Dēmos

EFFECTIVE REGULATION FOR THE 21ST CENTURY
REPORT SERIES

FLYING BLIND

Airline Deregulation Reconsidered

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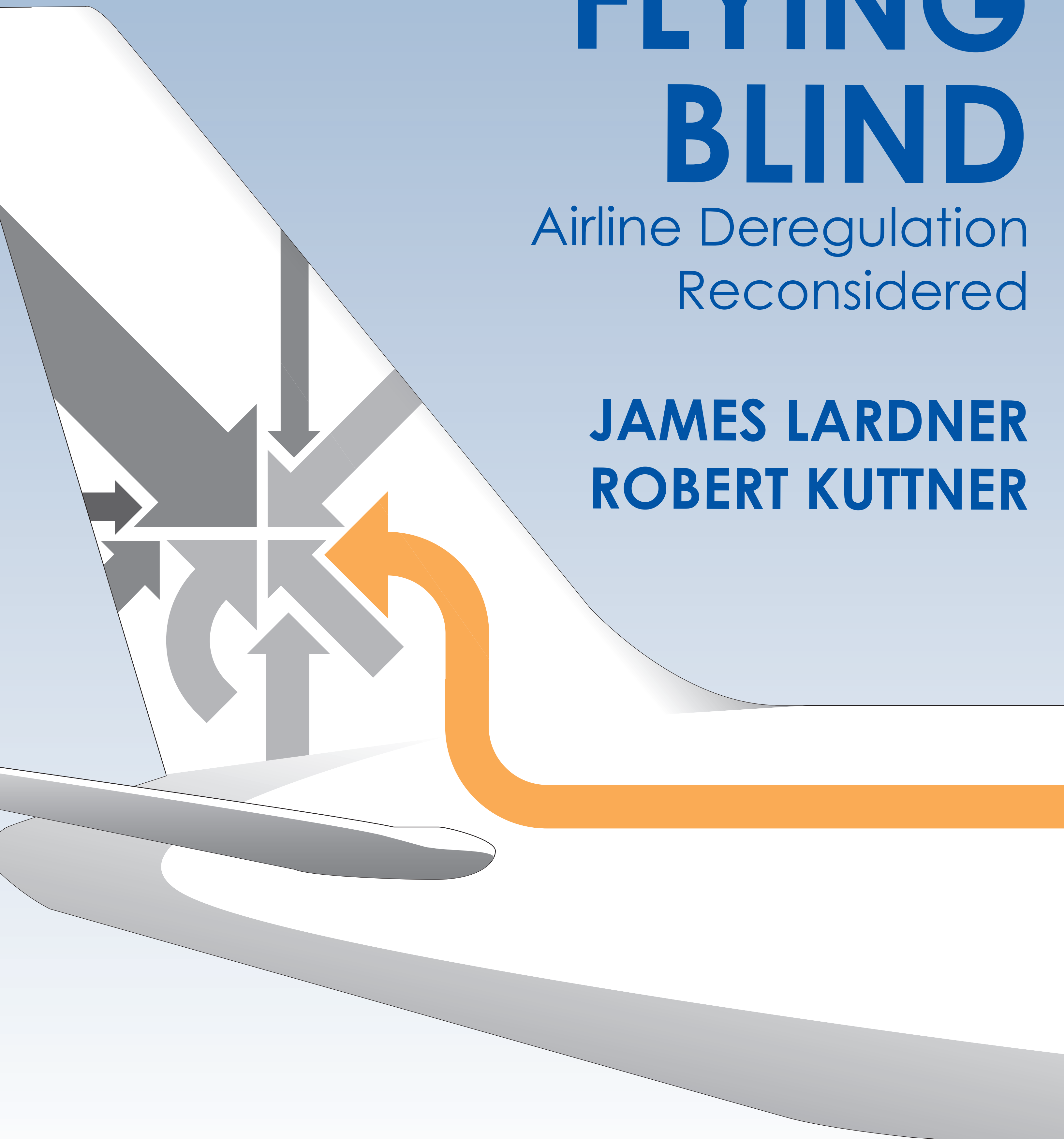

ABOUT DĒMOS

Dēmos is a non-partisan public policy research and advocacy organization. Headquartered in New York City, Dēmos works with advocates and policymakers around the country in pursuit of four overarching goals: a more equitable economy; a vibrant and inclusive democracy; an empowered public sector that works for the common good; and responsible U.S. engagement in an interdependent world.

Dēmos was founded in 2000.

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EXECUTIVE
SUMMARY

The February 2009 crash of a Continental/Colgan flight heading into Buffalo, New York called America's attention to the deeply troubled state of the airline industry. Since 2000, U.S. airlines have reported net losses of more than $33 billion—almost twice their accumulated profits from 1938 to 1999. Eleven domestic airlines filed for bankruptcy protection in 2008 alone; nine shut down altogether. The surviving companies have been on a cost-cutting tear, with some resorting to steps that (despite protestations to the contrary) clearly threaten passenger safety.

Preliminary findings in the Buffalo investigation suggest that the pilot and copilot lacked crucial experience and training; they may have been operating on insufficient sleep as well. Since the crash, critics have raised troublesome questions about the little-known regional airlines that now handle a growing proportion of domestic flights, effectively acting as subcontractors to the big brand-name airlines. The major carriers have been faulted for farming out more and more flights to these smaller companies, which, in many cases, appear to have significantly less rigorous hiring and training standards.

In ***Flying Blind: Airline Deregulation Reconsidered***, a wide-ranging new Dēmos report on the industry, co-authors James Lardner and Robert Kuttner point out that regional carriers now account for roughly 35 percent of all flight hours, more than double the 16 percent share that these companies held at the beginning of the decade. At that time, the report shows, two-thirds of all heavy aircraft maintenance was performed in-house, while today more than 70 percent of the work is outsourced, leaving federal inspectors scrambling to keep up with nearly 5,000 repair facilities in the U.S. and abroad.

The report links these practices to a broader "race to the bottom" on service standards and labor practices. While many industry leaders blame the airlines' difficulties on the price of fuel and the current economic crisis, ***Flying Blind*** uncovers a three-decade-long pattern of declining profitability and rising instability. The industry ran up huge losses in the early 1980s and again in the early 1990s, and, the authors note, "each of those periods, too, was marked by a wave of bankruptcies and layoffs. The economic downturn of 2000 and 2001 sent the airline industry into another tailspin, with nine airlines filing for bankruptcy *before* September 11."

STATISTICAL HIGHLIGHTS:

- Out of roughly 150 low-cost airlines founded since 1978, **fewer than a dozen are still operating**; they account for only about 10 percent of current airline capacity.
- Before deregulation, there were 11 major trunkline carriers; today, the country has six large mainline carriers—American, United, Delta, Continental, US Airways, and Southwest. The first **three, along with their regional partners, control two-thirds of domestic air travel**.
- **More than 100,000** pilots, mechanics, flight attendants, ticket agents, cargo handlers and other airline workers have **lost their jobs since 2001**.
- The number of **people on the payroll of the legacy airlines dropped 26 percent** between 1998 and 2006.
- DOT Data for US Airways, United, Delta, American and Northwest show **labor costs falling by nearly a third**, on average, between the end of 2001 and the beginning of 2006.
- According to the U.S. DOT, 2008 total **baggage-fee charges by U.S Airlines came to more than $1.1 billion**—a figure that is expected to triple by 2010.
- In 2007, **more than a quarter of all flights were delayed**, accounting for 112 million lost passenger hours.
- **More than 100 communities have lost air service** over the past decade.

The report traces the industry's current troubles back to the decision, three decades ago, to lift most federal regulation of air travel. "Deregulation was supposed to lead to a dramatically expanded universe of airlines—companies big and small, old and new, competing and innovating for the public benefit," the authors write. Instead, "Today's industry is more concentrated than ever, yet lacks the resources and motivation to make crucial investments in equipment, technology, and human capital. And most of the major U.S. airlines appear to have no long-term strategy except more of the same—more outsourcing, more service cutbacks and hidden charges, more wage and benefit reductions, and more consolidation in the hope of surviving long enough to be in a position to turn a profit and expand again during a future economic recovery."

