

U.S. DEPARTMENT OF TRANSPORTATION  
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STATEMENT OF CHARLES D. BAKER, ASSISTANT SECRETARY FOR POLICY AND INTERNATIONAL AFFAIRS, DEPARTMENT OF TRANSPORTATION, BEFORE THE SUBCOMMITTEE ON AVIATION OF THE SENATE COMMERCE COMMITTEE CONCERNING THE FINANCIAL CONDITION OF THE AIRLINE INDUSTRY, THURSDAY, FEBRUARY 11, 1971

Mr. Chairman and Members of the Committee:

I am pleased to have the opportunity to appear before you today to discuss the financial condition of the airline industry. The current financial predicament of the commercial airline industry is clearly worthy of the government's concern, especially with respect to its implications for the traveling and shipping public. The problems facing this industry tend to differ both in degree and kind from one segment of the industry to another, as do the apparent causes of these problems and outlook for the future. Moreover, this same general observation can be made concerning the respective situations of individual carriers within any single airline group.

The major element common to each group's problems is their recent and prospective failure to realize adequate earnings. Every segment of the industry--the trunks, the local service carriers, the supplementals and the "third level" carriers--lost money last year, and industry's forecasts predict a worsening trend, or at best only a very slight recovery, over the next year or two.

For the trunks, who had experienced several years of rapid growth and profitable performance in the mid-60's, this dramatic downturn in earnings has come in the midst of a major re-equipment cycle and its related heavy financing requirements. For the local service carriers, 1970 was the fourth

year in a row that this group failed to get into the black, notwithstanding subsidies. Except for Allegheny Airlines, which recorded a profit of \$520,000 for 1970, every other local service carrier lost money during this past year, and several are in serious financial shape. For the supplementals, 1970 was the second straight year that this group showed a net loss. The "third level" carriers have not escaped the general malaise of the industry. All this is more fully described in an analysis of the financial condition of the segments of the airline industry. (A copy of this analysis is submitted for the record as Exhibit 1.)

Without question a large part of what we are witnessing in the airline's poor earnings performance is a reflection of the economic slowdown experienced during the last eighteen months. Domestic air travel, which had been on a steep growth curve for years, leveled off sharply in 1970, confounding the air carriers' traffic projections. This unexpected turn combined with enlarged capacities, based on anticipated but unrealized growth, left the airlines flying, in too many instances, near-empty planes--a result totally incompatible with profitable performance. In addition, the severity of competition for the existing business, the rapid expansion of capacity with the delivery of the new wide-bodied transports, rising operating costs, high interest costs and reluctant lenders, work stoppages and basic structural problems in the industry as a whole, have also contributed to the carriers' present problem.

Some of these factors have already begun to change for the better. The economy is starting to turn up, and all segments of the industry will be benefitting from this continued trend. The President has proposed

new machinery for settling transportation labor disputes which holds out hope of eliminating the debilitating consequences of work stoppages. Interest rates have dropped sharply, and lenders are once again looking for borrowers, at least solvent ones.

It would seem that the trunks should be able to weather this period, provided that their capacity can be better attuned to actual demand. This will require stern managerial discipline on the part of the carriers. We are actively studying the effects of capacity as it relates to profit margins, and later on in my statement I will indicate some of our findings in this area.

The supplementals can also emerge from this downward cycle as a healthy, profitable segment of the industry, but there are still a number of challenging questions to be resolved with regard to the overall place of charter operations vis-a-vis scheduled operations, including the issues of substantial impairment and landing and uplift rights.

The local service carriers present quite a different situation. Their problems are less transient, more serious, and very pressing. In the near term, it is hard to see how this industry can survive without a significant improvement in their revenue position. The longer range solution will require rethinking and redefining the role which these carriers should play in the overall air carrier system, in particular, their interfaces with the trunks and the "third level" operators.

With respect to the "third level" carriers, their health as an industry should improve along with that of the economy in general. As with the other segments, there are a number of unanswered questions to be resolved



concerning these carriers, including their proper role, their relationship with the local service carriers, and the size of their aircraft.

