BRIAN BROWN

THESIS - RE-START AIRLINES

A.
INTRODUCTION

In the historical evolution of the Two Airline Policy, a number of related political, economic and legal events were occurring simultaneously. It, therefore, is difficult to relate them in a strict chronological format. A superficial review of the situation would indicate that the major cornerstones of this policy are enshrined in the enabling legislation, namely, (1) The Australia National Airlines Act 1945-1961; (2) The Airlines Agreement Act 1952; and (3) The Airlines Equipment Act of 1958. However, a more thorough review of the process toward rationalization suggests a much more complex interaction of the political, economic and judicial processes.

This chapter begins with the attitudes of the various states toward Federation and continues on through to the present day. Probably the last major event of significance in this story was the passage of Victoria Bill No. 888286, which reads:

> "An act to make Provision with respect to the Establishment and Functions of a Joint Standing Committee of the Legislative Council and Legislative Assembly with respect to Take-overs of Companies incorporated in Victoria, to amend the Parliamentary Committees Act 1968 and for other purposes."

The apparent intent of this Victoria State legislation was to avert a takeover of Ansett Airlines of Australia (a company registered in Victoria) by Thomas National Transport (TNT) registered in New South Wales. TNT was endeavoring a takeover of Ansett by "open market" purchase of shares on the stock exchange.

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This Act (No. 8286) successfully blocked the TNT takeover of Ansett by placing the whole subject of takeovers in the hands of a Committee. This action was taken in light of the fact that TNT acquired a controlling (not majority) share in Ansett. The result of the passage of this Legislation was to effectively prevent a TNT takeover of Ansett. For its efforts, TNT was allowed a seat on the Ansett Board.

B. ENABLING LEGISLATION AND LEGAL INTERPRETATIONS.

1. Early History: Toward Federation.

To fully understand the interplay between the States and the Federal Government with respect to legislation and legal challenges, a brief history of the evolution of the major institutions is considered appropriate.

The fledgling steps toward Federation were taken in 1849 when a subcommittee of the Privy Council for trade and Plantations recommended that uniform Inter-colonial tariffs be established. The tariff would be subject to amendment by a General Assembly which would be representative of the colonies. The proposed assembly would also be vested with the power to deal with matters affecting relations between the colonies regarding such matters as lighthouses, harbor dues, weights, and measures. It was envisioned that this body would additionally have the power of creating an

Australian Supreme Court. Further, the assembly would be vested with the appropriate revenue in relation to such powers as would be conferred upon it.

2. The Original Constitution Bill of 1850.

The original Constitution Bill of 1850, which was enacted to delineate the legal circumstances for the separation of Victoria from New South Wales, contained provisions along the lines suggested by the Trades and Plantation subcommittee of the Privy Council. Opposition emanating from both England and Australia was effective in having these early Federalist type provisions of the Act deleted prior to Royal assent. Even an effort to have a Governor General, with supervisorial powers over the various colonies' Lieutenant Governors, was dropped in 1861.

Inter-colonial rivalry continued to manifest itself in many ways. New South Wales followed a free trade approach while Victoria was strongly protectionist. Not even the enactment of Imperial Legislation (i.e., The Australian Colonies Duties Act, which prohibited differential tariffs could prompt New South Wales and Victoria to create an interstate free trade union.

The question of defense began to gain momentum. Australia with its vast area and fragmented economic and colonial policies realized the advantages of the economies of scale in terms of a uniform external

policy.

3. The Federal Council of Australia Act 1885.

<1885>

After a series of conventions the Federal Council of Australia Act 1885 was passed by the Imperial Government. All colonies, except New South Wales but including Fiji, requested its passage.

The Act created a Council consisting of representatives nominated by the colonies to meet every two years. Between meetings, a standing committee was to carry out executive functions on behalf of the Council. The powers of the committee were constrained to the following areas:

(a) Relations of Australia with the Islands of the Pacific.

(b) Prevention of the influx of criminals.

(c) Fisheries in Australian waters beyond territorial limits.

(d) Service and execution of process beyond a colony.

(e) Enforcement of intercolonial judgments.

(f) Extradition and criminal process beyond the confines of a colony.

(g) Custody of offenders on board colonial ships outside territorial colonies.

(h) Matters referred to it by the Queen on the request of the colonies.

(i) Matters referred to it at the request of two or more of the colonial legislatures.

4. Defects in System.

The major defects in the system were that membership was voluntary, New South Wales had elected not to become a

member. There was a lack of provision for an executive body, analogous to a cabinet or a court. This initial step toward a Federal union was more aligned to a confederation than to a Federation.

In 1888, under real or an imaginary German presence in the South West Pacific, the Imperial Defence Act was passed. This was an Act where all the Australian colonies, including New South Wales, agreed to a common defense system.

IMPERIAL DEFENCE ACT

5. Federation Convention: Intercolonial Compromises.

Impetus and momentum were now growing toward a more viable federal approach that would ultimately result in the formation of a federation. On March 2, 1891 representatives from all Australian colonies met at a convention in Sydney, NSW, to consider the question of Federalism and individual state rights. This convention approved resolutions embodying the following principles:

(i) That the powers and privileges and territorial rights of the existing colonies should remain intact except in respect of such surrender as may be agreed upon as necessary and incidental to the power and authority of the new federal Government.

(ii) No new State shall be formed by separation from another state, nor shall any State by formed by the junction of two or more States or parts of States without the consent of the legislatures of the States concerned as well as of

the federal Parliament.

(iii) That trade and intercourse between the federated colonies, whether by land carriage or coastal navigation, shall be absolutely free.

(iv) That the power and authority to impose customs duties and duties of excise upon goods the subject of custom duties and to offer bounties shall be exclusively lodged in the Federal Government and Parliament, subject to such disposal of the revenues thence derived as shall be agreed upon.

(v) That the naval and military defence of Australia shall be entrusted to federal forces under one command.

(vi) That provision be made in the federal Constitution which will enable each State to make such amendments in its Constitution as may be necessary for the purposes of the federation.

6. Principles (1), (3) and (4) and Sections 51 and 92.

Principles (1), (3) and (4) eventually became sections 3, 92 and 51. It will he later argued that it is (see Chapter X.X.X) these sections and the legal interpretations assigned to them that are the real cornerstones of the current Two Airline Policy cartel - a cartel that is able to constrain output and raise prices.

7. Convention and Structuring of Constitutional Format.

The convention also approved the framing of a

Constitution along a federal format:

(i) A Parliament which shall consist of a Senate and a House of Representatives, the former consisting of an equal number of members for each colony, to be elected by a system which shall provide for the periodical retirement of one-third of the members, so securing to the body itself a perpetual existence combined with definite responsibility to the electors, the latter to be elected by districts formed on a population basis and to possess the sole power of originating all Bills, appropriating revenue or imposing taxation.

(ii) A judiciary consisting of a federal Supreme Court which shall constitute a High Court of Appeal for Australia.

(iii) An executive consisting of a Governor-General and such persons as from time to time may be appointed as his advisors.

After various interstate disagreements were settled, a Bill proclaiming the birth of the Commonwealth of Australia received the Royal assent and the Commonwealth of Australia came into official existence on 1 January, 1901.

Australia was conceived as a Federation in which the residual of powers are vested in the various States. Additional powers can be granted to the Commonwealth Government through constitutional amendments or bequests by all the States. These two constitutional elements were to

play important roles in structuring the Two Airline Policy.

1930 & 1934

C. FIRST RUMBLINGS - GOYA CASE NO. 1.

The first rumblings can be traced back to the first Goya Case. In 1934, H.G. Goya estimated that, under favorable wind conditions, he could increase revenues generated from his barnstorming activities at Mascot Airport by taking a right-hand circuit of the airport rather than the mandatory left hand ones as required by the Civil Aviation Branch of the Department of Defence. Henry Goya had a previous skirmish with the Civil Aviation Branch of the Department of Defence.[1]

The New South Wales Police were summoned by the Airport Controller, V.W. Burgess, to arrest Goya. He was arrested because of his alleged violations of Federal Codes. Goya challenged this action on two counts: (1) It was illegal for State Police to arrest him on Commonwealth property and (2) the Commonwealth Government did not have the power to regulate intrastate flights.

1. The Goya Case - Section 51.

The 1936 "Goya Case" was fought before the Supreme Court under Part V - Powers of the Parliament. Concerned with the "Legislative Powers of the Parliament," Section 51

[1] In 1930 Goya took his wife from an event at Penrith Airport when his passenger was killed. It was ruled that Henry could no longer fly and his pilot's licence was cancelled. However, Henry argued his case successfully and was granted an "A" private licence. Henry promptly purchased Joy Fields flying at Mascot.

can be found in the Appendix. Among the crucial items are S 51 (iv), (xxiv), (xxv), (xxx), (xxxi), (xxxiii), (xxxvi) and (xxxviii).

2. The Air Navigation Act - 1919 Paris Convention.

In the Goya Case, the High Court of Australia rejected the view that S(xxix) was limited to the external aspects of subjects covered by other paragraphs of S 51. The specific issue upon which the Court focused its attention was the validity of air navigation regulations made under the (1) Air Navigation Act. This Act was passed pursuant to the Paris Convention of 1911 dealing with developing world-wide standards for uniform air safety.

3. Section 51 Concurrent and Exclusive Federal Powers.

The main grant of legislative power to the Federal Parliament is found in the paragraphs of Section 51. However, Section 51 does not clearly delineate between exclusive and concurrent powers exclusive to the Commonwealth. The unequivocal powers are S 51 (iv), (xxiv), (xxv), (xxx), (xxxi), (xxxiii), (xxxvi) and (xxxviii). Except for these exclusive powers conferred on the Federal Parliament, the powers are not exclusive of State powers: they are in effect concurrent with the continuing powers of the state over the same matters. Under S 109 of the Constitution, Commonwealth exercise of power prevails if there is any inconsistency between a valid exercise of power

by the Commonwealth and an exercise of power by the states.

4. Goya Case - Summary Findings

Regarding external affairs power, members of the high court adopted different interpretations.

5. Goya Case - Summary Findings; Latham, C.J.

In rejecting the proposition that S 51 (xxxv) should be restricted to a power to make laws only in regard to the external aspects of the other subjects in S 51, Latham C.J. noted:

> "The regulation of relations between Australia and other countries including other countries within the Empire is the substantial matter of external affairs. Such regulation includes negotiations which may lead to an agreement by the Commonwealth in relation to other countries, the actual making of such agreement in a treaty or convention or in some other form, and the carrying out of such an agreement."

In his opinion, it was basically "impossible to say a priori that any subject is necessarily such it could never be dealt with by international agreement."

6. Goya Case - Summary Findings; Dixon J.

Dixon, J. contended that:

"If a treaty were made which bound the Commonwealth in reference to some matter indisputably international in character, a law might be made to secure observance of its obligations if they were of a nature affecting the conduct of Australian citizens. On the other hand, it seems an extreme view that merely because the Executive Government undertakes with some other country that the conduct of persons in Australia should be regulated in a particular way, the legislature thereby obtains a power to enact that regulation although it relates to a matter of internal concerns which, apart from the obligation undertaken by the Executive, could not be considered as a matter of external affairs."

While Justice Starke found merit in the comment of U.S. Jurist Willoughby that the external power was limited to cases in which the subject matter was of sufficient international importance to make it a legitimate area for international cooperation and agreement.

7. Goya Case - Summary Findings; Evatt & McTiernan.

Justices Evatt and McTiernan took a broader view stating:

> In truth, the King's power to meter into international conventions cannot be limited in advance of the international situation which may arise from time to time. In our view the fact of an international agreement having been duly made about a subject brings that subject within the field of international relations so far as such a subject is dealt with by the agreement."

8. Agreement of Court on Commonwealth's External Powers.

The Powers Court was in full agreement regarding the fact that the Commonwealth could give effect to a treaty whose implementation demanded legislation affecting the domestic order of the Commonwealth. The treaty that the Court was specifically addressing itself to dealt with such matters as controls relating to aerial navigation, safety procedures and analogous mattes affecting Australian air space and at Australian airports.

Goya's appeal saw victory on November 10, 1936 under the ruling that the "Commonwealth had no general power to control civil aviation." But the Court did state that the Federal Government could make regulations to give effect to

the Paris Convention of 1919. Recapitulating, the Paris Convention dealt in detail with such matters as the markings of aircraft, airworthiness, and qualifications for pilot and navigator licenses. The main reason that the High Court set aside Henry's conviction was that the general nature of the federal regulations departed from the rules of the convention.

9. Federal Attempts at Amending Weaknesses in its Regulatory Powers over Air Transport.

The Commonwealth Government apparently anticipated defeat in the Goya Case and attempts to amend the constitution to give itself full control over both intrastate and interstate flying. Referendum pursuant to this change of power was held on March 6, 1937 and was defeated. Federal Government quickly circumvented this defeat in 1937 via the mechanism of a federal-state conference that agreed upon the concept of uniform federal-state laws to cover aviation. By 1938 each state had separately passed legislation that stated that the Commonwealth regulations were to apply to air navigation within a state as a matter of state law.

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It was further provided that individuals having the right to exercise powers pursuant to federal regulations would have analogous powers under the various State Acts. The Commonwealth instrumentality established for these purposes at this time was the Department of Civil Aviation.

To avoid further defeats in the courts, the Commonwealth Acts and Regulations were amended to conform in detail with the Paris Convention Regulations.

