statements to be construed as an attack on the C. A. B. What I am suggesting is that the role of the C. A. B. in the future should be substantially changed. It should no longer develop policy on a case-by-case method, but should carry out a regulatory policy which is clearly stated by statute. Your hearings are very ably developing and defining the problems of the present regulatory system.

First, we have found that since the original nineteen trunk carriers were grandfathered into the system there have been no new trunk carriers certificated and the original nineteen have shrunk to eleven, including Pan Am. After World War II, a number of smaller feeder carriers, now known as the local service carriers, were allowed into the industry. Originally, there were 19 of these carriers, but their

number has also been reduced to eight. Although the local service carriers have grown to become "mini-trunks", they still only account for about 10 percent of domestic passenger travel. And of course you have heard testimony from the supplemental carriers and the all-cargo segment of the industry. In other words, there's been some entry, but not nearly enough.

Second, route competition among the existing carriers has also been significantly limited. The existing carriers have many times been blocked in their attempt to enter routes already operated by other carriers. The Civil Aeronautics Board for several years engaged in a route moratorium in which it failed to respond to applications from existing carriers even though the Federal Aviation Act requires the Board to act "as speedily as possible." The C.A.B. testimony was quite open on this point. This moratorium has now ended, but there are still complaints of regulatory lag.

Third, the existing regulatory system inhibits price competition and a freer system would provide the opportunity for lower fares. The C.A.B. has historically inhibited those who would seek lower fares. At other times, carriers have found it difficult to obtain timely approval of fare increases even though their requests might be

justified by rising costs. C. A. B. pricing has been based on a highly artificial formula that uses industry averages and disregards differences between routes and carriers. Fares based on such averages deny the consumer the benefits of the more efficient carrier in a particular market. Denied the opportunity to compete in terms of fares, the airlines have been driven to compete in other ways, such as offering increased scheduling and frills. This artificial competition has often created excess capacity and added costly services that some passengers do not want. Some carriers stand ready to offer these lower fares. The C. A. B. has recently allowed several airline proposals to reduce fares to go into effect pending investigation. These proposals indicate that change is occurring, but we should provide pricing flexibility in a more permanent way that is not subject to a long hearing process and to the changing makeup of the Civil Aeronautics Board.

Fourth, the existing regulatory system does not protect against a loss of service. The Civil Aeronautics Board has very little control over the amount of certificated service that is offered a community. It is specifically prohibited by law from controlling either the type of equipment or the schedules of the carriers authorized to serve a

particular point. This means that, without any significant C. A. B. involvement, a carrier can drastically reduce service to a community or provide only unpopular, inconvenient service. In addition, the C. A. B. of its own choice has pursued a very liberal policy of allowing complete abandonment of unprofitable points. In the last 15 years, about 180 points have been abandoned by the certificated carriers. It is quite clear that the existing regulatory system is not protecting small community service.

The regulatory solutions thus must involve:

- o Entry into the system
- o Route competition
- o Rate competition
- o Exit from the system

Now, as we move to correct these problems, we face some potentially disruptive side effects which also must be addressed so we do not produce chaos out of the present system.

First, we must maintain quality service to our smaller communities. The President has made it quite clear in his statement that "small communities must be protected against the loss of needed air service." This means we must not only maintain the existing small community services but also not damage it further as we reform the system.

Second, we must consider how we want to address how shifting to market forces may affect airline users and employees.

Third, we should consider the financial impact on airport owners and airline investors.

The regulatory solutions should thus also involve:

- o Maintenance of a national system of service
- o Provisions to avoid hardship during transition
- o Consideration of financial impact

## I. THE REFORM BILLS: GENERAL COMMENTS

The framework we are discussing is set forth in the bill introduced by Chairman Cannon and Senator Kennedy (S. 689) and the bill introduced by Senators Pearson and Baker (S. 292).