Even many of the original champions of deregulation have acknowledged their failure to anticipate some of the key results. By the late 1980s, the economist Alfred Kahn, who has been called the "father of airline deregulation," was writing: "I should have recognized that the naturally monopolistic or oligopolistic character of most airline markets…would continue—indeed expand—under deregulation."

Kahn and others have taken refuge in the argument that deregulation has produced lower airfares and wider access to air travel. The Dēmos report concludes that even this benefit is widely overstated. "While the price of flying has come down over the past thirty years," the report notes, "it decreased at a comparable rate from the 1940s through the 1960s. In any event, low airfares are as much a problem as an achievement if they leave an industry without the resources to maintain service standards and make crucial investments in equipment, technology, and human capital."

POLICY RECOMMENDATIONS FOR REGULATORY REFORM

The authors call on Congress and the relevant executive agencies to make a thorough study of the airline industry. **They recommend creation of a federal task force to examine the industry's problems and propose solutions.** Specifically, they call on the task force to:

- Develop a plan to moderate the booms and busts and build a more stable domestic airline industry. Here, the remedies could include capital-reserve requirements and bankruptcy reform.
- Expedite (and establish stable financing for) a modernized Air Traffic Control (ATC) network.
- Develop coordinated national and regional transportation plans, with provision for high speed rail networks to eliminate the need for excessive short-haul air traffic.
- Devise a code of customer service that would, among other things, protect passengers from wildly varying prices and establish more uniform procedures for ensuring remuneration and rebooking when a flight is delayed or cancelled.
- Promote more equitable and stable labor practices and return to the pre-deregulation practice of pattern bargaining in order to discourage airline competition based on low wages and high-pressure working conditions.
- Insist on uniform airline safety standards, including mechanic credentials and oversight of maintenance facilities.
- Develop new regulations to curtail airline consolidation and promote genuine competition where feasible, while, at the same time, cracking down on monopoly pricing and the other abuses of concentration on routes that are incapable of supporting more than one or two carriers.

I. INTRODUCTION

"[I]f a farsighted capitalist had been present at Kitty Hawk, he would have done his successors a huge favor by shooting Orville down."
—Warren Buffett, 2007 annual letter to shareholders

Airline service is bad and getting worse, according to consumer surveys. And consumers don't know the worst of it. Delays, cancellations, over-stressed airports, a crazy quilt of airfares—these are only some of the more obvious problems of a chronically unprofitable and increasingly unstable industry.

America's airlines have lost more money in the first decade of the twenty-first century than they made in the entire second half of the twentieth century. It would be hard to name a line of business that has experienced more bankruptcies (11 in 2008 alone); and it would be hard to find a more demoralized workforce than the roughly half a million Americans currently employed as pilots, mechanics, flight attendants, ticket agents, cleaners, and bag throwers. (That is to say nothing of the well over 100,000 who have lost such jobs since 2001.) Many have taken painful pay and benefit cuts only to go through the process a second or third time.[1]

"We will never cut corners on safety"—so airline executives have long said. That claim is hard to reconcile with the February 2009 crash of Continental Connection Flight 3407 on its way into Buffalo, N.Y. While marketed by a well-known company, Continental, the flight was "operated by" a fairly obscure company, Colgan Air. The relatively inexperienced captain could not have qualified for a job at Continental itself; nor would a pilot earning a major-airline salary have been likely to sacrifice a good night's sleep, as this pilot evidently did, in order to save the cost of a motel room or an apartment share near his base at Newark International Airport.[2] Yet in addition to chipping away at the pay and benefits of its own employees, Continental, like most of the other top carriers, has been farming out short-haul traffic to partner airlines with much lower pay scales and hiring and training standards.

This increased reliance on regional airlines, which now handle half the domestic flights and a quarter of all U.S. passengers, is one of two clear ways in which the major airlines, seeking to economize, have put passengers at risk. The other great cause for concern is the outsourcing of maintenance. Airlines used to service their own planes as a matter of course; they did so at major hub airports, where federal inspectors were a regular presence and mechanics were licensed and carefully screened. Over the past decade, most of the airlines have been shifting maintenance to contract facilities with significantly looser standards and oversight, in many cases. The suddenness of this transition has overwhelmed the ability of the Federal Aviation Administration to monitor the quality of the work.[3]

The industry's troubles go well beyond the obvious; they also predate the obvious causes. With a few exceptions, U.S. airlines were no more than modestly profitable before the current economic crisis hit. Nor can their maladies be attributed to the terrorist attacks of September 2001, for all the additional economic damage they did. Most of this industry's problems can be traced back to the Airline Deregulation Act of 1978, and to the overconfidence of its architects—a group of elected officials and academics, liberal and conservative, who exulted in pointing out the deficiencies of the old regulatory regime but were oddly blind to the hazards of the free-for-all environment they created in its place.

DEREGULATION WAS PROMOTED AS A WAY OF ENHANCING CONSUMER CHOICE AND INDUSTRY EFFICIENCY. OVER TIME, IT HAS HAD THE OPPOSITE EFFECT.

Deregulation was promoted as a way of enhancing consumer choice and industry efficiency. Over time, it has had the opposite effect: service levels have deteriorated; mergers have curtailed choice on most routes; and most of the supposed efficiency gains to the air carriers have been the result of one thing—reduced wages, employment, and job security for airline workers. This is not efficiency in the normal sense of improved performance; it comes down to a simple squeezing of labor. Deregulation has allowed planes to fly fuller, which is a form of efficiency, since empty seats represent economic waste. But the carriers have taken this tactic too far, lowering comfort and safety levels and taking advantage of reduced capacity to over-charge those who need to change flights or make reservations on short notice.

With lower wages and increased market power, you might expect the airline business to be booming. But deregulation has been a big failure for the long term health of the industry as well. While the airlines have managed to stifle competition and boost fares on some routes, they have fallen into a pattern of recurring price wars on other routes, offering below-break-even fares in order to fill seats and hold market share. This trend of hyper-competition alongside price-gouging creates an unstable business model and removes the most reliable long-term source of improved efficiency and productivity—more modern and fuel-efficient planes. The airlines simply cannot afford to buy them.

Our conclusion is clear: **Deregulation has failed because air travel is not a naturally competitive business.** Defenders of deregulation fall back on one great claim—that it has lowered fares. They overstate the case. While the price of flying has come down over the past thirty years, it decreased at a comparable rate from the 1940s through the 1960s.[4] In any event, low airfares are as much a problem as an achievement if they leave an industry without the resources to maintain service standards and make crucial investments in equipment, technology, and human capital.

II. THE PUSH FOR DEREGULATION

"[T]his bill had few friends. I am happy to say that today it appears to have few enemies."
—President Jimmy Carter, Oct. 24, 1978[5]

Once in a long while, Congress passes a reform measure that is more ambitious than its supporters had dared imagine. The Airline Deregulation Act of 1978 was such a law, and the fortunes of the airline industry from then to now illustrate the perils of decision-making in a moment of sweeping consensus.

Since the early years of commercial flight, routes and fares had been set by the Civil Aeronautics Board, an agency known for its stately, courtroom-style deliberations—and for decisions that usually upheld the status quo in the end. The CAB was supposed to look out for the public interest (guaranteeing service to small cities, for example), and it had a mandate to help the airline industry grow and innovate. Over the years, however, the agency had come to be seen as the protector of the established airlines, insulating them from competition and assuring them of a set rate of return, much as the Pentagon did with military contractors.