This arrangement was credited to the then Attorney General, R.G. Menzies. It was ironic that it would be Mr. Menzies who in 1949 would make the decision to maintain the Australian National Airlines Commission (T.A.A.) and under whose administration the two airline policy was to gain government sanction and legality. A number of enabling acts blocked entry and allowed for the so-called competitive government and private airline system.

10. The Second Goya Case. 1938

In 1938, Henry was again in trouble with the authorities. This time Henry Goya was charged with low flying over Mascot. The event took place on April 13, 1938, before the passage of the New South Wales Air Navigation Act, but after the Commonwealth Act. Henry's appeal to the High Court in 1939 failed. The new Commonwealth regulations were not consistent with the Paris Convention regulations. The consensus of opinion was that the Federal Government did have the exclusive right to enter into international agreements effecting the external affair of the nation, including treaties pertaining to safety regulations.[8]

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[8] Transport in Australia, Vol. 1, No. 4, 1971, Department of Transport, p. 217.

DOES NOT MAKE SENSE

ii. Review of the Initial Impact of Legal Confrontations.

The space devoted to legislation and legal challenges is considered to any economic interpretation of the development of the Australian Airline system and consequent regulatory policies. Two major points must be considered: (1) The Australian Constitution is relatively new, but was drafted prior to the advent of aviation technology and (2) the passenger and freight aviation industry represented an entirely new mode of transportation for Australia. In essence, aircraft technology and related legislation and legal interpretations were a natural development of the interplay between many sections of the global socioeconomic Australian environment.

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Aircraft, with their ability to span vast distance in a relatively short time, were integral in the pattern of Australian economic development. Further, the demise of the Interstate Commerce Commission which was provided for in Section 101 of the Constitution in 1920, due to poor enabling legislation, left a void necessary for the direction and guidance of this new technology. Into this void stepped the courts and politicians and the result is the current system. It has been postulated that an Interstate Commerce Commission with substantive legislation would have guided the industry along a different path. While no prognosis regarding the social impact of such a

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regulatory body will be postulated in this study especially vis a vis the airline industry, it is hypothesized that much of the political and legal complications could have been negated.

18. ~~Best~~ BETWEEN WW I & World War 11 Legislation and Court Confrontations.

The Australian effort during World War 11 in all theaters of the global conflict is covered more than adequately in many excellent scholarly works. From the point of this work, the major contribution of World War 11 was the great expansion in plant, equipment, and the training of personnel of all categories related to aviation. Not only was there a proliferation of trained flight crews but the development of a large reservoir of skilled logistical experts with capabilities in all facets of the surging aircraft technology.

19. The Australian National Airlines Act, No. 31 of 1945.

The Australian National Airlines Act, No. 31, of 1945 received the Royal assent on August 16, 1945. This Act has been labelled the ". . . cornerstone of the Two Airline Policy." The Act created a ". . . body corporate with perpetual succession and a common seal." The Commonwealth Government attempted to give as much autonomy to the Commission as possible in order that it might not operate as a direct instrument of the Federal Government. In Brogden's words - "The Commission, not the Minister, was the authority

in connection with the establishment, maintenance and operation by the Commission of airline services for transport for reward of passenger and goods by air." The Minister retained the power to "direct the Commission to establish, alter or continue to maintain any inter-state airline services or Territorial airline service specified by the Minister." The Minister must approve the purchase of land worth much more than L5,000, any lease for land that exceeded five years, the disposal of any property, right or privilege with an original or book value of more than L5,000 and the purchase of supplies from abroad which might cost more than L10,000.

20. Australian National Airline Act 1945.

The period following the Australian National Airlines Act of 1945 saw a competitive environment in which price cutting, product differentiation and other competitive attributes prevailed. Unfortunately, it was this atmosphere of vigorous competition that lead to the now non-competitive rationalized environment that characterizes the current Australia Airline Industry. The Commonwealth Government under a Labor Party administration established the Australian National Airlines Commission basically in frustration at the failure of the Airline Nationalization Referendum of 1944.

The original objectives of the Commission may be

summarized in the Act:

Preamble

THE COMMONWEALTH OF AUSTRALIA

AUSTRALIAN NATIONAL AIRLINES ACT 1945-1973

(a) Trade and commerce with other countries and among the States are fostered and encouraged to the greatest possible extent;

(b) the maintenance and development of the Defence Force of the Commonwealth in relation to the defence of Australia by air and the establishment of plant and equipment necessary for that Force are assured;

(c) the development of the Territories is promoted with the utmost expedition; and

(d) the carriage of mail by air within Australia is promoted to meet the needs of the people in Australia.

The Australian National Airlines Act 1945-61 comprises the Australian National Airlines Act 1945 as amended.

Particulars of the Principal Act and of the amending Acts are set out in the following table:

Act	Number and Year	Date of Assent	Date of Commencement
Australian National Airlines Act 1945	No. 31, 1945	16th August, 1945	7th April, 1946
Australian National Airlines Act 1947	No. 90, 1947	11th December, 1947	11th December, 1947
Australian National Airlines Act 1952	No. 102, 1952	18th November, 1952	16th December, 1952
Australian National Airlines Act 1956	No. 105, 1956	15th November, 1956	23rd October, 1956
Airlines Equipment Act 1958	No. 70, 1958	10th October, 1958	10th October, 1958
Australian National Airlines Act 1959	No. 3, 1959	21st April, 1959	See note below
Australian National Airlines Act 1961	No. 71, 1961	27th October, 1961	27th October, 1961

See also the Airlines Agreements Act 1952-1961.

Note: By virtue of section 2 of the Australian National Airlines Act 1957, the provisions of that Act (except sections 13, 20, 21 and 22) came into operation on the day on which that Act received the Royal Assent. Sections 13, 20, 21 and 22 were to come into operation on a date to be fixed by Proclamation. The date fixed was 1st October, 1959. See Commonwealth Gazette, 1959, p. 349.

HOW HAS THIS BEEN CHANGED SINCE I ORIGINALLY WROTE IT ?

21. Prime Minster Menzies and the Two Airline Policy.

Brogden, in his often quoted book which still stands as a major milestone in historical works regarding the Australian Airline Industry, believes that the two Airline System was conceived when Prime Minster Menzies made the following pronouncement regarding his Government's policy:

> ". . . We are still only at the early stages of air transport. As for the Government airlines, which were designed by the Chifley Government (Labor Party) to be monopolies (and failed to be so only because of a High Court decision), we shall put them on to a true competitive basis, with no preferences either in cheap capital or dollar expenditure. Though the future of their operative staffs is assured, because Australia needs them, the form of their future management and control will be considered in the light of results and circumstances."

A reading of the above statement by Prime Minster Menzies would not indicate that it was his intention to bring about the establishment of a Two Airline Policy per se. His statement taken literally seems to indicate that the Government involvement was to encourage competition rather than eliminate it. His further utterances as quoted below can be interpreted to reinforce this opinion.

> "The Government has decided to attempt to secure the retention of the major airlines in competitive service to the Australian community. It is no part of the policy of the Government to foster either a government monopoly or a private monopoly on the major air routes. Trans-Australia Airlines has been successfully and efficiently established, and having secured a substantial share of the public goodwill, we consider it desirable that its competition should continue, so long as that competition is fair. Quite frankly, the Government would regard it as unfortunate if either Trans-Australia Airlines or Australian National Airways Proprietary Limited . . . disappeared from the

airline business, since such an event would create either a straight-out government monopoly or a private monopoly, to each of which this Government and, we believe, the public are in principle opposed."

22. A.N.A. - Capital Flight at Formation of TAA.

Brogden alleges that the shipping interest "behind A.N.A. at once made it quite clear that the retention of TAA under any circumstances was unacceptable."

An economist would ask at what price was it "unacceptable." ANA was apparently unhappy about the prospects of a "competitive" service with greater access to the capital markets and a guaranteed market share. Brogden states the ANA dilemma when he noted that "ANA needed A$10,000,000 for equipment." The salient question under such conditions is at what "price" was the $A10,000,000 "needed." Need being a somewhat unacceptable economic phrase in that it cannot be equated to any market phenomena.

With the advent of TAA, Australia now had three comparatively large airlines. By 1947, all major city pairs had three carriers serving them with the exception of Adelaide-Perth run which had two.

23. Initial Problems of TAA.

The birth of the "Commission" was attended with many difficulties - the use of the name Australian National Airlines Commission appeared as a direct affront to A.N.A. An example of this was where telephone calls for ANA were actually received by the "Commission." Due to the

similarity in names in the telephone directory (IBID), the "Commission" changed its name to TAA (Trans Australian Airlines).

24. T.A.A. v. A.N.A. and the Issue of Subsidies.

Brogden argues that the Governmental subsidies were incapable to driving TAA out of the market and he underscores the relative un-importance at that time of the total system to the global Australian economy. His thoughts on the matter may be summarized as follows:

"This (Government Business) was not sufficient to (for TAA) reach economic security, nor did it achieve the government's frankly stated goal of driving ANA out of business. The government made no secret of the latter ambition and made no effort to hide the intention. Why should it? Though the referendum had gone against it, the government knew it had the mass of the votes behind it, as was proved in the subsequent election of 1946. Labor could say that while the High Court could refuse the people their wish on the grounds of legal argument, the people still wanted a nationalized airline system and the way to get it was by employing every possible weapon at hand. As comparatively few Australians ever travelled by aircraft, the argument was academic. Only 96,000 airlines seats were filled in 1939 and 440,000 in 1945. As many passengers made multiple flights, it was apparent that the number of citizens who used the airlines was very small. The whole battle over airlines was whipped up by the press and by the politicians, the man in the street having little if anything at stake either way. The airlines were merely playthings in the contest between capitalism and socialism which developed in the immediate post-war years, a side issue, but none the less important to the thousands of men and women whose fortunes and future it affected."

25. A Recapitulation - Failure of 1944 Constitutional Amendment Referendum.

The referendum referred to above was the Constitution Alteration Act (Post-War Reconstruction and Democratic

Rights) of 1944. This Act resulted from a Convention of Representatives of Commonwealth and State Parliaments to consider the reference of powers by the States and the Commonwealth of Australia held on November 24, 1942. At this convention, which met in Canberra, a resolution was adopted that "adequate powers to make laws in relation to post-war reconstruction should be referred by the States to the Commonwealth for a period ending at the expiration of five years after the War. Only New South Wales and Queensland signed to the original draft bill as set forth at this 1942 convention. South Australia, Western Australia and Victoria agreed to the draft bill with varying modifications. In Tasmania, despite repeated requests by the majority in the legislative assembly the legislative council refused to pass the draft bill in any form. Of major concern to this study was the section in the referendum that dealt specifically with post world war air transportation. This section of the defeated referendum was:

> "60A - (1) The parliament shall, subject to the constitution, have power to make laws for the peace, order and good government of the commonwealth with respect to:- ((ix) Air Transport)".

Brogden maintains that this section was inserted in order that "Labor just wanted to nationalize air transport."

The attitude of the soon-to-be Prim Minster, R.G. Menzies, at the time (1944) may be summed up by restating in

his own words - Airline nationalization - "(A) dull adherence to the academic socialist theory for is own sake." The issues regarding the future of the commercial Air/Transportation was handed back and forth by individuals of every political suasion during this period. The issue of nationalization became a moot point when the referendum was defeated in 1944.

26. Results of Constitutional Amendment Referendum 1944.

Table No. 1 delineates how the various states voted and on an aggregate basis.

TABLE NO. 1

Post-War Reconstruction and Democratic Right Referendum 1944

State	Yes	No	Informal	Total	Percentage of Forma Votes Yes	No
New South Wales	759,211	911,680	23,228	1,694,119	45.44	54.56
Victoria	597,848	614,487	15,236	1,227,571	49.31	50.69
Queensland	216,262	375,862	7,444	599,568	36.52	63.48
South Australia	196,294	191,317	4,832	392,443	50.64	49.36
Western Australia	140,399	128,303	3,637	272,339	52.25	47.75
Tasmania	53,386	83,769	2,256	137,411	38.92	61.08
Total	1,963,400	2,305,418	56,633	4,325,451	45.77	54.01

27. Proposed Constitutional Amendments and Sections 51 and 92.

A review of the proposed Bill indicates that the suggested changes were far too sweeping in terms of the federal state power controversy. The powers were too "multidimensional" in that so many areas of economic, social and religious behavior would have been impacted by passage of the proposed constitutional changes. This is especially the case in the economic context. While guaranteeing personal liberties on one hand (that were analogous to the USA Bill of Rights), on the other hand the recommended changes tended to make economic activity subject to rigid centralized governmental controls over a broad spectrum of activities while "60 A (ix)" (Air Transport). The airline socialization section may well have passed on its own merit, but political observers believe it was the coming of so many other socioeconomic issues at the one time that were directly responsible for the failure of this referendum. The complications of this referendum are highlights by a reading of the provisions as presented below. Additionally, it should be noted that (especially in light of future legal confrontations) passage of this referendum would have led,

especially in the area of transportation, to an avalanche of court cases involving particularly sections 51 and 92. These cases would have been given an added stimuli in that there was no enabling legislation being framed to make provision for "resurrecting" the Interstate Commerce Commission (S 1106). The following is an outline of the proposed constitutional amendments as presented to the Australian people in August of 1944.