### A. The Trade Offs

First, I want to discuss what may be an obvious but very important point. We are dealing here with a very complex and interrelated set of problems. We cannot just talk in terms of entry or route competition or rate competition or exit alone. All of these issues

interconnect. Changes in one drastically affect another. We cannot have pricing flexibility without entry and exit liberalization. Without entry liberalization an upward pricing zone is a one way street to higher fares. Without downside pricing flexibility complete entry liberalization will lead to excess capacity as competitors crowd the rich markets. We cannot talk about removal of route restrictions without talking about replacement service for smaller communities or service will be jeopardized. I believe we ought to eliminate closed-door restrictions and phase out intermediate-stop restrictions. The purpose of intermediate-stop requirements, however, is to require some service to smaller communities, which are between major cities at a lower cost than if the small city were served on a separate flight. The phase-out of the intermediate-stop requirements therefore must be consistent with the implementation and timing of a small community program.

So must an abandonment provision be consistent with the phase in of a small community service program. Freer exit is desirable to rationalize routes and equipment but there must be provision for enough notice to allow for a replacement carrier and for the mechanics of a small community program to go into effect. I

believe that a key ingredient for a successful bill-- and I think this subcommittee will produce a successful bill--is the coordination of these interconnecting issues of entry, pricing, exit, and the necessary transition mechanisms to protect those who will be adversely affected by the changes.

B. Transition

The second general comment I want to make is the need for transition. We know a great deal about this industry, and I think we know a great deal about what will occur as we introduce regulatory reform. In the final analysis, however, there are still uncertainties. I am told that Mr. Nader referred to this process of reform as a "controlled experiment". This is probably a very apt characterization. For example, we may find that we need more entry to police the kind of pricing flexibility we adopt. Or that adjustments will have to be made in our small community programs. We have to allow ourselves the time to recognize and to correct the problems as we go along.

There is another reason for transition. The C. A. B. certificated carriers have been working under the present regulatory system for almost 40 years. The system has slowly broken down and yet a whole way of life is built around it. It is going to take time to

adjust. I believe that fundamental fairness to the carriers, to their employees and to the people who will have a change in the service they receive, requires a reasonable time for adjustment.

## II. SPECIFIC REFORM PROPOSALS

I would now like to discuss the concepts contained in the bills which are being used by the Committee to develop this legislation.

### A. Entry Into the System

I suggest we should have a more open system of route awards and entry for the aviation industry. S. 689 provides an appropriate mechanism, although a greater amount of transition may be required than is provided in the Cannon-Kennedy bill.

First, the C. A. B. Policy Declaration should be changed. This is no longer an infant industry, and the Board's attention should be directed towards competition, innovation, and the encouragement of new carriers.

Second, time limits should be placed upon Board actions. Government has to respond to the proposals of its citizens and to do it within a reasonable time. The time limits in S. 689 seem appropriate.

Third, unused authority should be used within a specified time or opened to new entry since the Board has already made a decision that the public convenience and necessity are consistent with entry. If one carrier does not wish to use its authority, it should be opened to another.

Fourth, the reversal in the burden of proof for the public convenience and necessity test is also a worthwhile change. The rule of the game should be that competition is consistent with the public convenience and necessity and you should have to prove your case if you're against new competition--not the other way around.

Fifth, raising the exemption for commuter carriers to allow them to use larger planes is another wise change and we should involve the commuters in a new small community program.

Sixth, I suggest that some amount of discretionary new entry will provide carriers with the kind of flexibility they need to provide a more efficient and low-cost air transportation system, but year around service should be required and I would not phase in trans-continental service in the first instance.

I believe we will need more transition than is provided in S. 689. There are many ways to approach this,

and I would welcome the opportunity to explore the possibilities. The ultimate approach will vary depending upon what you decide to do in the areas of pricing and small community service.

B. Route Competition

I am concerned about the different treatment accorded various classes of carriers under the S. 689. For instance, the discretionary entry provision of S. 689 distinguishes in a fairly radical manner between the trunk carriers and other carriers. S. 689 allows the larger carriers only one new route, but allows the smaller carriers up to four new routes a year. In addition, by the terms of that provision, only C. A. B. certificated passenger carriers and three intrastate carriers would qualify for discretionary entry. Ironically, the discretionary entry provision may provide a barrier to totally new entrants. I think we should proceed gradually to increased entry, within a fixed statutory framework that treats all carriers, big and small, new and old as equitably and as even-handedly as possible.