Legally, the CAB had the power to invite newcomers into the fold; in practice, it found reasons not to. Since 1950, the board had heard, and rejected, scores of applications from new carriers looking for permission to compete on established routes. Reduced in number by several mergers, the major airlines of the 1970s were the same companies that had dominated the business in the 1930s at the time of the CAB's creation. Several of the very biggest went all the way back to the awarding of U.S. airmail contracts in the 1920s.[6]

Presidents from Eisenhower to Johnson had leaned on the airlines (and the CAB) to lower fares, bringing them within reach of the majority of Americans who had never flown. In the 1960s, with the CAB's encouragement, the airlines introduced a series of discount promotions—youth standby fares, family fares, Discover America fares, and so forth. But most of the discounts came to an end in the early 1970s. As the economy soured, the CAB approved major fare increases, hoping to shore up the industry against rising oil prices and the need to pay off a heavy load of debt incurred in over-optimistic purchases of wide-body jets.[7]

RAISING THE ALARM

Airline regulation had not changed much over the years. The political mood, however, had shifted dramatically. America's faith in government had been shaken by Vietnam, Watergate, and a worsening economy—an economy characterized by the vexing combination of high unemployment and high inflation at the same time. Business leaders and lobbyists blamed both problems on increased regulation. Democrats as well as Republicans listened sympathetically.

In 1974 and 1975, Sen. Edward Kennedy presided over a series of hearings on regulation, with future Supreme Court Justice Stephen Breyer as his chief counsel. Kennedy and Breyer chose to make the airline industry their Exhibit A. Most of the recent wave of regulation had been in the areas of health, safety, and environmental protection; that kind of regulation, however, commanded wide popular support. It was harder to understand the need for a government agency to decide which airlines could fly where, and how much they could charge.

It was very hard to understand why they charged so *much*. To fly from Boston to Washington, for example, someone had to pay a minimum at the time of $41.67; yet a flight of the same distance from Los Angeles to San Francisco cost only $18.75. What accounted for this steep difference? Between Boston and Washington, Kennedy would be traveling on Eastern Airlines or another CAB-regulated carrier; the L.A. to S.F. service was provided by Pacific Southwest Airlines, which, because it operated only in the state of California, was not subject to CAB rules.[8]

PSA and a Texas airline, Southwest, represented an alternate universe of air travel. The national airlines tended to focus on business executives and wealthy vacationers, showering them with fancy food and drink and other comforts. The intrastate carriers catered to the middle-class masses. They packed more seats into their planes, and worked harder to fill their seats. While PSA and Southwest operated at about 60 percent of capacity, the big airlines had wide-bodies flying around the country half or two-thirds empty; and instead of trying to expand the customer base, they intensified their courtship of the affluent by outfitting planes with bars, lounges, and even live entertainment. (When American Airlines put pianos in some of its first class lounges, TWA responded by installing electronic draw-poker machines.[9]) The CAB, for its part, seemed more concerned with protecting one airline from another than with the public interest in affordable air travel. Sometimes, a flight would pass through a city but (in obedience to a CAB "closed door" rule) refuse to accept passengers there.[10]

BY THE LATE 1970S, THE ACADEMIC AND THINK-TANK WORLDS WERE CHURNING OUT REPORTS ON THE DANGERS OF EXCESSIVE REGULATION. ONE RESPECTED ECONOMIST WENT AS FAR AS TO CLAIM, WITH LITTLE EVIDENCE, THAT SEATBELTS AND AUTO SAFETY STANDARDS HAD MADE CARS MORE DANGEROUS BY ENCOURAGING PEOPLE TO DRIVE RECKLESSLY.

KAHN'S CRUSADE

Picking up where Kennedy left off, Jimmy Carter made heavy-handed regulation a theme of his 1976 presidential campaign. Once in office, he, too, zeroed in on the airlines, naming a trenchant academic critic of regulation, the economist Alfred Kahn, to head his regulatory reform effort and chair the CAB while he was at it.

Originally, neither Carter nor Kahn expected to be able to take government completely out of the business of setting routes and fares. But they under-estimated the growing appeal of their cause. By the late 1970s, the academic and think-tank worlds were churning out reports on the dangers of excessive regulation. One respected economist went as far as to claim, with little evidence, that seatbelts and auto safety standards had made cars *more* dangerous by encouraging people to drive recklessly.[11] Even mainstream scholars like Breyer and Kahn (both wrote influential books on the topic) seemed to suggest that regulation usually cost more than it was worth and frequently produced effects opposite to those intended.[12]

The word "deregulation," rarely heard before 1976, turned up in the headlines of 35 *New York Times* stories that year. In May of 1977, a feature story in *US News and World Report* painted a frightening picture of armies of federal regulators handing down rules that affected "the food people eat, the cars they drive, the fuel they use, the clothes they wear, the houses they live in, the investments they make, the water they drink and even the air they breathe."[13]

Kahn himself played a part in this attitude shift. Erudite and charming, he won many converts on Capitol Hill and in the media. The *The New York Times*, the *Washington Post*, the *Wall Street Journal,* and *Fortune* all carried laudatory articles on Kahn and his efforts to liberalize the CAB. He was a hit on the *McNeil-Lehrer Report* and William F. Buckley's *Firing Line*. "Maybe I should throw up my present job," Kahn jokingly told a friend, "and do what I really would love to do—play musical comedy on whatever stage will accept me."[14]

WHILE MUCH OF THE ANTI-REGULATORY AGITATION CAME FROM A RESURGENT CONSERVATIVE MOVEMENT, LIBERALS AND CONSUMER ADVOCATES ALSO TOOK AIM AT FEDERAL AGENCIES THAT HAD BEEN "CAPTURED" BY THE INDUSTRIES THEY WERE SUPPOSED TO OVERSEE.

While much of the anti-regulatory agitation came from a resurgent conservative movement, liberals and consumer advocates also took aim at federal agencies that had been "captured" by the industries they were supposed to oversee. Some commentators saw this phenomenon of regulatory capture as almost inevitable. A few, echoing the Right, argued that consumers would be better off in a world of unfettered competition than in one of corrupt regulation.

FROM REFORM TO DEREGULATION

By the fall of 1978, when Congress took up the airline issue, much of the initial opposition had melted away. United, the nation's biggest airline, broke industry ranks to support a bill championed by Sens. Kennedy and Nevada Democrat Howard Cannon. (Perhaps United's executives foresaw ways for the biggest carriers to grow even bigger in a looser regulatory environment.) Rural America's concerns were soothed by an agreement to subsidize existing routes for another decade.[15]

WHAT PRESIDENT CARTER HAD ORIGINALLY DESCRIBED AS A "REGULATORY REFORM" BILL ENDED UP AS UNABASHED "DEREGULATION [OF THE AIRLINE INDUSTRY]"

Only the airline unions remained flatly opposed. And the unions found themselves increasingly isolated—powerless to halt what *Fortune* magazine called "an odd coalition of academic economists, Naderite consumerists, liberal Democrats, and conservative Republicans."[16] And so, what President Carter had originally described as a "regulatory reform" bill ended up as unabashed "deregulation"—a measure that lifted all fare rules; opened the skies to new carriers; decreed "automatic entry" onto established routes; and, in a provision added late in the legislative process, called for the CAB itself to be phased out of existence.

III. DEREGULATION IN THEORY AND PRACTICE

"I should have recognized that the naturally monopolistic or oligopolistic character of most airline markets...would continue—indeed expand—under deregulation."
—Alfred Kahn, 1988[17]

People Express—no company's rise so powerfully evokes the early excitement of airline deregulation; no company's fall so fully captures the disappointing later trajectory of the story. People Express began operations in March 1981 with three recycled Boeing 737s and a Quonset-hut terminal at Newark Airport. There were no tickets; you reserved a seat by phone and paid on the plane. You paid $3 more for each checked bag, and (at the passenger's discretion) $2 for a "snak-pak" of cheese, crackers and salami. Everything extra cost extra on People Express.

And every element of the business plan seemed to point toward the goal of saving money. While most airlines timed flights for the convenience of passengers, People Express's schedule was designed to put its aircraft to maximum use. The company worked its people as hard as its planes. Flight attendants doubled as counter clerks. The cockpit crew occasionally hoisted baggage. Salaries were about half those of the legacy airlines; but an employee stock ownership plan offered the promise of long-term reward for short-term sacrifice.[18]

Thanks to all these economies, People Express managed to bring the cost of flying from an industry average of 8 cents per seat-mile down to 5 cents per seat-mile. On its inaugural run from Newark to Buffalo, the company turned a profit charging $38 for a peak fare and $25 for off-peak—at a time when the least expensive alternative flight cost $99.[19]

THE FARE WARS

The People Express formula worked well on the initial routes—from Newark to Buffalo and then to Norfolk, Virginia, and Columbus, Ohio. But the magic lasted only as long as the company concentrated on short runs and out-of-the-way airports. As soon as it began to pose a serious threat to the established airlines, the fairy tale turned ugly.