A quotation was brought to my attention the other day which I feel brings the present problems faced by the industry into some perspective.

"The drastic decline in profits of domestic trunk airlines . . . brought many complaints from the airlines and financial analysts. (W)hen the clamor was loudest, one analyst said that the airlines 'as a whole are seriously sick, perhaps almost as much as their rivals, the railroads'. Most explanations of low profits centered on 'CAB-induced over competition' and 'on abrupt slowdown in the growth of passenger traffic'."<sup>1/</sup>

The situation being discussed there is not the present one, but rather refers to the winter of 1961-62 and the economic aftermath of the introduction of jet aircraft. From the perspective of 1971, we should probably be able to take some heart in the proven resiliency of the U.S. airline industry.

On that optimistic note, I would now like to offer some comments on four particular aspects of the current situation facing the airline industry; namely merger criteria, capacity control, domestic fares and international fares.

#### MERGER CRITERIA

As the Committee is aware, the Department has a mandate from Congress to prepare a statement of national transportation policy by May of this year. As part of the Department's work on this important task, my predecessor, Paul Cherington, did some initial work on the identification of merger

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<sup>1/</sup> Gorden, Robert J. "Airline Costs and Managerial Efficiency" in Transportation Economics, National Bureau of Economic Research, New York, 1965.

criteria, and the drafting of guidelines which might be used to shape the position taken by Executive Branch agencies as a group with respect to proposed airline mergers. I have continued this effort at some length within our Department over the last several months. I expect to pursue our efforts within the Executive Branch, particularly the Department of Justice. I hope that a common general position can be achieved soon.

Nevertheless, I have no reluctance to indicate the policy perspectives from which the Department of Transportation is considering proposed airline mergers and the criteria and guidelines which are presently influencing the positions we take respecting such mergers and the comments which we file with the CAB.

1. Effective competition should be maintained in the leading city and regional markets for airline services after the merger, and the merger should not result in excessive market shares for the surviving firm.
2. Undue concentration in the air carrier industry should be avoided.
3. The size of the merged airline firms should not be such as to be unwieldy to management or potentially oppressive in relation to the rest of the industry and the public.
4. The merger should not lead to extensive reactions and defensive merger proposals by competitive carriers so that the end result will be a restructuring of the industry and excessive concentration of control in a very few firms.
5. The merger should not result in extensive injury to other carriers.

6. The merger should bring about substantial operational and service economies and organizational benefits for the surviving firm so that the public will receive benefits in terms of greater efficiency and better service.
7. In the case of a merger of a relatively prosperous carrier and one that is in failing or in marginal financial circumstances, or in the case of two marginal carriers, the resulting benefits of the surviving firm should be corrective of the original difficulty of the weaker merger parties. Alternative solutions to the problems of the merging carriers should be shown to be considerably less effective than merger.
8. The protection afforded labor in the merging firms should be in accordance with the present policies of the CAB.

#### CAPACITY CONTROL

Late last summer, three of the major trunk carriers, TWA, United and American, filed with the CAB a request for approval of their agreement to reduce capacity on certain specified long-haul transcontinental routes. The Department of Transportation did not oppose this proposal in principle, although we raised a number of questions about its need and probable effects. (A copy of DOT's comments to the CAB is submitted for the record as Exhibit 2.) As the Committee knows, the Board rejected the proposed agreement on a number of grounds.



This past December, TWA tried again and filed with the Board a request that it be authorized to engage in discussions with a number of carriers to identify routes on which capacity reductions might be accomplished, with the understanding that any particular agreements derived from such discussions would be subject to explicit Board approval. The Department of Transportation has accepted the premise that circumstances warrant the proposed discussions, in comments filed with the Board last month. We have reserved further judgment pending the outcome of any permitted discussions. (A copy of DOT's comments to the CAB is submitted for the record as Exhibit 3.) The Department of Justice, as the Committee is aware, took exception to the proposal as made and suggested three explicit additional conditions.

