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## Anarchy In The Airways

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# Anarchy In The Airways

## **Abstract**

In his dialogue - Anarchy In The Airways - Joseph C. Von Kornfeld, Assistant Professor, College of Hotel Administration, University of Nevada, Las Vegas initially states: "Deregulation of the airline industry has brought about financial vulnerability for the traveling public. The author analyzes the situation since that point in time and makes recommendations for some solutions."

In this article, Assistant Professor Von Kornfeld, first defines the airline industry in its pre-regulated form. Then he goes into the ramifications and results of deregulating the industry, both in regards to the consumer, and in deregulation's impact on the airlines themselves.

"The most dramatic consequence of the pressures and turbulence of airline deregulation has been the unprecedented proliferation of airline bankruptcies," Von Kornfeld informs.

"Prior to the deregulation of the U.S. airline industry in 1978, U.S. air carriers operated in a business environment that was insulated from the normal stresses and strains of open competition. They were restricted from actively competing with fares and routings by the Civil Aeronautics Board (CAB)," Von Kornfeld says.

In leveling the playing field, Von Kornfeld offers, "Each carrier was restricted to specific geographic routes, with those routes limited to two or three competing carriers.

The only thing that set carriers apart in this CAB defined atmosphere was their ability to either advertise, or to enhance their level of service; or both. "... ultimately paid for by the passenger through fare increases sanctioned by the CAB," Von Kornfeld states.

"Airline service standards were unquestionably superior during the regulated environment," Von Kornfeld renders an interesting observation.

He does mention, however, that carrier safety was also considered a concern immediately prior to, and then after deregulation. "The major controversy focused on the allegation that safety and maintenance standards would be compromised due to the financial pressures brought about by an openly competitive environment," Von Kornfeld says.

Pricing, as well as labor unions are important factors in the equation, and Von Kornfeld addresses their relevance in the deregulated environment.

"The primary rationalization for deregulation was to facilitate a more openly competitive environment. The increased competition was to ultimately have benefitted the consumer. Ironically, that's not entirely the case, Von Kornfeld elaborates.

In addressing some of the negative aspects of airline deregulation, Von Kornfeld suggests that some sort of federal re-regulation may be in order.

## **Keywords**

Joseph C. Von Kornfeld, Anarchy In The Airways, Deregulation, Airline industry, Civil Aeronautics Board (CAB), Pricing, Unions, Airline safety

# Anarchy In The Airways

by

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*Deregulation of the airline industry has brought about financial vulnerability for the traveling public. The author analyzes the situation since that point in time and makes recommendations for some solutions.*

Prior to the deregulation of the U.S. airline industry in 1978, U.S. air carriers operated in a business environment that was insulated from the normal stresses and strains of open competition. They were restricted from actively competing with fares and routings by the Civil Aeronautics Board (CAB). Any variation of the standard determinants of growth and profitability, such as capitalization, equipment utilization, cost controls, and productivity, had minimal impact in enhancing one carrier's position over another. Each carrier was restricted to specific geographic routes, usually limited to two or three competing carriers. The dominant carriers with larger fleets were effectively prohibited from expanding their route structure and encroaching on the markets of existing competitors.

Considering that all fares were identical within the specified protected route structures of the individual carriers, the marketing strategy that could be employed in order to increase market share was essentially limited to two costly methods. The first was extravagant advertising and promotional campaigns among the competing carriers, with the primary benefactor being the advertising agencies. The other was product variation and enhancement. Both factors had a significant and tangible impact upon a carrier's reputation and identity within the marketplace, although ultimately paid for by the passenger through fare increases sanctioned by the CAB.

Airline service standards were unquestionably superior during the regulated environment; for example; food service was far more lavish and appealing due to the diversity of menu planning and a higher standard of quality in both preparation and presentation. There was ample comfort for passengers. This usually meant fewer available seats per aircraft which warranted an increase in the frequency of service, which, in turn, meant fewer passengers per plane. All of these factors contributed to high operating costs, with little incentive for cost containment. Any increases in operating costs were usually negated by routinely applying for fare increases by documenting the increased costs to the CAB, which in most cases was found to be justified. Additionally, management had little incentive to contain labor costs as increased payroll expen-

ditures also contributed to the justification for increased fares by the CAB. This scenario perpetuated itself for decades and is the primary reason why the airline industry has traditionally offered extravagant salaries and very lucrative fringe benefits.