In the summer of 1984, People Express invaded Minneapolis-St. Paul, a Northwest Airlines stronghold. Northwest responded by adding flights and dropping fares—from $263 all the way down to $94, which was $5 less than People Express was charging. Within a few months, People Express had abandoned Minneapolis-St. Paul. Soon after it did, Northwest's fares began to inch back up toward their former levels.

When People Express began flying into Chicago's O'Hare Airport, American Airlines took Northwest's strategy a devastating step further. Instead of lowering fares across the board, American discounted a carefully measured fraction of seats—just enough, it seemed, to make the route unprofitable for People Express. The company's ability to make such a determination rested on its pioneering computerized reservation system, or CRS. That technology would soon allow airlines (the ones that could afford it) to have many different prices for seats on the same flight, fine-tuning fares as a departure date approached in order to come as close as possible to the ideal of exactly filling the plane without offering any passenger a lower price than necessary. Yield management, American Airlines CEO Robert Crandall dubbed it.[20]

THE DINOSAURS EVOLVE

CRS technology could be used to manage yield. It could also be used (and at the same time) to undermine a smaller rival. An airline with a proprietary CRS network like American's SABRE (or United's APOLLO) gained the power to track the effects of price changes, compare its own bookings with those of competitors, and, in the words of Michael Levine, a CAB official who went on to serve as dean of the Yale School of Management, create "targeted incentive programs" that "temporarily distort signals the market sends to competitors, in order to persuade the rivals to abandon fares, schedules, or even routes where, absent these secret interventions, [their] offerings would be preferred by customers."[21]

Thus American, like People Express, could offer $99 tickets from the New York area to Los Angeles. But by getting business travelers and late bookers to pay far more, American pocketed an average of $250 per seat; and unlike the passengers on People Express, American's lucky $99 ticket-holders got free meals, free baggage handling, free coffee, and, above all, a reasonable degree of confidence, with a reservation, that there would be room on the plane. (This was a comfort that the computerless People Express was never able to offer. Some of its flights were overbooked by as much as 100 percent.)[22]

The big airlines were widely regarded as behemoths—"overweight, possibly arthritic, dinosaurs, threatened by nimble, lean, and aggressive new entrant carriers," in Levine's recollection. But some of the dinosaurs proved to be surprisingly adaptable, American Airlines first and foremost. By developing the industry's most sophisticated computerized reservation system, American gained a crucial advantage with travel agents. By 1983, American's SABRE was handling 27 percent of all travel agency bookings. By 1988, SABRE and United's APOLLO together controlled 70 percent of these sales.[23]

THE BIG AIRLINES WERE WIDELY REGARDED AS BEHEMOTHS...BUT SOME OF THE DINOSAURS PROVED TO BE SURPRISINGLY ADAPTABLE... BY DEVELOPING THE INDUSTRY'S MOST SOPHISTICATED COMPUTERIZED RESERVATION SYSTEM, AMERICAN GAINED A CRUCIAL ADVANTAGE WITH TRAVEL AGENTS.

American Airline's Crandall had been opposed to deregulation. Once it became a *fait accompli*, however, American introduced a series of innovations that other legacy carriers were quick to adopt, because they had the effect of making it harder for an interloper to break into the club. American established the first frequent flyer program, AAdvantage. This was a way for a large airline—with flights to Europe and the Caribbean—to win domestic and short-haul business from customers who might otherwise have gone with a low-cost carrier. Since few companies decided to claim their employees' frequent-flyer points, such plans had a corrupting effect on business travelers, encouraging them to spend more of their companies' money than necessary.

Crandall was also a trailblazer on the labor-relations front. In early 1983, after threatening to impose new work rules unilaterally, American convinced its unions to accept a lower salary scale for newly hired employees. The other airlines and their unions followed suit, and soon all the legacy carriers had "A" and "B" workers, with drastically different salaries and benefits, working side by side.[24]

HUB AND SPOKE

In response to the challenge posed by People Express and other low-cost airlines, the legacy carriers began moving away from point-to-point flights toward a hub-and-spoke model. This had arguable efficiency advantages, allowing an airline to serve more cities with fewer planes. But hub-and-spoke routing was also a way for the bigger airlines to consolidate their positions and pricing power at major airports (such as Chicago and Dallas-Fort Worth in American's case), turning them into operations centers and changeover points—or "fortress hubs," as they came to be known. That strength translated into an ability to charge higher fares, scare off potential competitors and cross-subsidize discounts on more competitive routes.

HUB-AND-SPOKE ROUTING WAS ALSO A WAY FOR THE BIGGER AIRLINES TO CONSOLIDATE THEIR POSITIONS AND PRICING POWER AT MAJOR AIRPORTS... [WHICH] TRANSLATED INTO AN ABILITY TO CHARGE HIGHER FARES, SCARE OFF POTENTIAL COMPETITORS AND CROSS-SUBSIDIZE DISCOUNTS ON MORE COMPETITIVE ROUTES.

The phenomenon of airport dominance became the topic of several articles by pro-deregulation economists. They took the position that it was nothing to worry about as long as the *potential* for competition remained. "It is the threat of entry," Kahn testified before a congressional committee in 1977, "that will hold excessive price increases in check." But this "theory of contestability," as it came to be known, held up far better in theory than it did in life. Studies would show airlines charging 20 to 50 percent more on routes where they faced little competition.[25]

Under the terms of the Airline Deregulation Act, permission for an airline to begin flying on a new route was supposed to be "automatic." Saying so, however, did not make it so. Often, all the gates at an airport would be tied up in exclusive long-term leases with existing carriers.[26] In any case, the assignment of gates generally fell to local airport boards or authorities, and they tended to give preferential treatment to airlines they were already doing business with.

"Slots" as well as gates could be a barrier to entry. In the name of safety, which had not been deregulated, the FAA limited access to LaGuardia, O'Hare, Washington National, and Kennedy airports by assigning take-off and landing slots. The Reagan administration decided to let the airlines treat slots as assets, buying, selling, leasing, trading, and even mortgaging them. This gave the established airlines an even greater advantage, since they got to decide whether to sell or lease slots to newcomers.[27]

Size mattered. Incumbency also mattered. Perhaps it was partly a growing recognition of these advantages that led People Express' founder and CEO Donald Burr into the frenzy of over-expansion that preceded his company's collapse. By the spring of 1984, People Express had 150 departures a day out of Newark—the most flights of any airline in the New York metropolitan area. The company was carrying passengers to and from Chicago, Detroit, San Francisco, and West Palm Beach. But it was losing money on many of its new routes, and its share price had begun to fall as investors, initially dazzled, lost faith.[28] Burr's response was to bet the bank on a merger with a bigger airline, Frontier, which was losing even more money than People Express. He thus gained the empty honor of running the country's fifth largest airline company for the last few sputtering months before both operations were forced to shut down in the summer of 1986.[29]

THE BIG GET BIGGER

Burr was faulted for being long on vision and short on management skills. His lean corporate structure, critics said, was woefully inadequate for the big national airline that the company became. Indeed, Burr's notion of "cross-utilizing" personnel meant that People Express never had the kind of marketing and computer expertise that it would have needed to compete with the likes of America, Delta, and United.[30]

It would be wrong, industry observers said at the time, to interpret People Express's demise as a judgment on deregulation or as a sign that other low-cost airlines were doomed to fail.[31]Yet, one after another, they did fail. Midway Airlines, New York Air, Jet America, Muse Air, Pacific Express, Northeastern International, Hawaii Express, Best Airlines, Sunworld, Air One, Regent Air, Frontier Horizon, Air Atlanta, Florida Express, Presidential Air—these were just some of the companies that rose and fell during the 1980s. Most ceased operations within a few years. Two decades later, only one, America West, is still in business, now under the name US Airways, courtesy of a merger between the companies in 2005.[32]

MEANWHILE, AGAINST THE EXPECTATIONS OF THE DEREGULATORS, THE BIGGEST AIRLINES GREW MORE DOMINANT AT KEY AIRPORTS AROUND THE COUNTRY. THE TOP FOUR INCREASED THEIR COMBINED SHARE OF THE DOMESTIC MARKET FROM 42 PERCENT IN 1985 TO 75 PERCENT IN 1989.