PREAMBLE

Be it enacted by the King's Most Excellent Majesty, the Senate, and the House of Representatives of the Commonwealth of Australia, with the approval of the electors, as required by the Constitution, as follows:-

Short Title

1. This Act may be cited as Constitution Alteration (Post-war Reconstruction and Democratic Rights). 1944.

2. The Constitution is altering by inserting, after Chapter 1, the following Chapter and section:-

CHAPTER 1A - TEMPORARY PROVISIONS

Power to Make Laws, for a Limited Period, with respect to Certain Matters

"60A - (1) The Parliament shall, subject to this Constitution, have power to make laws for the peace, order and good government of the Commonwealth with respect to -

(i) the reinstatement and advancement of those who have been members of the fighting services of the Commonwealth during any war, and the advancement of the dependant of those members who have died or been disabled as a consequence of any war;

(ii) employment and unemployment;

(iii) organized marketing of commodities;

(iv) companies, but so that any such law shall be uniform throughout the Commonwealth;

(v) trusts, combines and monopolies;

(vi) profiteering and prices (but not including prices or rates charged by State or semi-governmental or local governing bodies or services);

(vii) the production and distribution of goods, but so that -

(a) no law made under this paragraph with respect to primary production shall have effect in a State until approved by the Governor in Council of that State; and

(b) no law made under this paragraph shall discriminate between States or part of States;

(viii) the control of overseas exchange and overseas investment; and the regulations of the raising of money in accordance with such plans as are approved by a majority of members of the Australian Loan

Council;

(ix) air transport;

(x) uniformity of railway gauges;

(xi) national works, but so that, before any such work is undertaken in a State, the consent of the Governor in Council of that State shall be obtained and so that any such work so undertaken shall be carried out in co-operation with the State;

(xii) national health in co-operation with the States or any of them;

(xiii) family allowances; and

(xiv) the people of the aboriginal race.

"(2) Neither the Commonwealth nor a State may make any law for abridging the freedom of speech or of expression.

"(3) Section one hundred and sixteen of this Constitution shall apply to and in relation to every State in like manner as it applies to and in relation to the Commonwealth.

"(4) A regulation of a legislative character under the authority of any law made by the Parliament in the exercise of any power conferred by sub-section (1) of this section -

(a) shall, subject to this section, take effect on the expiration of the fourteenth day after its contents have been notified in the manner provided by the Parliament to each senator and each member of the House of Representatives or on such later date as

is specified in the regulation;

(b) shall not take effect if, within fourteen days after its contents have been so notified, either House of the Parliament passes a resolution disapproving of the regulation; and

(c) shall take effect on the date of its making or on such later date as is specified in the regulation, if the Governor-General in Council declares on specified grounds that the making of the regulation is urgently required.

"(5) This section shall continue in force until the expiration of a period of five years from the date upon which Australia ceases to be engaged in hostilities in the present war, and shall then cease to have effect, and no law made by the Parliament with respect to any matter specified in sub-section (1) of this section shall continue to have any force or effect by virtue of this section after this section has ceased to have effect.".

28. Proposed Constitutional Amendment and Sections 51 and 92.

Given the hair splitting, gymnastics later undertaken by the courts in allowing for the continuing "Rationalization" of the Australian Airline System passage of this amendment. It would have to contain sections in direct contravention with Sections 51 and 92. These proposed new powers dealt specifically with trade, commerce and concurrent

and individual state and federal powers on a broad basis and specifically with air transport and uniformity of rail gauge.

29. 1945 ANA Challenge to Legality of TAA.

ANA challenged through the courts in 1945 and 1946 the validity of the establishment of TAA (The Commission). The main thrust of these court cases appeared to have been initiated by the failure of the "Post War Reconstruction and Democratic Rights (1944)" to pass, especially re "S60A (1) (ix) Air Transport" and the absence of an interstate commerce commission as provided for under Section 104 of the Constitution. This particular challenge is referred to throughout the Legal Establishment as the Airlines Case.

30. 1945 ANA Challenge and Section 92.

In the Australian National Airways Pty. Ltd. v. Commonwealth, the High Court was faced with two arguments relevant to S92 and the concept of Interstate trade and commerce. One was whether inter-state transportation was covered by the umbrella protection guaranteeing freedom of interstate trade and commerce. The other argument was whether Parliament was competent to create a corporation with power to conduct inter-state airline services. The Commonwealth argued that the establishment of an interstate airline did not violate the trade and commerce provision because transportation per se fell outside of S51 which specified only trade and commerce.

31. 1945 ANA Challenge: Outcome and Sections 51 and 92.

The final outcome turned upon sections 51 and 92. The Government could create an instrumentality to engage in airline activities; however, the government could not eliminate competition by creating a monopoly that would exclude freedom among the various states. As Dixon J. would have it regarding the validity of the Australian National Airline Act, No. 31 of 1945, it is only by imparting a limitation into the descriptive words of the power that such a law can be excluded." However, in regard to the establishment of a complete monopoly S51 which states "that Parliament shall subject to this Constitution, have power to make laws for peace, and good government."

32. Summary Statement of ANA Challenge.

In their landmark study entitled "The Constitution of the Commonwealth of Australia (annotated), R.D. Lumb and K.W. Ryan summarize the attitude of the Australian High Court as follows:

COMMONWEALTH TRADING CORPORATIONS.

The Commonwealth Parliament has passed several acts in pursuance of its power to create corporations with authority to conduct interstate or overseas trading operations. In Australian National Airway v. Commonwealth, the High Court upheld the validity of s 19 of the Australian National Airlines Act 1945 which gives to the Australian National

> Airlines Commission a body corporate establishment by that Act, power to establish, maintain and operate airlines services for the transport for regard of passengers and goods between States, between Territories and other places in Australia and within any Territory. Similarly, the Australian Coastal Shipping Commission Act 1956-1969 constitutes a body corporate with power to establish and maintain shipping services not only in Australian coastal waters, but also international services, between any place in the Commonwealth or a Territory and a place in another country.

Also, ANA Pty. v. Commonwealth (1945) 71 CLR 29 additionally points out that under S92 the Commonwealth Government is forbidden from forming an interstate monopoly. To recapitulate, S92 states trade within the Commonwealth on the imposition of uniform duties of customs, trade, commerce and intercourse among the states, whether by means of internal carriage or ocean navigation, shall be absolutely free. On this point in regard to nationalization of the airlines, Lumb and Ryan address themselves:

> "NATIONALIZATION. It was on the subject of the power of the Commonwealth to create a monopoly in favor of its agencies in certain fields of trade and commerce that the major constitutional cases involving s 92 in the post-war period turned, and it was in these cases that the main lines of the current interpretation of s 92

were settled."

In the Airlines Case, the High Court had to consider whether provisions in a Commonwealth Act that a Commonwealth instrumentality would have a monopoly in inter-state airline services on routes adequately served by the government service infringed s 92. The Court held unanimously that they did. Latham C.J. described the provisions as amounting to a prohibition of interstate air services, and not merely a system of regulation of such services. Starke J. said that an Act which was entirely restrictive of any freedom of action on the part of traders and which operated to prevent them from engaging their commodities in any trade was necessarily obnoxious to s 92. Dixon J. commented that if the test of freedom at the frontier was applied, it was plain that it was because the business involved crossing the frontier that it was eliminated."

Thus, on August 16, 1945, the Australian National Airlines Act No. 31 of 1945 received the Royal Assent. Australia was " . . . off and running" to form a more "perfect union" of its internal major city pair airline system.

33. The IPEC Case - A Direct Challenge to the Two Airline Policy.

The first major challenge to the two Airline Policy came from the Interstate Parcel Express Company of IPEC. IPEC, an Adelaide, South Australia based inter-state all freight road

service in March 1964 applied for permission to (1) import aircraft and (2) operate an all-freight interstate service utilizing aircraft.

In December 1964, Comet Pty. Ltd., another road hauler, also submitted an application for import and operating rights for aircraft to be used for freight purposes. Both applications were rejected by the Department of Civil Aviation without reason. Brogden's explanation is somewhat unequivocal "the key factor in the whole affair was that the government feared that the IPEC application was the first stage in a passenger operation." Brogden goes on to point out " . . . that IPEc did everything possible to assure government, industry and public that it wanted only freight business - covering Sydney, Melbourne, Adelaide, Perth and Launceston - and was prepared to enter into an agreement to this end."

34. IPEC's Position on Constitutional Basis for Challenge.

IPEC was of the opinion that the refusal of the Federal Government to allow it to import aircraft for the purposes of interstate commerce was in blatant contravention of s 92 of the Constitution and that, additionally, the refusal was thus discriminatory under the Commonwealth's External Powers to grant import licenses.

35. Economic Critique of Poulton and Richardson on "Australia's Two Airline Policy - Law and the Layman."

N.W. Poulton writing in the Federal Law Review explains

this latter point by stating "Because of Section 92 the Commonwealth cannot maintain discretionary licensing system for interstate air services under which it can confer on one operator yet for policy reasons deny a license to another." Yet in the same article they, in what would appear to be a legalistic paradox, renounce Mr. Brogden's hypothesis -- that the two airline system is perpetuated in contravention to section 92 by stating "it is not."

An in depth scrutiny of this Richardson and Poulton statement seems to indicate it is solely based on the decision by the High Court that the Director General of Aviation had acted with the scope of his powers in refusing to grant an import license to IPEC. However, a reading of the "IPEC Case" and subsequent legal rationale from an economist indicates considerable semantic "confusion" in the legal camp regarding the precedents and constitutional underpinning for this decision.

Browne in his work on the "International Monetary Environment and Its Relevance to the Airline Industry" and the "dissolution of the New South Wales Government Railroads and Impact on Unionization" very aptly points out that legislating market forces (exchange rates or wages) causes resource mis-allocation. The phrase "free and competitive" is often interpreted differently by Economist and Attorneys.

A legal decision in a specific case, such as IPEC, does

not in effect change the real economic context of a word. Market economists from most philosophical suasion would interpret "free" to mean without restriction from any regulatory process. Additionally, "without discretion" would have to mean that all economic units were given equal opportunity in the market place. A reading of these cases indicates that verbiage and semantics generated in the learned legal institutions quite often has a completely different interpretation to analogous phrases assigned the same use by practitioners of the "Dismal Science." To an economist, Poulton and Richardson's argument regarding Brogden's belief that the Two Airline System is in contravention of S92 is irrelevant and borders on the irrational.

Summary of IPEC Case and Findings by High Court.

The case and findings may be briefly summarized --

(HIGH COURT OF AUSTRALIA).

THE QUEEN

against

ANDERSON;

Ex Parte IPEC-AIR PTY. LIMITED.

Aerial Navigation (Cth) - Air Service Operations - Inter State charter services - H.C. of A.

License therefor - refused on ground unrelated to safety of operation - permission to import aircraft for proposed service

refused - Mandamus - Air Navigation Regulations (Cth) reg. 197 (1), 199 (2)

Customs (Cth) - prohibited imports - prohibition on importation of aircraft - March 25, 26 and 29.

Relaxation of prohibition with permission of Director General Civil Aviation. Discretion of Director-General to relax prohibition - whether mandamus lies - May 28.

Exercise of discretion - matters relevant thereto - governmental policy - customs.

(Prohibited Imports) Regulations (Cth) reg. 4(2) 3rd, Schedule, item 1.

Prerogative Writs - Mandamus - Public Official - order to perform duty - circumstances in which mandamus will issue.

Constitutional Law (Cth) - freedom of inter-state trade - aircraft required for operation of interstate air service - refusal of permission to import aircraft - whether freedom impaired - The Constitution (63 & 64 Vict. c 12) s 92.

Regulation 197 of the Air Navigation Regulations (cth) provides:

"(1) An aircraft shall not be used by any person after the first day of September, 19940, in charter operations except under the authority of and in accordance with a license (in these Regulations referred to as a 'charter license' issued by the Director-General."

Regulation 199 of the Regulations provides: " . . . (2) Where

the proposed service is an interstate service, the Director-General shall issue an aerial work, charter or airlines license, as the case requires, unless the applicant has not complied with, or has not established, that he is capable of complying during the currency of the license with, the provisions of these Regulations, or of any direction or ode given or made under these.

Regulations, relating toe the safety of the operations."

regulation 4 of the Customs (Prohibited Imports) regulations (cth) provides: ". . . (2) The importation into Australia of the goods specified in the second column of the Third Schedule to these regulations is prohibited unless the conditions, restrictions or requirements specified in the third column of that Schedule opposite to the description of the goods are complied with."

The Third Schedule provides in relation to Item No. 1 in the second column "Aircraft, airframes and aircraft engines" and int he third column "The importer shall produce to the Collector the permission in writing of the Director-General of Civil Aviation to import the goods.

The prosecutor applied to the Director-General of Civil Aviation for a charter license to carry freight between cities in each of the States of the Commonwealth by means of its own aircraft, which it was in a position to obtain if the Director-General would grant permission under the Customs (Prohibited Imports) Regulations for their importation. The prosecutor

established to the Director-General's satisfaction that subject to obtaining the aircraft it was capable of complying during the currency of the license with the provisions of the Air Navigation Regulations relating to the safety of the operations and also with any direction or order given under the Regulations and relating to the safety of the operations. The Director-General, acting in accordance with governmental policy against allowing persons other than those already engaged in it to operate inter-State airfreight services, refused permission to import the aircraft and refused the charter license upon the ground that the prosecutor would not be in a position to provide the aircraft necessary to operate the service to which the application related.