The general basis for the Department of Transportation's position stems from an analysis that we have made of the potential benefits of capacity reduction. Our work strongly suggests that the projected profit or loss for our domestic system in 1971 and 1972 can be sharply affected by the amount of capacity offered by the airlines in the system. Furthermore, a substantial decrease in industry's projected capacity offers excellent prospects for the major airlines to achieve an overall profit this year--a most interesting prospect when compared to the Air Transport Association's projected losses of \$493 million made last June or \$192 million made in its testimony last week.

I would like to illustrate the sensitivity of profit and loss projections to changes in capacity as well as changes in fare level for your consideration. Based on (1) projected 1971 operations of trunk

carriers as reported by them last fall, (ii) the fare increases that had been approved by the CAB through October, 1970 and the IATA Honolulu fare package and (iii) an assumed 5 percent growth rate in domestic traffic and 9 percent in international traffic for 1971, we have estimated an aggregate trunk carrier loss this year of \$181 million. Let me now indicate how this resulting \$181 million loss can be affected by changes to fare levels and capacity.

- A 5 percent domestic fare increase effective January 1 of this year, combined with an assumed elasticity of minus .8, would reduce the projected 1971 loss by \$46 million to \$136 million.
- With no fare increases during 1971 and the holding of 1971 capacity levels to those of 1970, trunk carriers could turn the \$181 million loss to a profit of \$108 million.
- If a 5 percent fare increase were added to a capacity reduction program and elasticity were about minus .8, the 1971 projected profit would be \$154 million.

(A more detailed description of this analysis is submitted for the record as Exhibit 4.) In the analysis we have made other assumptions and projections, including those applicable to 1972. We feel this exercise is significant because it demonstrates how sensitive the system's profit and loss projections are to variations in the capacity of the system. It also suggests that fare increases should not be viewed as the only effective way to improve the financial condition of these airlines.



I would like to reiterate that these calculations are based in great part upon the airlines' 1971 capacity plans as projected by them in the middle of the last year. We realize that several trunk carriers were mentioned in testimony before the Committee last week. Consequently, to some degree at least, the airlines have already moved toward improving their profit picture through capacity reductions. The Department is now recalculating its projections to reflect these changes in 1971 capacity, but we have not yet completed this job. Obviously, there will be a close relationship between these changed projections for 1971 and 1972 and the type of multilateral agreements which the CAB might approve in the event it acts favorably upon TWA's petition to hold discussions in the area of capacity reductions.

#### DOMESTIC AIR FARES

The Department has expressed its views concerning the structure and level of domestic air fares in extensive testimony and briefs presented to the CAB in its current domestic passenger fare investigation. I would be happy to furnish copies of any of this material to the Committee upon your request. (A listing of DOT's testimony and briefs is submitted for the record as Exhibit 5.)

Fundamentally, it is the Department's view that there should be more flexibility in the ability of air carriers to set their fares. In our testimony, we recommended the adoption of a "zone of reasonableness" which would allow carriers to freely adjust their fares within a predetermined cost-base range. As a result, some rate competition would occur in addition to the service competition presently existing. The Department believes that in the

in the absence of such rate flexibility, competition based only upon service tends to increase the costs of operation unnecessarily and leads to fare increases that would not otherwise be needed. In our judgment, the public interest requires a cost oriented fare structure so that fares can be maintained as low as reasonably possible.

#### INTERNATIONAL FARES

In the international markets, particularly in the North Atlantic, the Department recognizes that U.S. route carriers have experienced decreased earnings in recent years and that there is a need to raise the revenue yield. The recent IATA fare proposals agreed to by the carriers as a result of the Honolulu fare conference are intended to increase yields to more reasonable levels. But, the Department would have preferred if these proposals increased yields through changes in the fare structure more closely related to costs. For example, one problem we have with the existing fare structure is that it does not provide for stopover charges under normal circumstances. We believe that passengers wishing to stop over enroute to their final destination should pay a reasonable charge for that additional handling cost. We had hoped that the Honolulu fare conference would have corrected these types of problems, but unfortunately it did not.