Meanwhile, against the expectations of the deregulators, the biggest airlines grew more dominant at key airports around the country. The top four increased their combined share of the domestic market from 42 percent in 1985 to 75 percent in 1989.[33] Between 1979 and 1987, Northwest's share of the flights at Minneapolis/St. Paul climbed from 45.9 percent to 81.6 percent. By 1985, American Airlines controlled 61.1 percent of the flights out of Dallas/Ft. Worth, and Continental was up to 57.6 percent in Houston. Similar trends were in evidence in Pittsburgh, St. Louis, Atlanta, Cincinnati, Detroit, Memphis, and Salt Lake City. By 1988, monopoly or duopoly situations (with one carrier controlling more than half the market or two together controlling more than 70 percent) existed at 15 of the nation's major airports.[34]

THE COLLAPSE OF ANTITRUST

Swept away by their prejudice against government, the deregulators had failed to take any steps to restrain the monopolistic tendencies of the airline market. Because the CAB was simply abolished rather than being reformed or replaced, there was no agency to keep close track of a series of new airline practices (frequent flyer plans, airline-owned reservation networks, financial and marketing links between legacy and commuter airlines, and others) that made it increasingly difficult for new or small carriers to compete.

One potential tool remained: antitrust law. The Justice Department could have brought a predatory-pricing case against one or more of the legacy airlines. Regardless of the outcome in the courts, such a lawsuit would have revealed some remarkably brazen anti-competitive behavior. An American Airline executive, looking back on the price wars of the early 1980s, praised one of his fellow-executives for dreaming up the "the price structure that drove People Express out of business."[35] Among the selectively targeted deep discounts of the late '80s were a few (according to the Wall Street Journal) that were coded "FU," apparently to drive home the message to competitors.[36]

The vision of the deregulators was one that cried out for effective antitrust enforcement. Yet neither the Justice Department nor the Department of Transportation raised the issue of predatory pricing. Nor, for a long time, did they question the frequent flyer plans, the airline-owned CRS networks, or the "code-sharing" and feeder-payment arrangements that gradually turned many small commuter airlines into marketing arms of the legacy carriers.

Nor did the government object when established carriers began to buy up pesky competitors. If there was a logical moment for Washington to take a stand against airline mergers, it came in January 1986, when Northwest announced plans to acquire Republic, then its leading competitor in Minneapolis-St. Paul.[37] Neither DOT nor DOJ protested, however, and the merger was finalized in October of that year. With its acquiescence to the Northwest-Republic deal, the government sent a signal that other airlines no longer had to worry. A wave of additional mergers followed, with Delta acquiring Western, TWA taking over Ozark, Texas Air buying up the remains of People Express as well as Frontier and Eastern, and US Airways buying the combined PSA/Piedmont.[38] The Department of Transportation, under the leadership of Elizabeth Dole from 1983 to 1987, received applications for 22 airline mergers, without objecting to a single one. Dole's successor, Samuel Skinner, went as far as to say that even if the industry got whittled down to three carriers, there would still be competition enough.[39]

THE VISION OF THE DEREGULATORS WAS ONE THAT CRIED OUT FOR EFFECTIVE ANTITRUST ENFORCEMENT.

IV. THE INDUSTRY TODAY

"[P]lease do not think I exaggerate when I say that I do not know a single professional airline pilot who wants his or her children to follow in their footsteps."
—US Airways pilot Chesley B. Sullenberger III, testifying before Congress, February 2009[40]

No event of recent decades has brought such swift and profound change to the airline business as the terrorist attacks of September 11, 2001. Grounded for nearly a week, planes resumed flying with sharply increased security measures and long delays, despite a dramatic falloff in business. Less than a month later, the airlines received a federal bailout of $5 billion in direct aid and $1.2 billion in loan guarantees.[41] The industry had just begun to recover when the current economic crisis hit, along with a 1970s-style jump in the price of fuel.

As bad as these blows may have been, though, the fortunes of the airline industry since 2001 basically reflect a continuation of trends that go back to the first decade of deregulation.

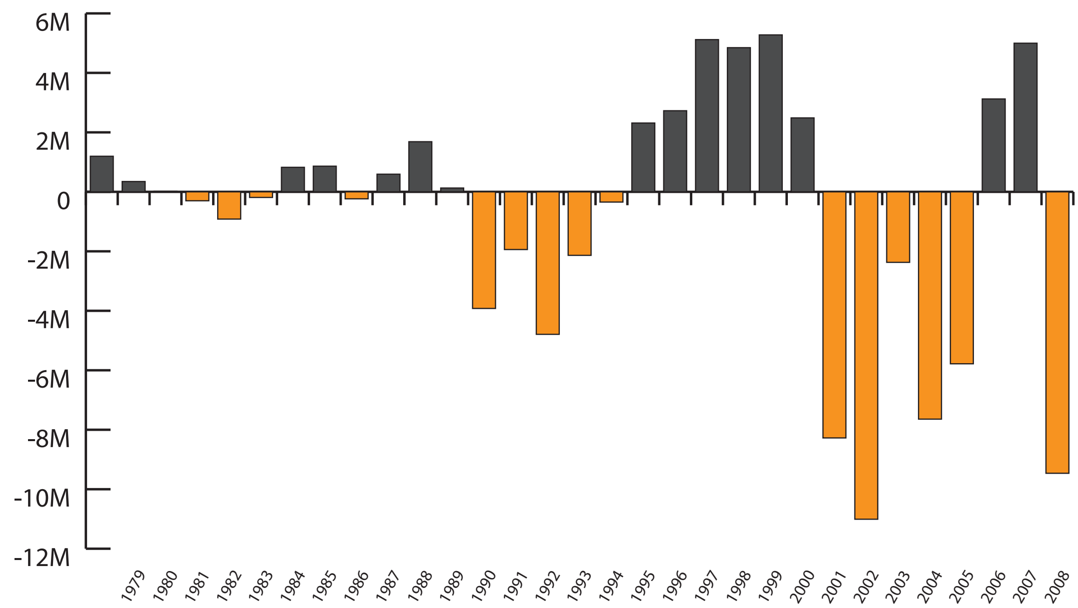
INCREASED INSTABILITY

Air travel has always been an industry of sharp ups and downs. Since deregulation, the downs have become increasingly severe, and the profits racked up in good times have no longer been sufficient to tide companies over the bad times (See Graphic A, this page). Most industries revolve around a core of reliably profitable companies. Among the major domestic airlines today, only Southwest fits that description. Otherwise, the deregulated airline industry has fallen into an oscillating pattern of modest profits in good years, followed by steep losses in bad years, despite the vast numbers of Americans who fly during economic downturns and upswings alike. Between 2000 and 2008, U.S. airlines reported net losses of over $33 billion—a sum that far exceeds their $17 billion in accumulated income between 1938 and 1999.[42]

While the impact of 9/11 was extreme, the industry ran up huge losses in the early 1980s and again in the early 1990s; each of those periods, too, was marked by a wave of bankruptcies and layoffs. The economic downturn of 2000 and 2001 sent the airline industry into another tailspin, with nine airlines filing for bankruptcy *before* September 11. Since then, bankruptcies have become almost routine: Between 2001 and 2005, fifteen airlines went bankrupt; they included four of the biggest filings ever—by Delta, United, Northwest, and US Airways. Hit especially hard by 9/11 because of its heavy volume of flights out of Reagan National Airport, US Airways filed for Chapter 11 protection in the fall of 2002, emerged from bankruptcy in March 2003, and re-filed in the fall of 2004. By 2005, more than half the industry's passenger capacity was in the hands of companies flying under Chapter 11 protection.[43]

BETWEEN 2000 AND 2008, U.S. AIRLINES REPORTED NET LOSSES OF OVER $33 BILLION—A SUM THAT FAR EXCEEDS THEIR $17 BILLION IN ACCUMULATED INCOME BETWEEN 1938 AND 1999.