Held, by Kitto, Menzies and Windeyer J.J. that the Director-General's refusal was contrary to his duty under reg. 199(2) of the Air Navigation Regulations and accordingly mandamus should go to compel him to issue to the prosecutor the charter license sought; by Taylor and Owen J.J. that an order requiring the Director-General to issue a charter license would in view of the prosecutor's inability to obtain aircraft for its proposed service by for all practical purposes futile and accordingly mandamus should be refused.

For the purpose of the Customs (Prohibited Imports) Regulations the prosecutor requested the Director-General's permission in writing to import certain freight aircraft with which it might operate, under a charter license under the Air

Navigation Regulations, to carry freight between cities in the xix States of the Commonwealth. The prosecutor was informed by the Director-General that he thought it necessary to seek the views of the Government on its civil aviation policies before deciding the application and that the Government did not favor the importation of aircraft as it considered that the provision of further facilities for the operation of trunk route freight services by air at that time could not be justified on economic grounds., The Director-General having obtained the Government's views to this effect, refused the application, having had regard inter alia to the Government's policy views.

Held, by Taylor, Owen and Windeyer, J.J, Kitto and Menzies J.J. dissenting,t hat mandamus should not go to compel the Director-General to consider the application for permission to import and to determine it according to law; by Taylor and Owen J.J. upon the ground that whether or not permission was to be given was a matter left to the Director-General's discretion which was to be exercised upon broad considerations relating to civil aviation in the Commonwealth, but this circumstance did not support any implication that there was reposed in him any public duty, or any legal right created, which was capable of enforcement by mandamus; by Windeyer J. upon the ground that in determining whether or not to grant permission the Director-General must have regard to the policy of the Government and must exercise his function accordingly.

Per Kitto and Menzies JJ: The Customs (Prohibited Imports) Regulations committed the power of decision to the Director-General whereas here the decision to refuse permission was not that of the Director-General but of the Government.

Held further by the whole Court that the Director-General's refusal to grant permission to import the aircraft was not obnoxious to s 92 of the Constitution.

The principles on which a discretion given by statute to the holder of an office should be exercised, and the circumstances in which the Court will grant mandamus in relation thereto, considered.

The nature of the discretion given by the statute to a Minister of the Crown on the one hand and a permanent departmental head on the other considered.

Circumstances in which a State will be given leave to intervene in proceedings to which the State is not a party considered.

An Economic Interpretation o IPEC Decision and Related Enabling Legislation.

From an Economist's point of view it is interesting to review a number of interpretations upon which the decision was reached. This is especially true in the context of the usage as noted above of economic terms by members of the Judiciary in interpreting the Constitution impress economic inefficiencies via the edifice and regulations and enforced collusion upon the Australian public. A reading of the decisions and rationale for foreclosing entry to

IPEC and concurrently other potential carriers were all basically assessed on the powers vested in the Director under the Airlines Agreement Acts and the Airlines Equipment Act to ensure, as in the words of Prime Minster Menzies, "it (is) desirable that competition continue, so long as competition is fair." The Prime Minster did not elaborate on what constituted "fair" in terms of competition. However, subsequent actions by his administration indicated that "fair" in the context of his interpretation of competition meant in the long run the institutionalization of a collusive well regulated illusion of competition between TAA and ATI.

In actual fact the Airlines are compelled to collude, witness specifically the section from the enabling legislation dealing with the "rationalization of services" which forbids, in the economic context, competition and extols the virtues of "Rationalization" which in this case would appear to be a euphemism for regulatory collusion under Government sanction. Witness Section 7 - (1) through (5) of the Airlines Agreement Act (1952-61).

RATIONALIZATION OF SERVICES.

7 - (1) The Commission and the Company will take immediate steps to review and will keep under review at all times during the continuance of this agreement, air routes, timetables, fare and freights and other related matters in respect of routes on which both the Commission and the Company are operating services at the

date of the commencement of this agreement, so as to avoid unnecessary overlapping of services and wasteful competition, to provide the most effective and economical services with due regard to the interests of the public and to bring earnings into a proper relation to overall costs.

(2) If the Commission and the Company are unable to agree on any matter arising under subclause (2) of this clause, a representative of the Commission and a representative of the Company will confer together upon that matter under the Chairman and, if the Commission and the company are unable to agree, the Chairman shall himself decide the matter in dispute between the Commission and the Company.

(3) The Commission and the Company will, upon being required so to do by the Chairman, furnish or produce to him all information, documents, books, papers and accounts which he considers necessary to enable him to make a decision on any matter arising under this clause.

(4) The Commission and the Company will each abide by and accept any decision which is made by the Chairman on any matter arising under this clause on which they are unable to agree, and will give effect to the decision and not take any steps which are inconsistent with the decision.

(5) Nothing in this clause requires or permits the Commission or the Company to act in any manner inconsistent with the Air Navigation Act 1920-1950 or with the regulations in force

under that Act.

Section 7 - (1) quoted above which deals specifically with regulations relating to avoid "wasteful and overlapping services" in order "to provide the most effective and economical services with due regard to the public interest and to bring earnings into a proper relation to overall costs." From an economic viewpoint on especially the IPEC context, this section is paradoxical and a contradictory play on words. Collusion and regulation with respect to "routes, fare, freight and other related matters" negates competition and retards movement toward an optimal resource allocation - referred to in this section as "wasteful competition." Competition is not the economic criterion for resource mis-allocation or waste. On the contrary, competition is regarded as an optimal method of allocating resources to their highest marginal value in use especially where transactions (entry and exit) costs and information costs are low. It will be argued that the social costs of airline entry and exit even in a fully competitive market characterized by zero competitive restraints is low or zero. Most of the effects are merely accounting transfers with most of the economic losses internalized by the individual entrepreneur.

Additionally, the Airlines Agreement enables the Director-General to closely control types and capacity of fleets. A major element for "disciplining" the total system and a major underpinning of the rationalization policy is the Director's

control over fleet size (and hence type of aircraft and thus elimination of product differentiation). This is spelt out specifically according to a rigid mathematical formula as delineated in the enabling legislation - Airlines Equipment (No. 70 of 1958 PB). The Formula (or equation) for the determination of the Revenue Load FACTOR is

$$A = \frac{100\ (B + CD)}{E}$$

Where A is the revenue load factor;

B is the number of passenger ton-miles performed by the aircraft in the period, based on a passenger weight (including free baggage) of two hundred pounds;

C is the non-passenger revenue traffic ton miles performed by the aircraft in the period;

D is the ratio of the revenue yield per ton-mile of non-passenger traffic to the revenue yield per to-mile of passenger traffic; and

E is the total revenue traffic ton-miles for which the aircraft could have been used on the flights performed in the period;

"ton" means two thousand pounds weight; and

"traffic" means traffic in respect of passengers, cargo and mails.

Revenue Load Factor is defined as the relation to an aircraft, means in respect of a period, the percentage that the revenue value of the work performed on the flights, ascertain in

accordance with the equation.

The two basic concepts related to the court's decision to deny entry by IPEC into the Interstate Airline Freight Market would appear to hinge upon the right of the Government under the customs (prohibited imports) regulations authority to refuse the granting of an Import License and, secondly, that the refusal to allow IPEC to import aircraft was not "obnoxious" to Section 92. However,LUMB states that the Government cannot be discretionary in its use of import licensing power. Further, while the decision to restrain IPEC from entering the Market may not have been "obnoxious" to Section 92 of the Constitution, it certainly had the impact of stopping IPEC from operating.

It would appear from a thorough reading of the IPEC case that non-economic criteria were invoked to upset their application to carry air freight. This is another paradox in that the basic issue boiled down to the right of the Minster to refuse an Import License for IPEC to bring in aircraft that met all required safety regulations. Further, it is held that the Commonwealth cannot be discretionary vis a vis its exclusive power over the issuances of import licenses. (R. v. Anderson (1965) 113CLR) per se. However, three of the five judges ruled that the Director-General of Civil Aviation had to follow Government policy. The Government policy was to keep intact the Two Airline System. However, it is unclear under what specific unequivocal provision of the Constitution the Government was able to do t his. The Court basically stated that

the Government could direct one of its agents under the customs (prohibited imports) regulations.

Had IPEC et al been Successful.

An effective interstate air freight business. Additionally, it paved the way for the crystallization of the Two Airline Policy. The economic impact of entry by IPEC and possible failure would not have been subsumed by society. Because of the nature of the Airline Industry any potential failure would have been internalized by IPEC with only transfer payments resulting the success of IPEC, financially and/or in the court, would possibly have restructured the total domestic airline industry. It is hypothesized that the following effects would have taken place.

The Two Airline System would have suffered a Natural Demise.

Exit and Entry would have taken place as in the era between the two World Wars. These conditions did not appear to create any great social costs. Losses and profits being subsumed by the individual operator social costs vis a vis airlines are low due to the nature of the industry.

Real competition would have emerged from downward pressure upon the price structure and less resource allocation.

There would have been a proliferation of city pair airline connections. For example - a Brisbane-Perth (direct) route would (possibly not on a daily basis) have developed.

The reasons for drawing the above conclusions are that the pre-World War II area saw an "orderly" development of an

extensive, privately financed, competitive system. A classic example of this is that in 1933 Kingsford Smith's Australian National Airlines was flying passengers on the major city pair routes at approximately 5.04c fare per mile. This in spite of the fact that seat mile costs have declined greater than inflation due to technology.

CHAPTER 111

INTRODUCTION (MAJOR MILESTONES IN THE ENSHRINEMENT OF THE TWO AIRLINE POLICY).

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Agreement of Court on Commonwealth's External Powers.

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Economic Critique of Poulton and Richardson on "Australia's Two Airline Policy - Law and the Layman".

Summary of IPEC Case and Findings by High Court.

An Economic Interpretation of IPEC Decision and Related Enabling Legislation.

Had IPEC et al been Successful.

5.0 INTRODUCTION

The United States System of rate making was enshrined in the Civil Aeronautics Act of 1938.[1] The act was reenacted in 1958 but remains substantively the same as the 1938 Act. This is particularly true of the economic parameters established in the original act.[2] This chapter deals with the evolution of the American system, its operations, and economic analysis of its effectiveness.

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[1] The Domestic Routes System: Analysis and Policy Recommendations of Staff Study by the Bureau of Operating Rights, October 1974, p. 28. U.S. Civil Aeronautics Board.

[2] Ibid.

5.1 HISTORICAL EVOLUTION OF UNITED STATES REGULATORY SYSTEM

The existing U.S. regulatory system came about as a result of the desire of Congress to develop an airmail system. World War I exposed the possibilities afforded by the airplane. In America, the Post Office was particularly interested in air transport as a method for conveying the mail more expeditiously. Experimental services were initiated by the United States Army, and the results suggested the feasibility of a more permanent system.[3]

5.1.1 THE KELLY ACT - 1927

In 1927, Congress passed the Kelly Air Mail Act (for U.S. Stat 805 (1925) which transferred primary responsibility for the carriage of air mail from the Army to private firms organized specifically for this purpose.[4] Since carriers could not survive financially on passenger and freight revenues alone, mail contracts became "the life-blood of air commerce in the United States."[5] The Kelly Act provided for competitive bidding by the air carriers for short-term mail contracts. The amount to be paid the airlines was limited to 80 percent of the postage valuation.

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[3] See, e.g., Meyer, The Civil Aeronautics Act: Grandfathered (1938), Keyes, Federal Control of Entry Into Air Transportation (1951), and Hall, Smith, Air Ways, The History of Commercial Aviation in the United States (1942).

[4] See, e.g., Levine, Air Transport Regulation, Is Regulation Necessary? California Air Transportation and National Regulatory Policy, The Yale Law Journal, Vol. 74:1416, 1965, p. 1437).

[5] Ibid.

This concept failed because the available aircraft could not operate profitably on the existing rate structure.[6] In light of this, the Act was amended to permit four-year contracts at a level of reimbursements considerably in excess of the original Act, and payments were no longer tied to mail revenue.

5.1.2 INCENTIVES AND CONTROLS

During the period 1925 to 1934, the United States Government continued to encourage airline development by "liberal"[7] payments. On the other hand, the government began to exercise an ever increasing control over routes and business practices. This was possible because operating a route without an airmail contract was virtually impossible. Therefore, the Post Office by withholding or awarding contracts could determine the pattern of service and route structures. This system was regarded as "informal and haphazard"[8] and caused the Post Office to initiate actions that led to smaller operators merging into two new systems, TWA and American. The former competitive bidding system was replaced by a "government approved system or rigged bidding." Senator Hugo Black, in an investigation in 1934, showed that three cartels held contracts for 90 percent of all airmail payments.

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[6] Ibid.

[7] Ibid.

[8] Ibid, p. 1417.

The ensuing furor caused the cancellation of all private contracts, and the Army made a disastrous effort to carry the mails.

5.1.3 AIR MAIL ACT - 1934

The Air Mail Act of 1934 sought to remedy the earlier defects by ensuring competition and specifically making collusive arrangements illegal.[9] The Act placed rates and contracts under the jurisdiction of the Interstate Commerce Commission (ICC) and route awards remained within the jurisdiction of the Post Office. The Act in main called for the development of four transcontinental routes. A "mail pay" subsidy formula was devised which was related to the type and capacity of aircraft available instead of the amount of mail actually carried. The only airline organizations able to handle the important routes, as delineated in the Act, were the discredited airlines.[10] In this context, a face-saving formula was developed which permitted them to bid for contract.[11] This action initiated the "big four" pattern of trunk carrier service in the United States.[12]

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[9] [illegible]

[10] [illegible]

[11] Ibid.