C. Rate Competition

I believe some modifications of the S. 689 pricing provisions may be appropriate. I would suggest using a zone, in which carriers can increase or decrease their rates without Board interference and that we phase in the new rate system carefully with Board discretion outside the zone. At

least in the beginning, I believe that the zone should provide for a maximum upward increase of no more than ten percent per year--and I think there might be some merit in even a smaller upward zone. I am hopeful that increased entry will prevent unreasonable increases in rates, but entry takes time and is expensive, and there may be many practical problems a company must overcome before it can provide viable alternative service. I would stress that I am talking about a ten percent increase a year. It would not accumulate if the authority is not used. In other words if you do not use your authority in year one, you can only go up ten percent in year two, not accumulate and increase twenty percent in the second year.

What about downward flexibility? There has been a great deal of discussion about whether we should allow carriers to price down to their "direct costs" or whether we should use a fully allocated cost floor. As you know, in the rail bill the Congress did adopt a variable cost test of sorts. Language was inserted, however, in the rail act that has been interpreted by some as preserving the ICC's right to prevent predatory or unfair rates.

In the long run, I think it is fairly obvious that if a carrier does not cover all of its costs including overhead it is going to go broke.

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In the long run, I think it is fairly obvious that if a carrier does not cover all of its costs including overhead it is going to go broke.

We have seen this happen with a number of railroads. Carriers may also be charging reduced fares to drive a competitor out of a market so it can dominate it. The President was quite specific in his determination to protect against predatory pricing. On the other hand, the airlines and the C. A. B. did experiment with a number of different youth and discount fares on the basis that filling the plane made some contribution to its overhead. A reduced fare might also be justified if a carrier is trying to attract off-peak traffic. In addition to these fare shifts by carriers on existing routes, there is some necessity for a new carrier to charge less to break into a market and compete against the existing carriers.

With respect to downward flexibility, again I prefer to have a specific automatic zone, free from C. A. B. interference, of perhaps 20 percent. However, I think we should also make it easier for carriers to go below this zone, but I would not make reductions below the 20 percent zone automatic. For fares below that level, I believe that the Board should have some power of review to ensure that the fares are not predatory. I recognize that the Board might abuse this discretion and to prevent this abuse I would suggest shifting the burden to the complainant to prove that a fare below the

20 percent level is predatory. In other industries, the burden is upon the opposing party to prove a price reduction "predatory", and I think it should be the same in aviation. As time goes on, and we see how well entry has worked, we may want to go further or establish different C. A. B. procedures for new as opposed to existing carriers on a route but this seems to be the place to start.

I think this approach will provide necessary downward pricing flexibility and ample protection against any possibility of either monopoly or predatory pricing, as will increased entry as time goes on.

D. Exit From the System

As I have previously stated most exit actions have already taken place. However, if the national policy is to let market forces work to a greater degree, then a competitor should not be forced to stay in a market where it believes it cannot survive.

IV. PROVIDING FOR A SMOOTH TRANSITION

A. Maintenance of a National System

A transition period is essential to help with the problems that may arise in some small communities in the event of an abandonment of service. I would suggest a specific provision, however, dealing with small communities. I consider air service as a public utility in that it

offers a vital public service that should be available to all our nation. I know the Committee has recognized the need for a provision for small communities and that Senator Pearson's bill has among other things a provision aimed at protecting service to small communities and rural areas. The C. A. B. has offered a provision dealing with small communities which in its basic form has merit.

Rather than offering another particular provision at this time, I would like to suggest four basic objectives that should be accomplished in the final provision.

First, the carrier proposing to abandon the route should give ample notice (i. e., 120 days), and, if there is an applicant or another carrier available to give service, exit can occur. If there is not then the C. A. B. upon application by the community involved could extend service for another 120 days or so to give the community time to find another carrier and apply for a subsidy.

Second, any subsidy system should be related to the needs of a particular point and not to the needs of a carrier and the carrier's whole system.