Graphic A: Total Annual Net Income of the U.S. Airline Industry, 1979-2008



Source: Air Transport Association

CONTINUED CONSOLIDATION

Champions of deregulation insist that it has led to increased competition and choice. They reach this conclusion, however, by assigning equal weight to tiny and giant airlines, and ignoring the arrangements that have effectively turned many of the former into offshoots of the latter.[44]

Today's airlines are commonly divided into three categories: legacy, low-cost, and regional. Most of the industry's recent expansion has been among regional carriers, which are small companies flying small planes, mostly out of small airports.[45] Unlike the low-cost startups of the 1980s, these companies do not compete with the legacy airlines. For the most part, they effectively function as subcontractors of legacy airlines. Through a variety of financial and marketing arrangements, the regionals give the legacies a way to reach communities that would be economically difficult for them to serve directly.

Since 2001, the major airlines have redirected their energies toward longer and more profitable routes, letting their regional partners handle shorter flights, using planes with anywhere from 50 to 90 seats. The regionals now account for roughly 35 percent of the industry's flight-hours, more than double the 16 percent share that these companies held in 2000.[46] Many passengers, having purchased tickets from American, Delta, or United, never notice the small print telling them that one leg of a flight is "operated by" Chatauqua, Pinnacle, or GoJet.

THE BIGGEST AIRLINES HAVE GOTTEN BIGGER THAN EVER. BEFORE DEREGULATION, THERE WERE 11 MAJOR TRUNKLINE CARRIERS; TODAY, THE COUNTRY HAS SIX LARGE MAINLINE CARRIERS.

Until recently, most of the legacy airlines paid their regional partners a negotiated hourly rate. Now the more common arrangement is a cost-plus contract that gives the regional airline a stipulated rate of profit. These deals have become the lifeblood of the regional airline business; today, only about one percent of these carriers are fully independent companies in the sense of marketing their own flights and being responsible for their own bottom lines.[47]

Leaving the regionals aside, the overall record of airline startups continues to be a poor one. In all, roughly 150 low-cost carriers have been founded since 1978. Of these, fewer than a dozen are still operating (the best-known being JetBlue and AirTran); add them up, and you're talking about approximately 10 percent of current airline capacity.[48] Meanwhile, the biggest airlines have gotten bigger than ever. Before deregulation, there were 11 major trunkline carriers; today, the country has six large mainline carriers—American, United, Delta, Continental, US Airways, and Southwest. The first three, along with their regional partners, control two-thirds of domestic air travel.[49]

The current economic crisis and recent fuel-price spike have been as bad for the airlines as 9/11 was. Last year saw 11 bankruptcies and nine shutdowns.[50] The surviving companies have been cutting flights, mothballing planes, and looking for partners. In April 2008, Delta and Northwest shook up the airline world by announcing plans to merge, creating the world's biggest airline, with control of 27 percent of all domestic flights. The new Delta has formed a joint venture with Air France/KLM, winning a grant of antitrust exemption that permits the member companies to pool revenues and coordinate operations based on shared schedule, cost, and pricing information. SkyTeam, as this alliance is known, already handles roughly a quarter of the transatlantic flight capacity.

The rise of these international alliances, facilitated by an "Open Skies" treaty between the U.S. and the European Union, marks a new stage in airline consolidation. Following the Delta/Northwest announcement, Continental decided to leave the SkyTeam Alliance in order to join United in its rival Star Alliance, which includes Air Canada and Lufthansa. This deal is "expected to provide many of the benefits of a merger," according to Julie Johnsson of the *Chicago Tribune*. American has been laying similar plans for a transatlantic alliance with British Airways and Iberia.[51]

DECLINING QUALITY OF SERVICE

With a few exceptions, the major airlines have been on a cost-cutting tear. Hot meals have become almost obsolete in coach service. Planes have gotten dirtier as well as older. Most U.S. airlines routinely charge for extra baggage, and flight-change penalties now typically range between $75 and $150. According to the U.S. DOT, 2008 total baggage-fee charges by U.S Airlines came to more than $1.1 billion—a figure that is expected to triple by 2010. US Airways, in the vanguard when it comes to imposing fees, charges $25 to book by phone, $15 for each checked bag, and $5 for a seating request, even if it's a case of two people trying to sit next to each other.[52]

In 2000, Congress voted to phase out the system of slot controls that existed at LaGuardia, Kennedy and O'Hare airports (controls remain in force at National). This was done in order to remove an unfair advantage for the incumbent airlines; but the decision had the effect of opening up the airports in question, LaGuardia in particular, to more flights than they could reasonably handle.[53]

IN 2007, MORE THAN A QUARTER OF ALL FLIGHTS WERE DELAYED, ACCOUNTING FOR 112 MILLION LOST PASSENGER HOURS.

When traffic declined after 9/11, on-time performance and baggage handling improved; both, however, took a nosedive as the business recovered. In 2007, more than a quarter of all flights were delayed, accounting for 112 million lost passenger hours, according to a 2008 report by the congressional Joint Economic Committee.[54] In Canada, the law requires airlines to give passengers the option of disembarking if a plane has been sitting on the tarmac for more than 90 minutes. In the past two years, both Delta and JetBlue have left passengers stranded for more than 10 hours. (The JetBlue incident led New York State to pass a law much like Canada's, but a federal appeals court struck it down.)[55]

The quality of the air-travel experience has declined according to almost every survey and by almost every measure—amenities, complaints, delays, cancellations, fees and penalties. "Our airlines, once world leaders, are now laggards in every category, including fleet age, service quality and international reputation," says Robert Crandall. "Fewer and fewer flights are on time. Airport congestion has become a staple of late-night comedy shows. An ever higher percentage of bags are lost or misplaced. Last-minute seats are harder and harder to find. Passenger complaints have skyrocketed. Airline service, by any standard, has become unacceptable."[56]

DETERIORATION OF PAY AND WORKING CONDITIONS

The airline unions expected bad things from deregulation. Even so, they could not have anticipated the precipitous decline in pay, benefits, and employment levels of the last decade. The terrorist attacks of 9/11 had the immediate effect of reducing air traffic and leading the airlines to cut back flights and lay off workers. (Of the major carriers, only Southwest resisted the tide.) Even as business began to recover, employment continued to decline as the legacy carriers engaged in more outsourcing and turned over more of their flights to regional partners. The number of people on the payroll of the legacy airlines dropped 26 percent between 1998 and 2006.[57]

Four major airlines (plus many smaller carriers) filed for Chapter 11 protection in the wake of 9/11. Taking advantage of their image as corporate victims of terrorism, United, Delta, Northwest and US Airways got bankruptcy judges to help them walk away from their existing labor contracts. In the most drastic case, US Airways—during two periods of bankruptcy protection—extracted pay cuts adding up to as much as 40 percent for some employees. (In 2005, the airline was acquired by America West, with the combined entity keeping the more familiar US Airways name.)[58] At US Airways and United, tens of thousands of workers were forced to exchange a guaranteed company pension for the drastically reduced protection provided by the federal Pension Benefit Guaranty Corporation.[59] DOT Data for US Airways, United, Delta, American and Northwest show labor costs falling by nearly a third, on average, between the end of 2001 and the beginning of 2006. Hourly wages declined by anywhere from 10 to 25 percent during this period. (The remaining savings came in the form of lost benefits and work-rule changes.)