[12] [illegible]

5.1.4 CONCERN - PRIVATE (MONOPOLY) AND INDUSTRY (COMPETITION)

These historical events greatly influenced the regulatory pattern that emerged as the Civil Aeronautics Act of 1938. On one hand, public attention focused on past abuses and potential monopoly practices within the industry while, on the other hand, the dominant carriers were becoming more concerned about excessive competition. Prior legislation had not excluded new entrants into the industry. Carriers with an airmail contract were forbidden from competing in a market where another airmail carrier was operating. This exclusive contract situation did not act as a barrier to entry by non-contracted firms. Because of the unit modal construction of aircraft and the relatively low capital investment requirements (at that time) to initiate competitive services, no-contracted firms continued to enter (and exit) the most profitable routes. Such competition cut severely into the non mail revenues of the contract carriers at the same time as the impact of the depression of the 1930's was also having a negative effect. In face of this so-called "competitive threat" the United States contracted carriers formed a trade association (the Air Transport Association) and pressed for protective legislation. They presented the usual arguments for the need for regulation, alleging safety and excessive competition as prime

determinants.[13]

5.1.5 THE CIVIL AERONAUTICS ACT(S) - 1938 - 1958

The result of this community and industry concern was the Civil Aeronautics Act of 1938.[14] This Act has been singularly effective in limiting entry in that not one carrier has received certification to perform domestic trunk service other than those operating on May 14, 1938 and therefore qualified for a certificate under the grandfather clause.[15]

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[13] In 1937, the president of the Air Transport Association argued the need for regulation as follows:

> Of the 120,000,000 of private investment which has been made in American Air Transport, more than half is gone. This condition of financial starvation not only makes it impossible for these lines to take full advantage of possible technological improvements, but could lead to traffic competition of such intensity that the accident ratio might accelerate instead of decline. Failure to correct the existing situation to do so promptly, means more than loss to the capital remaining invested in the Air Transport industry, to the labor employed in it, and to this country's position in civil aviation. It may very well entail a large cost in human life.

Kelly, The Sky's The Limit 101 (1963).

The president of the Association testified before a House Committee considering regulation:

> But the essential point is that it is possible to start a service on but a minor amount of capital, and this possibility has become an actuality from time to time in the past. With the increase in traffic, the temptation thus to begin new services is becoming stronger.
>
> It is needless to point out that this condition means much that is good, but also carries with it the threat of much that is bad. It promises haphazard growth, if we are not careful. It threatens unbridled and disastrous competition if we do not take heed. It leaves the small lines in a very precarious position. It requires some orderly procedure, preferably, I personally believe, the procedure of certificates of convenience and necessity already embodied in our Federal legislation as to railroads and interstate motor carriers, which will provide for minimum standards of service to be complied with before business is begun, and will give some protection to existing lines so that momentary, unsound over competition will not threaten.

Hearings on H.R.5884, 74th Cong., 1st Sess. 66 (1937).

[14] United States 52 Stat. 977 (1938).

[15] Section 401(e)(1), U.S. Stat. 988.

The Acts of 1938 and 1958 gave jurisdiction to the Civil Aeronautics Board (Civil Aeronautics Authority) over economic regulatory aspects of the industry. As delineated in the 1958 Act (Subchapter IV) the Board is empowered to supervise control over entry into the industry,[16] cities to be served,[17] rates,[18] direct subsidies[19] and terms of mail carriage.[20] The Act also empowers the Board to approve or prevent mergers, acquisitions, and transfers of control of air carriers.[21] Actions approved by the C.A.B. in this context are immune from operation of antitrust laws.[22]

The objectives of the United States Congress in regulating air commerce were:

> In the exercise and performance of its powers and duties under this chapter, the Board shall consider the following, among other things, as being in the public interest, and in accordance with the <u>public convenience</u> and <u>necessity</u>.

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16 72 Stat. 754, 49 U.S.C. 1371(a)(3) (1958).

17 49 U.S.C. 1371(e) (1958).

18 49 U.S.C. 1373, 1374 (1958).

19 49 U.S.C. 1376(b)(3) (1958).

20 49 U.S.C. 1375, 1376 (1958).

21 49 U.S.C. 1378, 1379 (1958).

22 49 U.S.C. 1384 (1958).

(a) The encouragement and development of an air transportation system properly adapted to the present and future needs of the foreign and domestic commerce of the United States, of the Postal Service, and of the national defense;

(b) The regulation of air transportation in such a manner as to recognize and preserve the inherent advantages of, assure the highest degree of safety in, and foster sound economic conditions in, such transportation, and to improve the relations between and coordinate transportation by, air carriers;

(c) The promotion of adequate, economical and efficient service by air carriers at reasonable charges, without unjust discriminations, undue preferences or advantages, or unfair or destructive competitive practices;

(d) Competition to the extent necessary to assure the sound development of an air-transportation system properly adapted to the needs of the foreign and domestic commerce of the United States, of the Postal Service, and the national defense;

(e) the promotion of safety in air commerce;

(f) The promotion, encouragement and development of civil aeronautics.[23]

The Civil Aeronautics Act of 1938 (McCarran-Leas Bill), which represented the major milestone in economic regulation of U.S. air transport, was signed by President Roosevelt. The Act of 1938 created a single, independent agency thereafter named the Civil Aeronautics Board by the 1958 Federal Aviation Act).[24] The enabling legislation was created to permit the Authority (Board) to regulate civil aviation, particularly the economic elements. The Authority was composed of five members, plus an Administrator, who exercised executive functions, and a 3 man Air Safety Board (later constituted as a separate entity; the Federal Aviation Agency (FAA) under the 1958 Act). The Act of 1938 which became effective on August 22, 1938 (1) bordered the scope of safety regulations, (2) subjected the carries to the same type of economic regulations normally imposed upon public utilities, and (3) authorized subsidy assistance to air carriers in the form of pay for mail carrying services.[25]

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[23] 49 U.S.C. 1302 (1988).

[24] 1938 Edition, Hand Book of Air Line Statistics, Civil Aeronautics Board, Town 1, "Air Commerce and Land Marks in U.S. Air Transport 1908-1938, p. 489.

[25] Ibid., pp. 488-489. By January 1, 1953 most of the "Big Four" were receiving subsidies.

5.1.5.1 THE GRANDFATHER CLAUSE

The basic stimulus to growth and development of the major U.S. carrier groups is rooted in the so-called "grandfather clause." The "grandfather clause" per se evolved in the first instance from the decision by the newly formed Civil Aviation Authority (CAA) not requiring the original nonscheduled carriers to have certificates of public convenience and necessity. On October 18, 1938, the C AA allowed " . . . the first bona fide nonscheduled operations under the Act when it exempted nonscheduled operations from the economic provisions of the Act."[26] On this date (October 18, 1938) twenty-six applications were filed by the various nonscheduled domestic U.S. air carriers under the "grandfather clause" for ". . . permission to operate from their fixed base" to any place in the U.S., or from their "fixed base" to any specified radius of such a base." Of the airlines that were certified in 1938 the following remain delineated in Table . Table also itemizes overall operating revenues (1972), rank (1972), passenger ton miles (1972), and freight ton miles (1972) for these original carriers.

"Basic Statistics of Carriers Who Received Certification on August 22, 1938-1972 Statistics." Eleven of the twelve carriers are in the top eleven carriers in the U.S. in terms of overall operating revenues produced. The twelfth carrier, Hawaiian Airlines, Inc.,

[26] Ibid., p. 4802.

whole not ranked nationally is prominent in inter-island revenue generating statistics.

5.2 REGULATORY PROVISIONS OF THE ACT(S).

The major economic regulations enacted into law in 1938 remain largely unchanged to the present. In terms of the administration of an ongoing route management program, five basic statutory elements have molded the development of the present United States domestic interstate air transport system.

5.2.1 EXPANSION OF THE SYSTEM

The first regulatory feature is that the Civil Aeronautics Board can expand the existing system by two basic methods: (1) granting "additional authority" to an existing carrier and (2) by authorizing entry into the route structure by a new carrier.[87] The Board's ability to take away operating rights are highly constrained under the enabling legislation. This constraint is a direct result of the intent of the 1938 Act to insure " . . . security of route . . . stability of the carriers and route operations conducted by them." In effect, the 1938 Act intended to pursue the cartelizing policies of the ICC in regulating

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[87] See Chapter II--Civil Aeronautics Board, Code of Federal Regulations, 14 Aeronautics and Space, parts 200 to end, Jan. 1978, Sub Chapter A--Economic Regulations, parts 200, 201, 202, pp. 614.

surface transportation.

The history of the Civil Aeronautics Act indicates that Congress clearly sought to correct "the uncertainty created by the animalities in the administration of and changes in the Federal airmail contract system, which served to subsidize air service, by the issuance of licenses that would have permanent validity."[88] The impact of the existing formulation of the enabling legislation is that entry into a market segment and extension of existing services are clearly delineated, while unilateral reduction in route authority by the Board on the basis of economic rationale are clouded. Historically, such reductions have required "carrier acquiescence."[89]

The basic effect of this provision in that substantial reductions in route authority are a function of the carriers' own determination. However, wilful failure of a carrier to obey the law can result in revocation proceedings that could result in a reduction in route authority. In general, however, carrier concurrent results in reduction of authority, generally through <u>ad hoc</u> situations where a carrier desires to exit from a marginal or loss situation. A major example of this took pllace in the 1940's and 1950's where over 200 trunk points were transferred to local

[88] The Domestic Route System, p. 29.

[89] Ibid, p. 29. See also Section 401(7) of Federal Av Act.

carriers because the major carriers considered them marginal or loss points.[30]

5.2.2 CAPACITY, EQUIPMENT UTILIZATION AND SCHEDULING

The second statutory feature with a significant economic impact related to carrier capacity, equipment utilization, and scheduling. In the United States the Civil Aeronautics Board is forbidden to impose certificate limitations that constrain the carriers to operate particular types of aircraft or to interfere in scheduling changes by a common carrier with a certificate or public convenience and necessity. In this context, the Staff of the Bureau of Operating Rights note " . . . that, within the terms of its license, an air carrier has freedom to operate as much capacity as it may wish in the exercise of sound business judgment---subject only to the minimum level of service that is required by the certificate obligations and the adequacy provision of the act."[31]

To balance this apparent lack of route control, the Civil Aeronautics Board does indeed have considerable leverage in terms of imposing constraints upon a carrier in (1) requiring that a carrier not operate beyond a given point, (2) requiring that a

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[30] Ibid., p. [illegible]. See also Section 401(j) of Federal Av. Code.

[31] Ibid., p. [illegible].

carrier make intermediate stops on a specific route segment, and (3) requiring that a carrier operate beyond a given city pair market segment. These constraints are spelled out when carrier is certificated. They are alternatively referred to as (1) the single plane restrictions, (2) the stop restrictions, and (3) the long haul restrictions.[32]

Another important element in implementing policy restrictions for the Board is the profit criteria. In 1974 fare on U.S. interstate domestic trunk carriers were set for the aggregative system to produce a profit or rate of return on investment of 12% on capital at a 55% load factor. Historic evidence indicates that current interstate fare on U.S. trunk carriers produce a rate of return equal to or in excess of the 12% criteria at an average load factor of 50%. The external implication of this higher fare, lower load factor rate of return generation is that there has been a qualitative increase in the level of service attendant with this rate (fare) structure."[33]

5.2.3 ROUTE LINEARITY

The third statutory element that has "significantly impacted the U.S. interstate air carrier system is the implementation of the

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[32] Ibid, p. 30.

[33] Ibid, p. 30.

linearity concept of the route certification."[34] This Statutory Relationship pertains to routes and segments that are delineated in the certificate (of Public Convenience and Necessity) license as city pair markets. They are of the construct of a terminal, intermediate points, and terminal points. This type of certificate allows flights to operate between multiple segments or routes via intermediate function point stops.[35]

This system, in the absence of restrictions, allows airline management considerable flexibility to serve a series of markets in differing combinations. The Board maintains that this linearity permits airlines to combine traffic on "a single flight--subject only to the requirements for minimum service."[36] Exit from intermediate points is permissible without prior Board permission. Points falling within the linearity of the two terminal points can be added by a carrier without prior Board agreement, and as such represent potential intermediate city pair markets.

5.2.4 LICENSE CHANGES AND MARKET ENTRY

A fourth major impact resulting from enabling legislation is the

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[34] Ibid., pp. 26-27.

[35] Ibid., p. 30.

[36] Ibid., p. 30.

case by case system that must be followed in rate and route submissions. The statutory requirement is that the Board will authorize license changes (or permits), and act on market entry applications only after a hearing by the Board. Formal hearings, where evidence is required, are necessary where two or more competing applications are pending. This usually is the case where a valuable authority is at issue. It is the concern of the Board that this approach currently lacks a planned rationale in terms of " . . . any specific blueprints."[37]

5.2.5 PUBLIC CONVENIENCE AND NECESSITY CRITERIA.

Fifth, the 1958 Act specifically requires the Civil Aeronautics Board to authorize new or improved air services, including entry, based upon the criteria of public convenience and necessity. The Civil Aeronautics Board has developed over the years a series of general guidelines, derived in main from the declaration of policy in the Act (presently Section 102), which is applicable to competitive authority as delineated.

> "competition to the extent necessary to ensure the sound development of an air transport system properly adapted to the needs of foreign and domestic commerce of the United

[37] Ibid., p. 31.