In our comments to the CAB in connection with these Honolulu fare proposals, we did not recommend their disapproval, but we did express concern over the appropriateness of the proposed increases in the normal economy fare. (A copy of DOT's comments to the CAB is submitted for the record as Exhibit 6.)

In connection with this subject, I would like to quote from the Statement of International Air Transportation Policy of the United States, approved by the President on June 22, 1970: "The effectiveness of the Board in its dealings both with IATA and governments should be enhanced by vesting it with authority to regulate rates and fares between the U.S. and foreign points, subject to Executive Review." It is the Department's view that if the Board had the necessary regulatory tools, it could require that increased yields, currently needed by the industry, be earned from a fare structure related closer to the carriers' cost.

Presently, if the Board finds a proposed fare to be inconsistent with the public interest, its only recourse is to disapprove the proposal. We feel that the Board's power simply to disapprove rate resolutions is not an effective regulatory tool. In areas of little fare competition, such as the Pacific, history supports the likelihood that the carriers would unilaterally file virtually the same fares with the Board, thereby mootting the Board's disapproval of an IATA resolution. In areas of heavy competition, such as the Atlantic, where there is strong competition between scheduled and charter services, an open-rate situation could result in fare cutting to the point that yields would be unduly depressed. On the other hand, if the Board is empowered to regulate international air fares, it would be in a stronger position to assure a reasonable fare structure consistent both with the interests of the traveling public and an economically sound airline industry.

Mr. Chairman, this concludes my prepared statement. At this time I will be happy to answer any questions which the Committee may have.





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# NEWS

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WASHINGTON, D. C. 20590

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Excerpts From Remarks by Assistant Secretary for Policy and International Affairs Charles D. Baker Before the Federal Bar and Foundation of the Federal Bar Associations, March 9, 1971, Washington, D. C.

Good afternoon, ladies and gentlemen. Over the course of yesterday and today you have heard a number of horror stories related and a number of propositions advanced. Some of both of these have, I am sure, involved the government so perhaps the first thing I should do is comment on what I think the government's perspective and roles are and should be. In my view, the role of the Federal government is to facilitate and foster the continuation and growth of the most efficient means of passenger and freight transportation for the American public -- not to save the railroads, or the airlines, or even their bankers. Now "most efficient" is subject to some interpretation, and public perception of this has been known to change over time. Cost, level of service, speed, comfort or freight handling characteristics have pretty much always been criteria, but now we are increasingly adding environmental and sociological considerations.

These reassessments are good, and I hope we'll continue to revise our thinking on transportation just as society continually evolves new thinking about practically any subject you can think of. The point I want to make, however, is that in the ultimate crunch, my perspective and I think that of the government generally is (and must be) that of the public who uses -- either in traveling or shipping -- and is affected by the nation's transportation systems.

Now that it's clear that I do not care what happens to the operators (particularly the common carriers) of the system, let me state emphatically that I do care -- very much. The intercity common carrier systems -- and that's what we are here concerned about -- are privately owned, profit-making operations. Clearly, they or some substitutes must exist and exist in healthy form or the transportation may cease to be efficient and perhaps cease to be available. Of course, the possibility of "nationalization" has at times been bandied about. My own view is that foreign experience in transportation and our own experience in Federally-operated programs generally suggest that nationalization is not simply a poor answer, but no answer at all. There are no -- I repeat, no -- foreign nationalized railroads that I know of that break even, much less generate a plus. In short, they all cost their tax payers a lot of money. With all the other expensive problems we have to solve, nationalized railroads are a luxury this nation simply cannot afford. So, the answer is, I'm very concerned about healthy, growing, privately-owned, intercity freight systems!