While some pilot groups have done slightly better than other airline workers, their pay levels, too, have declined sharply. After his miraculous touchdown in the Hudson River in February 2009, US Airways pilot Chesley Sullenberger III used his newfound celebrity to issue an appeal on behalf of his profession. "My pay has been cut 40 percent," Sullenberger told members of a House subcommittee. "[M]y pension, like most airline pensions, has been terminated and replaced by a PBGC guarantee worth only pennies on the dollar."[60]

Airline mechanics have been placed in a particularly vulnerable position by the practice (and the threat) of outsourcing. Line mechanics—those who service planes between flights—still work directly for the airlines, as a rule. But heavy-maintenance mechanics are more and more likely to be employed by subcontractors, whether based in the U.S. or abroad. The pace of this trend has been dramatic. Ten years ago, two-thirds of all heavy maintenance was performed in-house; by 2007, more than 71 percent of the work was outsourced.[61] Many mechanics, having lost airline jobs, go back to work for subcontractors, taking pay cuts of tens of thousands of dollars a year.

Flight attendants have experienced pay cuts and work-rule changes as well as layoffs. At American Airlines, the number of positions has fallen by 35 percent, from 26,000 to 17,000, since 2003. Many flight attendants are working three or four extra days a month in order to come even close to their former pay levels.

Airlines have also been cutting back on rest breaks for flight attendants during layovers. FAA rules normally call for a nine-hour break between flights. That break can begin, however, as soon as 15 minutes after a plane pulls into a gate, and it does not officially end until an hour before the next departure. As a result, the "rest" period typically includes mealtime (since many airlines no longer offer in-flight meals for crew members) and travel time both in the local airport and from the airport to the layover hotel. Hardly generous to begin with, this provision leaves many flight attendants with no more than three to five hours of actual sleep. Nevertheless, over the past decade, the airlines have negotiated an eight-hour "reduced rest" option to cover unusual circumstances. Although the difficulties of unexpected weather and congestion were originally cited, some airlines, according to union officials, now treat the eight-hour standard as the norm.[62]

FOR FLIGHT ATTENDANTS, MECHANICS, PILOTS, AND OTHER AIRLINE EMPLOYEES, DEREGULATION HAS BEEN A STEEP DOWNHILL SLIDE IN WAGES, BENEFITS, WORKING CONDITIONS, AND LABOR STANDARDS.

The damage has been greater still for other categories of airline workers. Cleaning and food preparation used to be done in-house at most airlines; today, these functions are routinely outsourced. Ramp workers have gone from full-time to part-time or from employee status to contract. Some airlines outsource customer service and gate checking, too. In the process, tens of thousands of decently paid jobs with benefits have evaporated.[63]

A handful of airlines have battled against these trends. Among the legacy carriers, American Airlines continues to use employees in all key service jobs. Southwest (whose success as an intra-state carrier in Texas helped inspire airline deregulation) has not only avoided layoffs but has maintained its industry-leading pay levels.

From the start, Southwest sought to combine high wages with low costs. While rejecting the "cross-utilization" approach of People Express, Southwest encouraged an unusual degree of coordination among pilots, flight attendants, mechanics, ramp agents, gate agents, and operations agents. Each Southwest employee had a defined job, but part of the job was to help other employees. In making the transition from a regional to a national carrier, Southwest controlled its costs through a combination of innovative practices. By relying exclusively on one type of aircraft (the Boeing 737), the company kept maintenance and pilot-training expenses down. Through a policy of one-class unassigned seating, it reduced the turnaround time between flights and helped achieve an unusually high rate of fleet utilization—nearly 11 hours a day, on average, compared to about 9.4 hours for the industry as a whole.[64]

JetBlue, a non-union company, has also been successful in holding overall costs down without slashing pay and benefits. JetBlue's management, like that of Southwest, speaks of putting employees ahead of customers. "We worry about crew members first…," says JetBlue's senior vice president Vince Stabile. "We can trust that if the leadership really worries about crew members, then crew members will worry about the customer."[65]

If there is a bright side to the deregulation story for workers, it has been the relatively good performance of these two high-road companies. Among the legacy airlines as well, there appears to be a growing sentiment that the industry may have gone too far in its strategy of responding to every financial difficulty with a new round of pay and benefit cuts. The current leaders of American and Continental have advocated a more collaborative relationship with their workers.[66] But even at American and Continental, the reality has been harsh. For flight attendants, mechanics, pilots, and other airline employees, deregulation has been a steep downhill slide in wages, benefits, working conditions, and labor standards.

FALLING PRICES

Of all the trend-lines, one is strikingly positive at first glance: since 1978, airfares have fallen by more than 50 percent, from an average of 10.08 cents per mile to (as of 2006, adjusted for inflation) 4.2 cents per mile.[67] From that fact, some industry observers proceed to a simple conclusion: Deregulation has lowered prices.

The truth is more complicated. Although it is rarely acknowledged by proponents of deregulation, prices have been declining through most of the history of commercial air travel. The early 1970s were exceptional: between 1970 and 1975, a bad economy and an oil-price hike caused fares to increase by nearly 40 percent, creating the impetus for deregulation. Both before and after that period, however, airfares fell; in fact, the regulation era as a whole saw price declines comparable to those of the deregulation era. (Some industry observers argue that airfares (adjusted for changes in the price of fuel) actually declined more rapidly before 1978 than they have since.[68]

The key difference between now and then is not that fares have fallen faster, but that the airlines have changed their approach to controlling costs and prices. CAB regulation, with all its failings, encouraged the industry to invest in new and more fuel-efficient planes. The deregulators expected the airlines to continue on this path, even as they emulated Southwest and PSA by finding creative ways to use equipment and personnel more efficiently. Instead, after a burst of optimism over the early success of the 1980s startups, deregulation led to hub-and-spoke routing and a shift toward older and smaller planes.

With a few exceptions (Southwest itself, most notably), the airlines adopted a two-pronged strategy of cost reduction, cutting back on workers' wages and benefits, in the first place, and on customer service and amenities, in the second. So, while most of today's passengers pay less, they also get less—less legroom, less service, and less help in the increasingly common event of a cancelled flight or a missed connection. For many passengers, air travel is not just a less pleasant experience but a longer one, because of the increased difficulty of finding an affordable nonstop flight.

THE REGULATION ERA AS A WHOLE SAW PRICE DECLINES COMPARABLE TO THOSE OF THE DEREGULATION ERA.

SCATTERSHOT PRICES

The deregulators hoped for a broad and even-handed reduction in fares. Instead, air travel has become a world of low prices for some alongside high prices for others. The line between winners and losers is partly one of geography. Flights out of such fortress hubs as Charlotte, NC, and Minneapolis/St. Paul cost far more than flights on more competitive routes. The difference is also partly a matter of market segmentation: by linking discounts to advance-booking and Saturday-night-stayover rules, the airlines seek to offer the best deals to price-sensitive leisure travelers, while holding the line on business fares.

Yield management adds another layer of complication. Most of the costs of any particular flight are a given regardless of passenger load. Each additional passenger adds only a few dollars of expense—the cost of "a bag of peanuts, a cup of Coca-Cola, a few gallons of kerosene in the wings, and sometimes, a sales commission and other distribution costs," to quote Paul Dempsey, a law professor who has written extensively about the airlines.[69] So the math makes it tempting for an airline to fill more seats with promotional fares, even if the result is merely to steal a few passengers away from another airline.

In an economic downturn, however, this divergence between cost and price tends to get out of hand. When the economy contracts, air traffic plunges, creating excess capacity across the industry and leaving airlines with no easy way to reduce costs. Since frequency of departure is one of the factors that attract passengers to a given carrier, a decision to cut back on flights can damage an airline's competitive position for years to come. As load factors decline, many airlines resolve to fill empty seats by slashing fares. It's a strategy that makes sense for the individual airline, but one that (as consumers become conditioned to fares that don't cover any company's full costs) can be calamitous for the industry as a whole.

V. SAFETY: NOT SO SACRED

"I've never seen icing conditions. I've never de-iced. I've never seen any—I've never experienced any of that."
—First Officer Rebecca Shaw, shortly before the crash of Continental Connection Flight 3407, February 12, 2009[70]

The pilot had failed several computer-simulated check rides. His co-pilot may have had a cold in addition to being worn down from a 36-hour cross-country commute. Descending into the icy, blustery skies over suburban Buffalo, Captain Marvin Renslow and First Officer Rebecca Shaw bantered about personal and career matters (violating an FAA rule against small talk below 10,000 feet), and seemed to be taken by surprise when their plane went into an aerodynamic stall.