States, of the Postal Service, and of National Defense."[38]

5.2.1 ROUTE RELATED STATUTORY PROVISIONS

The Board's powers to formulate direct economic policy are constrained by the structuring of the enabling legislation relating to " . . . mergers and acquisitions, transfers of authority from one carrier to another, single plane 'interchange' services over the route systems of two carriers, and inter-carrier capacity agreements." The Civil Aeronautics Board may act upon carrier filings pursuant to these elements, but the Acts of 1938 and 1958 (amended) do not endow the Board with the statutory power to initiate concomitant actions.[39]

5.3 IMPACT OF MERGERS ON U.S. DOMESTIC TRUNK CARRIERS

Table No. "Mergers and Acquisitions, Certificated Route Carriers: 1938-1972" delineates the extent of merger and acquisition activity of U.S. airlines during the period 1938-1972.[40] These mergers require Board approval, but their initiations was a result of bilateral (or multilateral) carrier

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[38] The Domestic Route System "Analysis and Policy Recommendations" p. 38.

[39] The Domestic Route System "Analysis and Policy Recommendations" p. 38.

[40] Handbook of Airline Statistics, Civil Aeronautics Board, U.S.A., Bureau of Accounts and Statistics, Statistical Data Section pp. 568-569.

negotiations. While the Board ultimately decides on the "merit" of a proposed merger or acquisition, the Board is restrained from formulating any definitive predisposition planning per se for structuring the interstate trunk carrier system. This ex parte action by the Board is considered analogous to the "case by case" control structure that the Board exercises over the planning attributes related to entry into the U.S. domestic airline trunk system.[41] In this context, it may be seen that the enabling legislation of 1938 and 1958 did not bestow upon the CAB the same regulatory powers enjoyed by the Unites States Interstate Commerce Commission and the ministerially controlled Australian Airline System.[42]

A review of Table No. indicates that for this period the CAB approved 44 mergers. Mergers and acquisitions do not appear, at least with the "Big 4" (American, Eastern, TWA and UAL), to be of the relative significance that they were in the Australian setting.[43]

5.3.1 MERGERS, ACQUISITIONS AND EMERGENCE OF THE "BIG FOUR"

Unlike their Australian counterparts (the "big two" Ansett and

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[41] [illegible]

[42] [illegible]

[43] [illegible]

TAA), the "big four" United States domestic trunk carriers, American, Eastern, TWA, and United Airlines, did not evolve so dramatically from mergers, acquisitions, and direct government intervention. Their growth was a direct consequence of the "grandfather clause" rights obtained in the initial regulatory legislation. American Airlines, which ranked third in U.S. domestic airline trunk revenue producing operations in 1972, received its certification in 1938 (8/22/38) only acquired one additional carrier, American Export Airlines, Inc. on June 1, 1945. This was only the ninth such merger/acquisition following the Act of 1938. Eastern Airlines, which also received its certification on 8/22/38) delayed until 1967 before acquiring another carrier. In this case Eastern, which in 1972 ranked fifth in total U.S. air carrier revenue producing operations, absorbed Mackey Airlines. This was the thirty-second such acquisition for all airlines since the original Act of 1938. Trans/Continental and Western Air Inc., which later became TWA on 5/17/50, only absorbed one airlines between 1938 and 1972. It absorbed Marquette Airlines, In. on December 5, 1976. United Airlines, which like American, Eastern and TWA received certification on 8/22/76 also saw cause to take over or absorb on additional carrier. In June of 1961 United acquired control of Capital Airlines, Inc. This was the 30th takeover among all airlines

since the original Act of 1938.[44]

5.4 GROWTH OF UNITED STATES AIRLINE SYSTEM

Statistically, like Australia, the U.S. airlines have shown a strong secular growth pattern. This pattern in recent years has ended to reflect major macro-sectoral trends in the economy. However, with the early onrush of technological advancement and concomitant qualitative (speed and improved safety) edge that aircraft exhibited over rail and road, air passenger growth was counter cyclical during the 1929-1936 United States Depression.[45]

5.4.1 EARLY DEVELOPMENT

Between 1909 and 1913, only 51 commercial and military aircraft were produced in the United States. Prior to 1917 the aggregate U.S. output of all aircraft stood at approximately 200. However, with the U.S. entry into the war, production increased dramatically, in that between July 1917 and November 1018, U.S. manufactures turned ut 13,943 aircraft, mainly for military use. However, in spite of the initial emphasis on military aircraft,

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[44] 1973 Edition Handbook of Airline Statistics, CAB, Part 1 Statistical Description of the Individual United States Carriers 1972 Table is "Some Basic Facts About the Certification Route Air Carriers and the Supplemental Air Carrier Systems Operations, pp. 1-2.

[45] 1973 Edition, Handbook of Airline Statistics, Civil Aeronautics Board, Item 2, Statistical Indicators and Trends in U.S. Air Transport, 1910-72, p. 500.

the war year of 1917-1918 laid the foundation for (1) a new U.S. aircraft industry and (2) a corps of aircraft personnel familiar with the production, operation, and logistical requirements of this new industry.[46] This experience was not unlike the Australian experience, in fact the developments in both countries were quite parallel.[47] This is attested to in that in 1921 there were 1200 "commercial" planes operating the U.S. skies. These were mainly one or two passenger converted military aircraft.[48]

1926 was a landmark year in terms of U.S. commercial aviation. In that year private carriers were used to carry the mail. At this period in the evolution of U.S. airlines, revenue from mail carriage exceeded both passenger and freight revenues.[49] However, 1926 was a bench mark year for airline penetration of the passenger market in that 5,782 passengers accounted for 1,272,000 passenger miles. By 1929 this figure had climbed to 35,396,000 domestic and 2,696,000 international miles. In spite of this relatively spectacular growth, and the apparent insensitivity of the U.S. air carriers to the depression, in 1930 only 0.2% of all common-carrier traffic (rail, bus, water, and air(was carried by aircraft.[50] At the time of the inception of the CAA (later CAB)

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[46] Ibid, p. 500.

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[48] Ibid, 1973 Airline Statistics, p. 500.

[49] Ibid, p. 500.

[50] Ibid.

in 1938, approximately only 2.6% of all common carrier traffic was performed by aircraft.[51] This may account partially for the decision not to place airlines under ICC jurisdiction.[52]

5.4.2 RECENT DEVELOPMENTAL TRENDS

Between 1935 and 1963, the U.S. airline system was becoming more oriented toward passenger carriage. The early history of airline development in the U.S. was however mail oriented. But with the greater acceptance of aircraft as a viable traffic mode, by 1935 approximately 83.6 percent of the domestic trunk ton miles flown were by passengers, contrasted with 13.0 percent for mail, 3.4 percent for express and a negligible amount for freight. The historical evolution of air transportation from its inception until present times is that (1) all types of traffic carried have shown a secular increase, however, (2) the proportionate composition has varied, with mail and express deliveries declining in relative terms while freight has shown a proportional increase.

During the 1930's and post World War II years, U.S. commercial aircraft production continued to show substantial growth and, with one major exception, the British Viscount Turbojet, U.S. airframe manufacturers dominated the free world airframe industry. The

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three major U.S. airframe manufacturers that survived the early days of continual exit and entry into the market[53] were Lockheed, Douglas (later McDonnell Douglas) and Boeing. The initial advantage that U.S. manufacturers enjoyed over their European counterparts came as a result of (1) a fast developing domestic trunkline market and (2) concentration in the U.S. (especially in pre-World War II days) on commercial rather than military development.

5.4.3 IMPACT OF DOMESTIC AIRFRAME INDUSTRY ON REGULATORY COHESION

The presence of a vigorous internal domestic airframe market in the U.S. placed a severe constraint upon the economic regulatory powers of the CAB. As noted earlier, a basic statutory limitation (from a regulatory standpoint) "is that the Board is expressly forbidden to impose certificate limitations that restrict the ability of carriers to change schedules or equipment."[54] This regulatory "loophole" concomitant with a vigorous effort by the carriers and airframe manufacturer to "product differentiate" has led to a profusion of non-price competitive elements in the

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[53] See Item 18 Milestones and Landmarks in U.S. Air Transport, 1903-73, pp. 470-483, also R.E.G. Davies, _A History of the World Airlines_, particularly Chapters 1, 5, 6, 8, 16 and 18, London, Oxford University Press, New York, Toronto, 1967.

[54] The Domestic Route System: Analysis and Policy Recommendations--A Staff Study by the Bureau of Operating Rights, Civil Aeronautics Board, October 1974, p. 30.

domestic U.S. Interstate trunk market.

5.5 REGULATION RATES AND ROUTES

It is widely argued that the impact of regulation through the 1938 and 1958 Acts has caused higher fares in many U.S. domestic trunkline markets than would have existed without regulation.[55] It has been estimated that "in most cases regulated fare have been 50 per cent or more above non regulated fares and differences over 100 per cent have been common."[56] These results were based on a cross sectional analysis of Canada, California, Texas, and military aircraft procurement by William A. Jordan.[57] In high density city pair markets, Theodore E. Keeler estimated that the direct impact of airline regulation caused a yield markup of between thirty and fifty-six percent.[58] However, a counter argument to laying all the blame at the foot of the regulatory agencies is advanced in "cost of production" studies for high density, heavily travelled markets.

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[55] United States of America, Civil Aeronautics Board, Washington, D.C., "Regulatory Reform", Report of the Special Staff, July 1975, p. 150.

[56] Regulation of Civil Aeronautics Board Regulation, Testimony of William A. Jordan before the Subcommittee on Administrative Practice and Procedure, Senate Committee on the Judiciary, February 14, 1975, p. 88.

[57] Ibid, see also Airline Regulation in Canada, Europe and Australia by John Hopkins Press, Waltimore and London 1970 by William A. Jordan.

[58] Regulation and Texas Air Fares, Testimony of Theodore E. Keeler before the Administrative Practice and Procedure, Senate Committee on the Judiciary, February 25-26, 1975, p. 15.

5.5.1 RECENT DEVELOPMENTS AND PRODUCTIVITY

The era of jet aircraft in Australia and the U.S. show similarities and wide divergences in experience. Jets were introduced into the Australian markets in a controlled scenario. Competition between the carriers for variances in capacity and utilization was prohibited under the two airline policy. The impact of jets upon Australian city pair traffic has been significant in two major areas (1) there has been a substantial increase in production of revenue passenger kilometers (miles), and (2) passenger yields/kilometer in real terms have advanced.[59] The U.S. experience, on the other hand, suggests that the Civil Aeronautics Board and the individual carriers overestimated traffic growth for the jet era.[60] This optimism was attributed with producing excess carrier capacity and a proliferation of new routes which unwittingly made the U.S. domestic airline environment more competitive.

5.5.2 RATE MAKING

Prior to 1960 the Civil Aeronautics Board set rates for passenger and cargo traffic on an ad hoc informal system, geared to protecting the profitability of the carriers. After 1960, the

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[60] See p. 65 Regulatory Reform.

Board elected to set a definite rate criteria of "reasonableness" for return on trunk line investment. Pursuant to a General Passenger Fare Investigation[61] 10.5 percent was adopted as a standard of "reasonableness." This figure was ". . . the weighted average of the rates of return thought to be needed by the Big Four and other eight carriers for the attraction of capital."[62] For the local service airlines, a rate of 5.5 percent on debt and 21.35 percent on equity capital was determined to set the parameters of reasonableness.[63]

5.5.2.1 RATE MAKING AND NEW TECHNOLOGY

However, with the introduction of turbo jets and then pure jets into the system, the existing criteria for rate making was challenged. (Regulatory Reform, p. 63.) This challenge was underscored by the historical evolution of rates of return on investment for the major carriers. Table No. "Rate of Return on Regulatory Investment Certificated Route Air Carriers, Calendar Years 1962-1972 indicates the relatively dismal showing of the twelve major U.S. carriers during this period. Also, Table No. reflects an analogous trend for the major local service carriers in the same period. Two relevant items are noted: (1) Certain

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[61] Regulatory Reform, pp. 62-63.

[62] CAB Order E-11609, November 29, 1960.

[63] Order E-15676, August 1960.

carriers in both categories made continual rates of return in excess of the weighted average and (2) rates of return tended to correlate with the business cycle trends. While the latter is a relatively easily explainable item, it would appear that either or both conditions could exist for higher than average rates of return, namely (a) the airline was efficient and/or (b) it generated a sufficiently high demand at a fare structure that would permit these rates of return. In the latter case this could be attributed to a non-competitive route structure and/or a superior product in a competitive market setting.

A review of the various airlines vis a vis their route structure suggests that in general the most logical cause for higher than average rates of return on investment were due to the market structure. Airlines operating in competitive market situations tended to have an average or lower than normal rate of return. However, airlines with new or non-competitive route structures tended to produce higher than average rates of return on investment. American and United which have relatively competitive route systems tended to produce average rates of return. While airlines such as Delta and Continental, and to a lesser degree National with relative new city pair markets in general, outperformed the other airlines, using the rate of return on investment as a criterion.