With deregulation on the horizon in the mid '70s, the larger carriers were for the most part in favor of it, and the smaller carriers were opposed. The major controversy focused on the allegation that safety and maintenance standards would be compromised due to the financial pressures brought about by an openly competitive environment. The recent increase in accidents and fatalities has revived this controversy and has facilitated additional concern and support regarding this allegation.

The deregulation of the airline industry occurred in phases starting in 1978 with the substantial expansion of the route structures of the existing carriers; subsequently, a laissez-faire pricing structure evolved. The final phase of deregulation culminated with the complete abolition of the CAB on December 31, 1984. Another significant factor during the transition period was the entry of a multitude of new carriers into the marketplace. Initially, the existing carriers weren't concerned, as they were in a far better position in terms of capitalization, expertise, and identity.

However, there was a revolutionary change in the marketing strategies that could now be employed by the various air carriers. Airlines traditionally had two strategic options. First, they could compete in terms of product variation and enhancement and with advertising and promotional campaigns. Second, price and routes had become unprecedented and effective variants of the marketing options available. For the first time, the airlines were exposed to open competition which translated into survival of the fittest.

The new carriers entering the marketplace had one primary competitive advantage: far lower labor costs. The new carriers were non-union; therefore, management had absolute discretion in setting salary scales and fringe benefits. Additionally, the management philosophy of the new carriers stressed cross-training and utilization of personnel, which ensured higher productivity. In contrast, the traditional carriers were compelled to deal with as many as six different labor unions per airline. They were confronted with unproductive and archaic work rules, and with militant employees who had substantial seniority with greater allegiance to their respective unions rather than to the companies that employed them. The dichotomy of the methods of management between the old and new carriers contributed to a more fiercely competitive environment. Something had to give, and the passenger was caught in the crosswind.

### **The Passenger Is The Creditor**

In this credit-oriented economy, the provider of goods and services is usually perceived as the creditor. Whether for the purchase of a set of luggage, for checking into a hotel, or for obtaining a meal in a restaurant, the consumer has the goods conveyed to his possession or the services rendered, and only then, through either a formal credit contract or by custom, is payment made.

The purchase of an airline ticket provides an unconventional perspective. If viewed objectively, a passenger is required to pay for passage in full prior to embarkation by cash, check, or credit card. The airline will then issue a ticket, usually agreeing to provide passage on a specified future date. If the ticket is not purchased in advance, it is highly unlikely that the desired flight will be available. This procedure renders the passenger financially vulnerable for a loss in the event that an air carrier cannot provide for the agreed passage or for a refund of the amount rendered.

Compounding the financial vulnerability of the airline passenger still further is the advance purchase requirement in order to qualify for discount fares. This type of promotional fare, sometimes referred to as "Super-Saver" or "Ultra-Saver," requires the passenger to purchase the ticket prior to departure in order to qualify for a significant discount. The advance purchase requirement usually ranges from three to 30 days. Lately, however, the trend has been toward the 30-day requirement.

The availability of advance purchase discount seats is restricted in yet another manner, through controlled capacity. This concept means that the airlines allocate a specific block of seats for a specific promotional fare on designated flights correlated with internal load factor statistical data. The reality of this practice usually requires the passenger to purchase his Super-Saver ticket as much as 60 days in advance in order to qualify for a seat on a flight of his or her choosing. It is interesting to note that an airline is not required to disclose how many, or if any, discount seats were allocated for a particular flight.

Another factor to consider is that in the event a passenger secures a seat on a Super-Saver fare basis, he or she is usually subject to a 25 or 50 percent penalty factor if he/she should change an itinerary or cancel a reservation due to unforeseen circumstances. If the trend continues, it is highly probable that some air carriers will require the forfeiture of the entire fare in the event of a cancellation. Conversely, if an air carrier cannot accommodate a passenger with a confirmed reservation due to a flight cancellation, there is no regulatory remedy available to the passenger. Flight cancellations can be attributed to inadequate crew staffing, mechanical problems, equipment shortages, or inclement weather.