Well, does the rail industry really have our attention? You have heard various people describe the "plight of the railroads." I know that story well. Last spring I played a role in the drama of the Penn Central and since that time we at the Department have met with Penn Central trustees on a number of occasions. Last fall the chief executives of virtually all the nation's major railroads and rail labor unions met with us to discuss the levels of the problem, and George Stafford and various White House and Congressional staffers joined with us. Not long ago we had a similar gathering, this time with the country's major shippers and representatives from the academic and investment communities to get another slice at the problem from a different perspective. In summary, I think it is correct to say that the industry does have our attention. We do recognize the dimensions of the problem. We are heavily involved in assessing the whys, the national impact, the options, and, finally, the "What should the Federal government do?" question.

Before going on to what we are doing and might do, let's reflect a minute on why we are where we are. Some have suggested that one major problem is the existing rate structure, and I personally think a convincing case has been made. Another issue that has been raised is labor productivity. Here I think the ground is somewhat more spongy -- it appears to me that labor productivity has improved dramatically in the last decade. Potential for improvement may



remain, but I think that attributing present railroad problems to labor productivity is a difficult point to sustain. General operating effectiveness? Here a lot can be both pro and con, but in relative terms over the last decade or two, again I think it is probably not a cause of the current economic erosion in the rail industry even though service issues abound.

How about volume and diversions? The fact that the rail share of the market changed from about two-thirds of the total domestic ton-miles in 1939 to just over 40 percent in 1969 gets a lot of attention, but during the same three decades, actual ton-miles hauled by rail more than doubled -- from 339 billion to 780 billion. I will concede that GM strikes and "rolling readjustments" are short-term issues of consequence but never the less long-term demand has been good.

Then there is trackage. It has been implied that abandonments or route rationalizations wouldn't help us much. I think this is by no means clear! Taxes are generally paid on property, some maintenance is being done, and discontinuance and abandonment of marginal service are perhaps more related than a cold look at the laws would show. In any case, today we have about 90 percent of the line-miles (in fact 90 percent of the track as well) that we had in 1939 -- that was before the Interstate System was a gleam in Eisenhower's eye, before pipelines increased their ton-miles eightfold, before intercity rail passenger service went from two-thirds of the total to less than 10 percent. In short, although rail

tonnage has doubled the structure of all intercity transportation has changed dramatically, and yet the track essentially has remained the same.

I don't think I need elaborate the costs of rail passenger service. They have indeed been a major drain. But let me comment on another area -- equipment utilization. The ASTRO Report calls for \$36 billion in new capital over the next decade -- half for freight cars. However, some analyses indicate that new cars don't pay off. Why? Marketing and ratemaking. I'm sure this is all true, but let me cite some figures: The nation's 1.5 billion freight car fleet moves loaded or empty only 11 percent of the time and since it is loaded only 60 percent of that time, it's engaged in moving freight only roughly 6 percent of the time.

Above and beyond this, 30 percent of the time is spent in classification and interchange, 40 percent in loading and unloading, 15 percent in waiting to be loaded and 5 percent out of service. This certainly suggests some opportunities for technology, control and deployment, and marketing and ratemaking. And, if you'll excuse the pun, some opportunities for making capital investment move!

Just what does the Department think about all this? Clearly the rail industry has problems, and apparently there are some discernible causes. But do we really care and where is the public interest?

DOT estimates that in the next 10 years the railroads will be called upon to haul at least one-third more freight -- for a total of over one-trillion ton miles -- than it now is carrying, and this is

viewing alternative transportation systems very optimistically. Nevertheless, these are freight levels viewed as economically logical and sociologically desirable from my client's, the public, perspective.

So, the answer is clear. I do care and so does the rest of the government. What have we done recently and perhaps more important what should we do? Brave words -- where are the chips? Let me cite a few. The 91st Congress passed what I consider some fairly significant railroad legislation. First, the rail passenger legislation-- the Corporation established by this bill to all intents and purposes takes the rail industry out of the passenger business and effectively reduces the railroads' loss on this service by \$240 million a year.