5.5.2.2 RATES AND PROFIT

What can be deducted from a review of the historical evolution of the various rates of return is that they did not "provide an operative ceiling on the fare level" in the years studied.[64] Only in 1965 when the rate of return reached 11.57 was the indicated rate exceeded. Because of the relatively poor performance of the industry during this period, fares were no decreased proportionately with the efficiencies related to use of jet equipment. It has been argued that by the mid-1960's that efficiencies in terms of operating costs were in the order of 20 to 30 percent.[65] The special ad hoc staff report on Regulatory Reform argues that profit erosion, even with a continuing high fare structure was a result of ". . . the Boards excessive authorization of competitive route authority, and, on the other hand, that the failure of the board to initiate fare reductions resulted in high earnings margins (reflected in low break even load factors), especially on long haul routes."[66] The Board's ad hoc committee attributes the "excessive" over-investment in jet equipment to the concomitant factors of lower cost of production functions and low capacity break even factors.[67] This situation

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[64] Regulatory Reform -- Report of the CAB Staff, p. 69.

[65] Ibid, p. 64.

[66] Ibid, p. 64 -- Regulatory Reform.

[67] Ibid, p. 61.

can be sharply contrasted with the Australian experience, where capacity was constrained.[68]

5.5.3 STRUCTURED APPROACH TO ROUTE AUTHORITY AND RATE CHANGES

At this time it would be well to review the basic format by which the Board grants new route authority and changes in rate structures. The Board's "piecemeal" approach to the regulation of these two basic economic attributes, especially prior to the domestic passenger fare investigation (DPFI). This investigation was initiated as a manifestation of congressional interest.[69]

Part 201, Subchapter A, Title 14, Aeronautics and Space, Economic Regulations delineates the basic steps necessary for a carrier to receive a certificate of public convenience and necessity.[70] The steps necessary to receive such a certificate are highly structure and legalistic in construct.[71]. However, as with rate cases and additional route authority applications, heavy emphasis is placed

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[68] An easily accomplished goal in the Australian setting where import licenses and the lack of a domestic jet airframe industry made constrained capacity a readily obtainable regulatory objective. The Australian jet experience as delineated in Chapter , was of a high capacity and utilization factor, concomitant with a high fare structure. It has been shown that the Australian yields (see Chapter) were in some cases 200 percent higher than similar U.S. city pair fare structures where the same types of jet equipment were in service.

[69] George W. Douglas and James C. Miller III, Economic Regulation of Domestic Transport: Theory and Practice, Washington, D.C., The Brookings Institute, 1974, p. 159.

[70] Code of Federal Regulations, 14 Aeronautics and Space, Part 200 to End, Revised as of January 1, 1985, pp. 6-8.

[71] Ibid.

upon the economic impact pursuant to any decision by the Board.[78] The applications must meet the requirements set forth in the following sections of Title 14, Subchapter A - Economic Regulations:

Section 201	Formal Requirements (see also Sections 302.909 and 377.10(c))
Section 201.2	Amendments
Section 201.3	Incorporation by Reference
Section 201.4	General Provisions Concerning Content
Section 201.5	Operations Other Than Between Fixed Points

This structured, legalistic approach differs from the Australian system in that, theoretically, any potential carrier can obtain a certificate to operate as an air carrier pursuant to public utility type regulation as administered by the Civil Aeronautics Board. The granting of an operating permit in Australia is less legalistic but subject to the constraints of the two airline policy and other state and federal policies and legislation related to carrier entry. The two systems defy exact comparison in that (1) the U.S. interstate system is defined by specific enabling legislation while (2) the Australian intra and interstate system for market authority is an offshoot of the commingling of

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[78] Conversation with Mr. Cooke, Chief, Authority Division, Bureau of Operating Rights, Civil Aeronautics Board, Washington, D.C., December 1, 1971.

state and federal legislation, state and federal agreements, import licensing, and the specific acts creating the airline policy.[73]

5.5.4 ROUTE AUTHORIZATIONS AND RATE CHANGES

Route authorizations and rate changes within the United States' domestic airline system are codified in a analogous way as to the granting of certificates of public convenience and necessity.

5.5.4 NEW ROUTE FILINGS

The steps that are followed in filing for a new route are basically:

(1) New route application is accepted by Board.

(2) If an application is accepted it is referred to a Chief Administrative Judge.

(3) The Chief Administrative Judge then assigns the application to an Administrative Law Judge (ALJ).

(4)(a) Then there is a prehearing conference followed by

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[73] See Chapters and for a historical and structured review of the fundamental underpinnings for the "Australian System."

(b) a presentation of exhibits--these represent the economic arguments by the applicant regarding why a new authority should be granted, then (c) a hearing is filed before an Administrative Law Judge, and (d) the brief, which is a review of all economic evidence, is filed.

Based on a review of all economic documentation, the ALJ makes an initial decision. This initial decisions becomes final, unless party is granted a review by the ALJ. If the review is granted by the ALJ, then the applicants are free to present review to Board and give (or not) arguments to the Board. On the basis of this review procedure, the Board will reach a final decision.[74] Mr. Cooke, Chief of the Authority Division, Bureau of Operating Rights, noted on December 1, 1975, ". . . that very few initial decisions are final." The "gestation" period, a new route authority decision, takes between one and two years, depending upon the size of the case.[75]

Exit from a particular city pair authority involves a similar process. However, carriers can exit from intermediate city pairs without Board's permission. This is due to the way in which route authority certification is written. City pair authority is

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[74] Mr. Cooke, Chief, Authority Division, Operating Rights, Civil Aeronautics Board, December 1, 1975.

[75] Ibid.

"endowed" by the Board along a linear concept. This concept is present diagrammatically in the following figure, "Figure No. , Linearity Concept for Route Authority."

Carriers with certificates to operate, say, Washington, D.C., and Los Angeles, California as terminal city pairs, may add or delete intermediate stops along linear path between the terminal cities. In this case, as presented in Figure No. , A, B, C, and D, could be added or deleted to the route structure of a carrier with Los Angels-Washington certification, without the Board's permission. However, the carrier could not delete either Los Angeles or Washington without a formal hearing. Also, cities not served by carrier but within the linearity of the city pair authority, represent a potential market segment, or stand in effect as unused authority.[76]

In granting a city pair authority the Board can only demand "adequate service." The Board cannot compel a carrier per se to adhere to specific schedules or to use designated equipment. In the latter element thee exists a wide dichotomy between the Australian system, and the U.S. Interstate system. This is particularly the case on major city "competitive" markets in Australia, where the dictums of the two airline policy, specifically the Airlines Equipment Agreement Act of 1958, states

[76] Ibid.

the type and capacity of equipment that must be utilized.[77] However, while Australian airlines schedule simultaneously, a low cost method for market sharing as per the two airlines enabling legislation, they, like their U.S. counterparts, are not legally restrained as to specific scheduling. Further, Australian airlines are not directed to provide "adequate service." However, in the context of the Civil Aeronautics Board's administration of the 1958 Act, the concept adequate service appears to be a difficult concept to operationally define and implement.

5.5.2 RATE STRUCTURE DETERMINATION

Rate structure determination is integral to airline development, in that rates and rate of return on investment are directly related. The Board exercises direct control over rate making by (1) responding to carrier initiatives by suspending (and investigating) or approving rates (fare) filed by the various carriers and (2) the Board can establish ". . . exact fares and/or maximum and minimum fares following the completion of a formal hearing."[78] In both instances the Board provides a forum where the various carriers can discuss and evaluate proposed rate (fares) changes prior to action by the Board. The first

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[77] See D. Gerbode, Politics and the Airlines, London, 1968, p. 139.

[78] See Civil Aeronautics Board, Washington, D.C., The Johns Hopkins Press, Baltimore and London, 1970, p. 87-88. See also Section 1002(g) and Section 1002(d), 72 Stat. 738.

procedure, according to Jordan,[79] is used more often than the latter mentioned procedure. The former procedure is made possible by the constrain that a thirty-day minimum period of time elapse from the public filing of the proposed rate change with the Board and the date of implementing such a change.[80] During the first twelve days of this thirty-day period, any other carrier or interested party may file documents with the Board supporting or opposing this proposed change.[81] In the case of complicated alternative rate cases, Jordan[82] notes that ", , , the Board may even permit or sponsor a meeting with the certificated carriers' presidents or other officers to discuss the effects of alternative fare changes." He cites as an example of this a January 1969 meeting of airline presidents, called the CAB, to discuss what eventually became an across the board rate increase in February 1969.[83]

5.5.4.2.1 CONVENTIONAL AND PROMOTIONAL FARES

The basic dichotomy found the U.S. domestic trunk line fares are (1) conventional and (2) promotional. Conventional fares are those fares that are available to all prospective passengers, with

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[79] Ibid.

[80] Ibid., Jordan, p. 87.

[81] 14 CFR 221.160 and 302.209.

[82] Jordan, p. 87.

[83] Ibid., p. 87.

little or no limitation on use. They may be either first class or economy. Promotional fare, unlike conventional fares, are restrictive in that they may only be purchased by particular classes of prospective passengers. They may differentiate passengers by type, e.g. military and non-military personnel, or by time of travel, or by length of advance period in which a ticket is purchased. These latter type fares conform to the orthodox definition of discriminate pricing in that (1) identifiable groups of buyers are separated, at a low transaction cost, in order to avoid resale between buyer groups, (2) there exists some form of monopoly and agreement among sellers not to lower prices in a competitive mode, and (3) differing price elasticities with respect to demand among various buyer groups.[84]

5.5.2.2 FARE LEVEL AND FARE STRUCTURE

Jordan[85] points out the divergence between fare level and fare structure. He defines fare level as passenger revenues divided by revenue passenger miles (kilometers). This figures is referred to in the trade as the fare "yield." Fare structure pertains to the types of fares existing. In a monopolistic, or oligopolistic market, various fare types reflect wealth maximizing behavior by

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[84] See Jean Robinson, The Economics of Imperfect Competition (London: MacMillan and Co., 1969), pp. 179-81 and A.C. Pigou, Economics of Welfare (4th Ed.) (London: MacMillan and Company, 1969), p. 279.

[85] Jordan, p. 59.

the carriers. In using multipart pricing by user categories, in a constrained (regulated-CAB/two airline) environment, the producers (carriers) are able to engage in wealth maximizing behavior. By collusive, overt or covert, multipart discriminatory pricing, there is less pressure on the carriers to attempt overt competitive measures through the price mechanism.[86] However, as was witnesses during the 1975 recession, the weight of exogenous economic factors did indeed precipitate price competition.[87] It would appear from recent U.S. history that as price types proliferate, cartel discipline tends to break down and lower unit prices emerge.[88]

5.6 RECENT DEVELOPMENTS IN RATE SETTING

As noted above,[89] the criteria for rate making was based upon attracting capital into the airline industry. With the apparent over-investment in airline capacity, it would seem that the rate making criteria was oriented toward preventing "capital flight," or at a minimum of protecting capital already invested. The failure of the economy to continue its secular expansion, as witnesses during the 1960's, and concomitant decline in demand for

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airline services,[90] ". . . and some manifestation of congressional interest,"[91] caused the Board to institute the Domestic Passenger Fare Investigation (DPFI).[92]

While this investigation (DPFI) did not change the structure of the mechanism for rate making, it did result in a substantive number of changes relating to the rules of rate making in the airline industry.[93]

This investigation was conducted in ten phases and resulted in (1) an upward revision of the "fair rates of return", (2) the adoption of a load factor standard (and related seating configuration) to be a bench mark in determining U.S. trunkline domestic fare levels, and (3) "a comprehensive prescription of the normal fare structure, together with rules governing discount fares."[94] These steps would appear to be counter productive in terms of creating a more market oriented environment. A review of these DPFI standards suggests that the Board, especially in adopting load factor and seat figure configuration criteria, attempted to move a step closer toward the totality of the Australian two

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[90] See Chapter , Econometric Analysis of Demand For Airline Usage.

[91] Regulatory Reform Report of the C.A.B. Special Staff, p. 6.

[92] CAB Order 70-1-174.

[93] Ibid.

[94] Ibid., p. 69.

airline cartel (duopoly).[95] However, the efficacy of implementing these standards will face a sterner test in the U.S. where there is an inherently broader base for "competition or defying cartelizing edits.

5.6.1 RATE OF RETURNS ON INDUSTRY INVESTMENT

Under the guidelines set forth in the DPFI, the Board determined that twelve percent (12%) on total investment constituted a fair rate of return. This figures was predicated upon a 6.2 percent cost of debt, a 16.75 percent cost of equity plus a 45/55 debt equity ratio.[96] The special staff of the CAB in their study on regulatory reform noted ". . . since the actual ratio od debt to equity was substantially higher than the ratio to be used for rate making purposes, the actual return on equity which could "fairly" be earned under this standard is substantially higher than 16.75 percent."[97] For local service carriers, it was determined that a fair rate of return was 12.35 percent, and this was based upon a 20 percent cost of equity, a 7.25 percent cost of debt, and a 60/40 debt equity ratio.[98]

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[95] For a discussion of the Sumbrella Review Structure, see Robin Hocking, Some Economic Aspects of Sumbrella's Two Airline Policy, Committee for Economic Development of Sumbrella, August 1F, Chapter 2, pp. 10-18.

[96] C.A.B. Order 71-4-88.

[97] Ibid. 62-66.

[98] C.A.B. Order 71-4-88.