Third, the program should involve state and local participation in the decisionmaking part of the program. Ultimately, any new subsidy program should involve cost sharing by the state or locality and the Federal Government for those points not included under the present subsidy system, so any local community seeking a new subsidy has a stake in watching the amount of the subsidy cost--an incentive to provide traffic--and a voice to complain about the carrier's actions. Not to involve the state or locality in the costs of a program encourages waste.

Fourth, any subsidy program should be open to participation by commuter carriers. However, the program should guarantee that any commuter carrier participating in the program is financially responsible and safe, which would be done either through a licensing program by regulations or some other measure to assure safety and financial responsibility.

I think that as we move towards greater reliance upon commuters, we have to increase our vigilance of their safety. I am sure it is well known to this Subcommittee that the safety record of the commuters is below that of the scheduled carriers. If we have more aircraft or scattered facilities, we will report to you on the needs of the FAA to maintain safety. But I strongly believe we have an extra responsibility

with respect to those commuters participating in a new small community program.

B. Provisions to Avoid Hardship

We should examine provisions to protect labor against any dislocations or hardships associated with the transition to an improved regulatory system. This is a matter which should be carefully studied. We must not disregard the possible problems of the working men and women who have invested their lives in this industry. This is already provided for in merger cases. We should consider carefully what might occur in the event there is a failure in the system causing significant unemployment.

We should, together with the unions and the carriers, identify the problems that might occur and strive to find equitable solutions for them.

C. Consideration of Financial Impact

We should be certain that the franchise operations of existing carriers are not immediately destroyed by discretionary entry. I do not believe new entry will be the same threat.

We must also recognize the reality of some disruption if carriers withdraw from airports or do not land as many flights when fees determine the financial basis of an airport operation.

V. MISCELLANEOUS PROVISIONS

A. Mergers

The bill makes certain changes in the way mergers and agreements are now handled by the Board. I do not think that we should make changes for changes sake. The record of the Board in airline mergers has been that bad and without some reason for change, my preference is to leave the merger authority with the Board. Moreover, removal of the Board's authority with respect to mergers and antitrust review would hamper the Board's ability to deal with protecting employees in a merger situation. The Committee may want to consider granting the Board authority to also alleviate hardship in the event of a bankruptcy and liquidation of a carrier. I would support a stronger merger standard for the Board to apply and I would also support placing time limits on any Board considerations. There is little possibility of placing time limits on merger cases if that authority were placed in the courts.

B. Agreements

As for agreements, I think we should limit the Board's power to sanctify all agreements and specifically remove the Board's authority over capacity agreements. There are some present agreements that should be affirmed such as ticketing and baggage agreements. These would probably be upheld under the antitrust laws, but such a determination might take a rather

long time. I would suggest that a better approach would be to list the agreements which don't cause problems in the statute and leave them with the Board, but to remove the Board's authority with respect to other agreements.

C. International Aviation

Unlike certain earlier bills, S. 689 would deny the President his present authority under Section 801 with respect to international aviation cases. I would hope that you would not place this in any bill since the Constitution requires the President to conduct our foreign relations in aviation as well as in other fields. The President and the Executive Branch have to be involved in negotiations with foreign countries over fares, routes and landing rights, and this means he has to be involved in Section 801 cases. We should not eliminate Section 801 because of possible problems with the policies of past Administrations. In addition, executive procedures have been adopted to open the Section 801 process, which should prevent any future abuse of the process.

VI. SUMMARY

The principal issue before the Committee is whether the nation wants to establish rules for the aviation market or simply let the system function in the open market with prices and service determined by supply and demand and potential application of the antitrust laws.

If the decision is made to enforce some rules in the market place then it is a question of whether to continue to delegate the establishment and enforcement of rules under broad guidelines to an independent Board - or to establish some new system.

I believe the Cannon/Kennedy bill and the message of the President provide an appropriate conceptual framework for reform and therefore I have suggested the Congress set specific but limited rules for open market competition on routes and fares but continue delegation of power to the C. A. B. to grant more competition if it is found to be in the public interest. This would be done over a period of time so all parties involved could adjust and the Congress can monitor the results of these changes.

This concludes my statement and I would be happy to answer your questions.