The Urban Mass Transit Bill deals primarily with urban transportation, but there are currently five cities which have fairly extensive commuter rail service and these systems will be eligible for capital equipment aid under the provisions of this legislation. We obtained loan guarantee legislation for \$125 million. The money this provides is designed to meet urgent and (we hope) temporary needs, but we feel that it might have some long-term impact as well -- we might need it to get from here to there.

The Discriminatory Taxation Bill did not make it through the last Congress, but we would hope that this or a similar proposal, if re-submitted, would get favorable consideration. If passed, it is estimated to save the industry in the neighborhood of \$40 to \$60 million a year in State and local taxes.



Over the past couple of years DOT has gone on record as being opposed to across-the-board general rate increases. Although I don't think our basic attitude vis-a-vis this issue has changed, given the present condition of the railroads we haven't opposed recent rate increases before the ICC.

This brings me to another question -- that of the whole rate structure and revisions to it. I think that some revision is definitely in line -- the present system simply isn't working. And, in part due to our concern, the ICC now has a large-scale review of the structure of rates underway, a move which I heartily applaud.

Beyond this I think a general and comprehensive review of the whole regulatory process is in order. Restructuring the regulatory institutions has recently been proposed, **and** Chapter 4 of President Nixon's recent economic message provides much thought on the substance of regulation.

I earlier made some remarks on route structure and here I'd like to point out that the Department has been doing some deep thinking on this subject and the whole question of mergers. We are in the process of formulating policy so that we can make recommendations based on our view of things.

And the mini-train, the IC rent-a-train, and other similar marketing experiments are I hope indications of new thinking. The Department supported rent-a-train before the ICC and we'll continue to react favorably to innovation and new ideas.

Many of the issues I have discussed here are being addressed in the legislative package of items concerning the railroad industry that DOT is putting together. The proposal(s) are based on staff input, the ASTRO Report, deregulation studies undertaken by the Cabinet Subcommittee on Transportation as well as comments we have received from shippers and investors. And although I am not free to deal in specifics at this time I would like to give you a general idea of the direction our thinking is taking.

The package addresses what we consider the major causes of the industry economic problem -- the inability of the industry to attract sufficient capital for modernization, outmoded regulatory laws and policy, and unbalanced public investment in the various modes. In general, our approach has been to return the industry to an earnings level that will enable it to attract private capital, including providing some financial incentives over a limited transitional period and, in addition, making substantial policy changes.

We want to create an environment in which a privately-owned and operated railroad system can exist and prosper -- this means avoiding involving the government deeply in the ordinary affairs of the industry, committing it to new investment (or maintenance of current investment), or otherwise trending toward nationalization. To the extent direct Federal budget outlays are called for, we feel that these should be

carefully evaluated and certainly held to a limit. On the practical side there is the question of credibility with OMB and the Congress but also there is a danger of distorting the capital market and creating an imbalance of private investment in the railroads.

To the extent the legislative proposals affect the other modes of transportation, that in the interests of fairness and equality and where possible and appropriate those modes should also be included. To do otherwise would only be to create a new set of inequalities. Finally, any regulatory changes that are proposed should be consistent with the tenor of the deregulation report. And lest the problems of the railroads get swallowed up in the hot debate that is bound to ensue over the question of deregulation itself, we believe that regulatory revision should be modest in scope and directed to specific identifiable problems of the industry.

Now, not all the things I have discussed today indicate immediate action, but they do get the government grappling with the gut policy and program issues. And I think you will admit that historically the government has not always done this. Nor do these accept all the recommendations of the ASTRO Report, although they do address many of them. What they do indicate, I think, is that the government is rising to its responsibility and ultimately better transportation will result.



What we really need is a profitable, efficient, high-service level, private rail industry. What we don't need is a Federal system or a Federally-supported system. To get from where we are to where we need to be calls for industry skill and imagination -- management and labor alike -- and government realism in regulation, legislation, and in certain developmental and "transitional" areas -- some means of financial support. We are moving, and we will get there.

Thank you.