### **Passengers Incur Expenses**

In many cases, passengers left stranded due to flight cancellations incur increased travel expenses for hotel accommodations, meals, and/or alternate transportation. The inconvenience and expense of being stranded can also be attributed to missed connections due to numerous factors. There is no regulatory remedy available to the passenger once again. These stranded passenger scenarios are not to be confused with those passengers who are denied boarding due to the overbooking of a particular flight. In this case there is a regulatory remedy known as the Denied Boarding Compensation Act, previously enforced by the CAB and now under the purview of the Department of Transportation. Needless to say, this paradox in cancellation policies places the passenger in an inequitable, precarious, and uncompromising situation which is inconsistent with most consumer transactions.

Prior to deregulation, if a passenger could not be accommodated due to a cancelled flight or missed connection, most air carriers would provide alternate transportation, hotel accommodations, and meals. This was a customary practice in order to retain the goodwill of the passenger and to protect the reputation of the airline. Additionally, prior to deregulation, the CAB would not permit fare structures to be established on a controlled capacity basis, as they could be perceived as loss leaders which could contribute to "bait and switch" activities. The airlines were also prohibited from imposing penalty factors due to cancellations.

Management's rationale for the pricing structure of advance purchase (Super-Saver) fares has a two-fold approach. From a marketing point of view, the advance purchase requirement and other restrictions make the fare inconvenient and inaccessible for the committed (business traveler) segment of the market; at the same time, it stimulates demand from the discretionary (pleasure traveler) segment of the marketplace which tends to be price sensitive. Secondly, from a financial point of view, this pricing strategy obviously enhances the cash flow position of any carrier receiving revenue for services which aren't required to be provided until some distant point in the future.

Recent promotional trends indicate that some carriers are engaging in highly imprudent pricing practices. As an example, if a ticket is purchased at present at the regular rate, the passenger is then eligible to purchase a ticket on a 2-for-1 basis at some distant date which can be as much as six months in the future. Another unorthodox advance purchase promotion encourages buying four tickets to a specific destination and receiving four more at no cost. These practices can and should be viewed as a distress sale, indicating a severe cash flow problem.

### **Airline Casualties Increase**

The most dramatic consequence of the pressures and turbulence of airline deregulation has been the unprecedented proliferation of airline bankruptcies.

Since the Airline Deregulation Act was implemented in 1978, 53 scheduled air carriers have filed for bankruptcy protection under Chapter 11. Table 1 illustrates the names of the scheduled air carriers and the years in which they filed for bankruptcy. Some of the carriers may not be familiar, as they operated as regional or feeder carriers with routings confined to specific geographic regions of the country.

The primary rationalization for deregulation was to facilitate a more openly competitive environment. The increased competition was to ultimately have benefitted the consumer. Ironically, however, the Department of Justice's Anti-Trust Division has radically changed its policies by approving airline mergers and take-overs in an unprecedented manner, which ultimately can and will minimize competition. This revolutionary change in policy was necessitated in order to minimize the prospect of additional airline bankruptcies. It is entirely possible that within the next two to three years there may be only seven or eight major trunk carriers.

Table 1 clearly demonstrates the financial vulnerability of the travel-

**Table 1**

The following scheduled air carriers filed for bankruptcy protection since the inception of the Airline Deregulation Act of 1978:

	<b>1979</b>	
Aeroamerica		American Central
*Mackey International		*New York Airways
	<b>1980</b>	
Florida Airlines		Indiana Airways
	<b>1981</b>	
Air Bahia		Apollo Airways (later
Coral Air		Pacific Coast Airlines)
Golden Gate Airlines		*LANICA
Mountain West Airlines		Tejas Airlines
	<b>1982</b>	
Aero Virgin Islands		AeroSun International
Air North		Air Pennsylvania
Air South		Altair Airlines
Astec Air East		*Braniff International
Cochise Airlines		North American Airlines
Silver State Airlines		Swift Aire Lines
Will's Airlines		
	<b>1983</b>	
*Continental Airlines		Golden West Airlines
Inland Empire Airlines		National Florida Airlines
State Airlines		
	<b>1984</b>	
*Air Florida		Air Illinois
Air Vermont		American International
Atlantic Gulf		Combs Airways
Dolphin Airways		Emerald
Excellair		Hammond's Commuter Air Service
New York Helicopter		Oceanair Line
Pacific Air East		Pacific Express
Wien Airlines		Wright Airlines
	<b>1985</b>	
Northeastern International		*Provincetown-Boston Airlines
	<b>1986</b>	
Pride Air		Air Hawaii
		*Frontier Airlines

\* Designates air carriers in operation prior to the deregulation act of 1978.

ing public. Exact losses quotable in dollars would be extremely difficult to ascertain, as the bankruptcy proceedings were held in a variety of federal bankruptcy court jurisdictions, and many prospective passengers have never filed a creditor's claim. It is also important to note that in the case where a passenger has filed a claim, indemnification would be highly unlikely, as the unaccommodated passenger would be deemed to be an unsecured creditor, placing him or her in a low priority status. Preference in the liquidation of the assets of a bankrupt company would

be prioritized by taxes owed to federal and state authorities, employee payroll obligations, secured creditors such as the providers of equipment and facilities, and unsecured creditors such as unaccommodated passengers, respectively.

In the past, commercial aviation was under the strict regulation of the federal government. Jurisdiction was shared by the Federal Aviation Administration (FAA) and the Civil Aeronautics Board (CAB). The FAA is still intact, providing safety and technical oversight; however, since the demise of the CAB, there has been a complete regulatory void, leaving the traveling public totally exposed to deceptive trade practices, inferior service standards, and financial vulnerability. The Department of Transportation has inherited some of the jurisdictional responsibility from the CAB, but has demonstrated little concern in protecting the public interest. Most of the transgressions and inequities would not be tolerated within the customary consumer environment existing under regulatory laws of the various states. Historically, however, there has never been a need for state intervention or regulation except in the matter of intrastate air routes, so a void exists here as well.

It is obvious that some sort of modified re-regulation is justified in order to at least protect the financial interests of the traveling public. The CAB had provided stability and financial solvency to the airways, and since its demise there have been phenomenal losses to both the consumers and the airline industry, which have contributed to anarchy in the airways.

#### **Legislative Remedies May Be In Order**

One would assume that purchasing a cruise ticket for passage on a foreign flag cruise line would place the prospective passenger at far greater financial risk, considering that the average cost of a seven-day cruise is \$1,500 per person. In most instances, a minimum of two people travel together, which would amount to a cash outlay of \$3,000. Additionally, most cruise passengers will book space far in advance, usually three to four months. This is a comparable situation to that of the airline passenger, whereby the passenger is the creditor and any number of unforeseen circumstances could place the prospective passengers' funds in jeopardy. Situations could arise, such as damage to or the loss of a ship, labor disputes, or international political turmoil, as well as a declaration of bankruptcy. Any prospect of legal restitution would be further complicated and expensive by virtue of having to deal with various ramifications of international and admiralty law.

The reality of this cruise/airline passenger analogy is quite the contrary, due primarily to the fact that the Federal Maritime Commission (FMC) requires that any passenger vessel embarking from a U.S. port must file a certificate of financial responsibility to provide for the indemnification of passengers in the event of non-performance of transportation. This performance or surety bond is required pursuant to Sub-Part A, Part 540, Title 46 of the United States Code of Federal Regulation.

Taking this pertinent precedent provided by the regulatory policy of the FMC into consideration, a legislative remedy is obviously called for in order to provide comparable financial protection to the airline



passenger, under the auspices of the Department of Transportation.

It would also be in the best interests of the various scheduled air carriers to post a surety bond in order to facilitate the restoration of the public's confidence in commercial aviation.

Until the time comes that some sort of modified re-regulation is enacted, it might be in the best interest of the airline passenger to ascertain the financial solvency of the prospective air carrier with his stockbroker prior to placing his reservation with the airline.