In its study "Regulatory Reform," the C.A.B. (p. 66) special staff note that ". . . a major policy innovation resulting from the DPFI was the decision to set the trunkline fare level not on the basis of the actual cost level but on the basis of hypothetical costs . . . " (p. 66). These costs would be generated by estimating the investment and operating expenses of a carrier. With a standard seating configuration obtaining a load factor of 55 percent (55%), the Board used the load factor to avoid, what it termed, a chronic tendency to "over-investment, high fares, and general impoverishment among carriers. The Board acknowledges that its "piecemeal" approach of the fare structure was warranted. A fact that Richard E. Caves also noted.[99] However, the Board now believes that the approach to fare structuring ex poste DPFI has established a set of comprehensive "guidelines" to the problems of rate making. The Board makes specific reference to Phases 5 (discount fares) and 9 (fare structures) to illustrate the comprehensive rationale related to the current CAB principles for rate determination.

CAB Order 72-12-18 in establishing principles for dealing with all "discount and promotional fares"[100] that are not predicated upon cost savings states:

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[99] Air Transport and Its Regulators, pp. 367-369.

[100] C.A.B. Order 72-12-18, p. 728.

(1) Carriers should be free to utilize discount fares within their managerial discretion, subject to the condition that such fares are not unjustly discriminatory and meet the profit impact test;

(2) Promotional fare tariffs should contain expiration dates not to exceed 18 months from the effective date; and

(3) Fare Levels will be computed upon a hypothetical full normal-fare basis, i.e., as if the discount fares were not part of the fare structure.[101]

The "profit impact" test, referred to above, requires that the fare level by such to generate "sufficient additional traffic to more than offset the diversion of full-fare traffic and the added non-capacity costs associated with the generated traffic, less any savings in cost attributable to the nature of the services provided to discount traffic."[102] The added non-capacity costs criteria applied in this contest were assumed uniform in all travel markets (time and location). The criteria established as of July 1975 was 25.6 percent of revenues for family fare traffic and 30 percent for youth and other discount fare types, e.g.,

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[101] Order 75-3-13, p. 79.

[102] C.A.B., Order 75-12-18, p. 79.

Discover America.[103]

5.6.2 "REGULATORY REFORM" SUMMARY

The special staff report on "Regulatory Reform"[104] believes that principles (1) and (2) should pay more attention to the temporal and spatial nature of the markets to which the discount fares are applied.[105] They note ". . . the theory on which principles (2) and (3) are based holds that discount fares are generally warranted for short periods only . . . ." They interpret the intent of these principles to be such that promotional fares should not become a permanent part of the fare structure.[106] The rationale, as interpreted by the special staff, pursuant to the DPFI, is that such permanent changes to the fare structure would burden the general fare level.[107] As noted earlier, Jordan dichotomies between fare level (yield) and fare structure (types of fares).[108] In this study, all econometric analysis is based on levels not structure. The variety of fares (structural distribution) reflect carrier wealth maximization strategies. While the fare levels, or "average" fares, reflect the direct

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[103] Regulatory Reform, p. 70.

[104] Loc. Cit. pp. 7-71, 102-107.

[105] Ibid. p. 71.

[106] Ibid.

[107] Order 78-3-13, pp. 3-4, 48-50, 53-54.

[108] Civil Aeronautics Board Practices, pp. 59-62.

impact of the diversity of the structural attributes of the fare dispersion upon "profitability."[109] Obviously, the Board in "allowing" only short term structural changes is trying to avoid fare level "dilution" by a multiplicity of fares.

The rationale advanced for this approach is that all airline costs are variable in the long run and are therefore constant with regard to output[110] and from this the Board would appear to have "deduced" that the cost of carrying discount passengers is identical to the costs associated with carrying "normal traffic."[111] The argument advanced here is that discount and promotional fares, due to constant returns, cannot lower average costs in the long run. Further, the findings of the DPFI did not indicate that "off peak" or temporal fare structuring (within a twenty-four hour time frame) did not constitute "promotional."

In Phase 9 of the generalized approach to fare structuring[112], a "precise"[113] formulae were prescribed to relate distances with fare structuring among specific classes of travel. The critique

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of this approach is that the strict application of the cost/distance/travel class formulae do not account for such factors as traffic density, and thus these fares cannot be "cost based." Strazheim notes that "route density is also an important factor influencing direct operating costs, in that it is an important determinant of unit costs."[114] However, the concept of a mileage based fare structure is supported on two major premises, namely (1) fares that diverge from fully allocated costs have the tendency to distort the quantity of service offered in each market. The argument here is that in short haul markets, where fares are allegedly set below costs, it is said that there is a scarcity of service. Conversely, it is argued that on the long haul markets, where the fares are established above the fully allocated cost criteria, there is an "over supply" (quotation marks to emphasize the non economic context of this phrase) of services.[115]

5.7 CAB ANALYSIS OF PERFORMANCE

By 1974 Congress had approved about thirty amendments to Section IV, the section dealing with C.A.B. control over economic regulation. Roy Pulsifer, Bureau of Operating Rights, Civil

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[114] The International Airline Industry, Mahlon R. Straszheim, The Brookings Institution, Transport Research Program, Washington, D.C., 19969, p. 85.

[115] Regulatory Reform, p. 72.

Aeronautics Board noted: ". . . not one--indicates any movement toward regulation." He goes on to add ". . . not one indicates any movement toward deregulation." In fact Pulsifer believes that ". . . a little cement has been added here and there.116 While the "Kennedy Hearings" of 1976 and current legislation pending congressional action may change this, Pulsifer succinctly summarizes the success of airline regulation and its longevity. In reference to the grandfather clause and the impact of regulation, Pulsifer notes : . . . in 1938 we had nineteen non specialist carriers and today we have eighteen, the Board having kept constant (or brought back to constancy) the number of carriers operating in the system."117

5.7.1 CAB IMPACT

When the CAB began in 1938 the forty-eight states produced 500 million revenue passenger miles, by 1972 the CAB-regulated carriers generated 120 billion passenger miles. The original (1938) fleet of aircraft consisted of about 250 DC3 and other similar aircraft, today there are a wide variety of multi-engine aircraft with a production capacity in excess of 300 times the original fleet. The CAB staff which quickly grew from the inception of the regulatory statutes to 500 people has remained relatively stable increasing to only 700 in recent years. The CAB considers this figure to be inadequate and note " . . . the

unregulated component (today) of the interstate system, the commuter/air taxi carriers make up an industry about the same size as the original grandfather carriers (in volume capacity) . . . (but) the present staff (700) . . . is not economically regulating these commuter operations, and the Board has determined as a matter of policy that they should not be regulated."118

CAB Evaluation of Industry Performance

The CAB considers that " . . . the (aggregate) performance of the airlines represents a very mixed bag."119 The summary elements in the CAB statement (which of course changes from period to period) are that

". Eastern is experiencing serious operating losses,

". American is also experiencing operating losses (however a recovery was considered imminent)."

". Pan American continues a . . .trend of net losses . . . but the gap is narrowing."120

Pulsifer goes on to summarize industry performance "the balance of the industry is doing well. Continental is marginally profitable, (the only middle sized carrier that is doing relatively poorly). .

. . Delta, Western, National and Northwest are all earning quite high levels of profit." The profit margin criteria for the CAB being a 12 percent rate of return on investment.121 In this context, it is further noted by the CAB "while the rate of return earned by TWA (Trans World Airlines) does not meet the CAB's standard of 12 percent on total investment, it is acceptable."122

5.7.2 CAB AND ENTRY

It is noted that the Board has acted very "cautiously"123 in terms of new routes for the domestic carriers. This policy has been a cornerstone of CAB's regulatory approach since its inception. However, in terms of the international airline environment, and pursuant to bilateral and multilateral international agreements, it is observed that " . . . paradoxically, while constraining route entry domestically, the CAB is going forward with the biggest route case of all time on the international side (transatlantic) . . . ."124 The "flexibility of the CAB on international case submissions appears to bear a direct correlation to the complexity of the international agreements, and the potentiality of foreign carrier retaliation resulting from unilateral dictates by the CAB.

5.7.3 DOMESTIC FARE INVESTIGATION

The domestic fare investigation, which is discussed above, was a major economic evaluation undertaken by the CAB. The investigation was aimed at determining the price of air transportation in relation to distance traveled. This is alluded to as the "fare taper." 125 The two criteria considered were whether the fare was to be cost based, or cost related. The decision, CAB Order 74-3-82 126, found that the generic construct of U.S. domestic carrier fares should " . . . cost based, not simply cost related." In issuing this order, the Board rejected several proposals for the so-called "zone of reasonableness" approach to pricing. 127

5.8 DEREGULATION

The case against deregulation or for regulation is also pursued with vigor by both economist and field practitioners. A major thrust of those who view some regulation as a normative policy approach believe that "deregulation theorist" abstract too much from the real work and in effect establish an artificial dichotomy between practice and theory. A major element in this argument is that in the complex price matrix (or trade-off systems) generated within an economy, regulated prices per se are integral to the existing solution dynamics. In this context it is argued that questions such as: what is the decision calculus of regulatory commissions? How is economic efficiency evaluated? What

constitutes efficiency? National interest? Is the policy stated explicitly? What is meant by "justification?" 128 should he asked, and answered prior to a full de-regulatory program being instituted. In the United States, fact that ". . . Congress has not been persuaded by the arguments of de-regulators, as witness . . . "ninety years" . . . of ICC regulation and ". . . thirty-nine years . . ." of CAB regulation." 129... is argument enough for the pro regulatory disciplines that in the aggregate regulations has been efficient and effective.

5.9 EVALUATION OF U.S. REGULATION

For a variety of reasons, a growing band of economists have been assaulting such modern day "institutional citadels" as the Civil Aeronautics Board. These studies have had a broad base in their thrust in demonstrating, among other things, that regulation is ineffective in protecting consumers against monopolistic exploitation,130 that regulation often has been instituted at the request of the regulated,131 that regulation produces serious distortions in the incentive structure facing the regulated firms, 132 and/or that economic regulation results in varying degrees of net welfare loss to society.133 Some economists believe that " . . . the weight of economic evidence has become so great that any economist venturing to support legislation today is apt to find himself in a very lonely position." 134 Professor George Eads of

George Washington University notes in this context that "what was only a short time ago considered heresy now has assumed the status of conventional wisdom."135

5.9.1 "EQUITY"

The concept of "equity" was investigated in a recent CAB study "service to small communities." The findings of this body were that the cost to the federal government of supporting short-haul, low density air service was not two or three dollars as originally claimed, but was in fact of the order of $20 per passenger on average, and in one extreme case the subsidy was in excess of $200 per passenger.136 This latter case was at Martinsburg, West Virginia, where the subsidy to Allegheny Airlines was $206.13 per passenger.137 Allegheny was suspended at Martinsburg on December 1, 1970 and the point was transferred to a scheduled air taxi. 138 The concept of a variable sized flexible air mode for air travel is not new. This type of service permeated the fledgling United States and Australian systems prior to regulation. And it provided a comprehensive route service, especially in the context of the existing technology. It is interesting to note that in degree the United States has come "full circle" in deregulating this type of carrier. 139

5.10 REGULATORY EFFICIENCY

William A. Jordan, in evaluating the regulatory efficiency of the CAB, asks the generic or over-riding question - Is the

5.10.1 ECONOMIC EFFICIENCY

U.S. domestic trunk carriers under the auspices of the CAB were significantly less productive than with the non-regulated California intrastate carriers? Real output per employee of Pacific South West Airlines 146 exceeded the average from all domestic CAB carriers 147 by 100 percent. However, as Jordan notes " . . . the relative efficiency of the CAB carriers would probably be higher if their output were defined to include the benefits from superior quality of service and contributions to national defense."

5.11 SUMMARY

The United States domestic airline system presents a number of paradoxes. While air transportation has grown at double the GNP rate, it has not rewarded its investors with exceptional profits. The average system-wide rate of return has met the CAB criteria ("fair return") on only five of the past twenty years. George W. Douglas attributes this condition to " . . . that excessive costs of production and inefficient service levels have resulted in regulated prices which greatly exceeded the estimated prices of an

efficiently configured air transport system."148

The proponents of the CAB believe that the airline system has been "stabilized" due to the presence of the Board. They point out that regulation has provided economic stability and growth in the dual perspective of national and private (consumers and producers) interests. Opponents of the system argue that it has led to an inefficient system fed by the misconception of the CAB that the industry is not viable outside a regulatory framework.149 Based on California experience, and only using market criteria to determine efficiency, the latter argument is persuasive.

CHAPTER 11

INSTITUTIONAL AND THEORETICAL BACKGROUND

1. INTRODUCTION

The basic thrust of this investigation focuses on the Australian airline industry, stressing the economic implications associated with the current regulations. The study will be coached in terms of the economic effects of regulation on the structure and performance of the industry. The main study areas will be (1) the degree of price competition, (2) the fare levels, (3) areas of non-price competition, (4) technical efficiency of operation of the individual carriers and (5) the demand for air travel as expressed in the various comparative elasticities. This set of evaluation criteria for the Australian system will be studied in comparison with regulation and industry performance in two other markets, namely, the United States Interstate domestic market, under the regulatory central of the Civil Aeronautics Board (CAB) and the California system under the regulatory influence of the California Public Utility Commission (CPUC).

In performing this analysis, an examination of the cost conditions in the three airline systems will be undertaken. This part of the study will concentrate on assessing average and marginal costs over the relevant output ranges. _____ in this

cost analysis will be a study of the regulatory set-up and institutional framework within which the three systems operate. The results of these two analytical elements of the study will be compared and contrasted in terms of which airline system is the most efficient. In this vein, emphasis will be placed on discerning the economic imports of the three regulatory systems - more specifically - how the particular modes of regulation have affected the system.