Renslow had only limited experience with the aircraft. The 70-seat Dash 8 turboprop had an automatic stick-pusher that was designed, in a stall, to point the plane downward so that it would pick up speed, giving the pilot a chance to regain control. Untrained in the use of this crucial emergency system, Renslow apparently did the instinctive—but wrong—thing: he pulled back when he should have pushed forward.[71]

A WORLD APART

It was a horrifying story, quickly and widely accepted as "pilot error." As the investigation proceeded, however, attention shifted from Renslow and Shaw to their employer, Colgan Air, and to the shadowy world of regional airlines—a world that has thrived on lack of attention until now.

The crash of Continental Connection Flight 3407 blew a dirty secret: most of the major U.S. airlines are no longer directly responsible for many of the flights they advertise and sell. Since 1998, the regional air fleet has multiplied tenfold, from about 1,100 planes to more than 11,000.[72] Flying turboprops and small jets, regional carriers handle about half the nation's passenger flights, and more than 35 percent of all flight-hours.[73] "Be paid but not seen" could be their motto. The aircraft and crew may belong to Colgan or Comair or Air Midwest; but the ticket and the airplane insignia and colors are those of Delta, United, or US Airways.

By law, all airlines are subject to the same federal safety regulations. In important practical ways, though, the regional airlines are a world apart, perhaps most dramatically in terms of hiring, training, and salary standards for pilots and co-pilots. Captain Renslow had just 625 hours of flying experience when he went to work for Colgan; according to the Air Line Pilots Association, a pilot would need several thousand hours, as a rule, to land a job at Continental or one of the other legacy carriers. Renslow was earning around $60,000 a year—not much more than half what most legacy-airline pilots make, despite the pay cuts that many have endured. Shaw, according to various accounts, was making between $16,000 and $24,000.[74]

BY SHIFTING FLIGHTS TO SMALLER REGIONAL AIRLINES..."YOU HAVE RELATIVELY INEXPERIENCED PILOTS FLYING AT LOWER ALTITUDES THROUGH MORE CHALLENGING WEATHER CONDITIONS, OFTEN TO MORE ISOLATED AND DIFFICULT AIRPORTS."

These figures may help us understand the backstory of Flight 3407. At the major airlines, pilots typically live (or have a regular place to stay) near their base airports. In the world of regional-airline pilots and co-pilots, it is common to live hundreds or even thousands of miles away and catch your sleep, as you can, in a crew room at the airport. Joking with Renslow in the cockpit, Shaw said that Colgan's crew room at Newark had a couch with her name on it. Renslow himself had logged in from a crew-room computer at 3 a.m.[75]

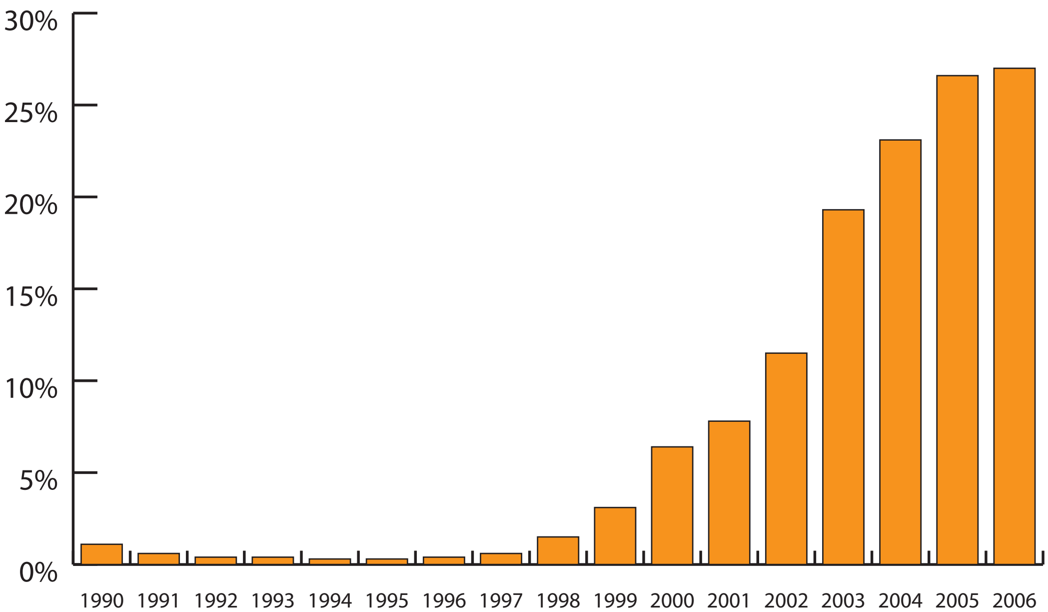
Since 2002, the U.S. passenger fleet has experienced three multi-fatality crashes, with a total of 164 lives lost.[76] All three involved regional carriers. While that fact does not prove that the regionals are more dangerous, their dramatic growth and increasingly close ties to the legacy airlines have greatly altered the dynamics of the piloting profession. The regionals—often compared to baseball farm teams—form a subtier of airlines where pilots, in effect, pay for their own training and accept a measure of immediate hardship in the hope of eventually establishing a secure, well-paid career. Today, with the major carriers shrinking and the regionals expanding, it is much harder to move up. By shifting flights to smaller regional airlines, the legacy carriers have created a system in which, says Dan Akins, a transportation economist and airline consultant, "You have relatively inexperienced pilots flying at lower altitudes through more challenging weather conditions, often to more isolated and difficult airports."[77]

A LOGISTICAL NIGHTMARE

The outsourcing of maintenance raises parallel concerns. Maintenance, repair, and overhaul facilities—MROs—come in all shapes and sizes. Outsourcing can mean sending a plane back to the manufacturer for servicing. Some MRO facilities specialize in a particular class of aircraft. (Airlines from all around the world rely on a state-of-the-art repair shop in Hong Kong to overhaul their Boeing 747s.) In other words, an airline may have good reasons for relying on another company to do its maintenance, and many non-airline-owned facilities do high-quality work. But the speed at which the practice of outsourcing has grown is deeply problematic in itself.

As recently as a decade ago, most maintenance was performed in-house at hub airports, where an FAA inspector could go from the avionics shop to the battery shop to the car and wheel shop, and so on, kicking the proverbial tires. Today, while the inspection staff is no bigger and remains largely based in the same hub cities, the work is scattered across nearly 5,000 facilities in the U.S. and abroad.[78] To visit repair shops overseas, inspectors must apply for visas, sometimes waiting months for permission. Surprise inspections are all but impossible in most countries. When inspections do occur in China or El Salvador, for example, local managers typically have weeks to prepare. "It's a logistical nightmare," says Linda Goodrich, vice president of the Professional Airways Systems Specialists, the union that represents the inspectors.[79]

Graphic B: Regional Carrier Percentage of Domestic Block Hours, 1990-2006



Source: U.S. Department of Transportation, Form 41 Data

Faced with such a sudden expansion of its task, the FAA might have been expected to protest or plead for additional funding and personnel. Until recently, FAA officials have been oddly complacent, asserting that it was up to the airlines to decide where to service their planes, and that onsite inspections were largely unnecessary. The FAA, it was argued, had only to make sure the airlines were keeping tabs on their contractors, and it could do so by reviewing data submitted by the airlines themselves.

While the FAA sought to distance itself from the job of monitoring maintenance, some FAA officials began referring to the airlines (not the public) as the agency's "customers." In March of 2008, a group of FAA whistleblowers reached out to the office of Congressman James Oberstar, chairman of the House Transportation and Infrastructure Committee, with evidence that superiors had "been deferring in frightening ways to the airlines on safety inspections," as a *New York Times* editorial subsequently put it.[80] Southwest wound up being fined more than $10 million for failing to do mandated fatigue-crack checks on its Boeing 737s. Within days, American and Delta had been forced to remove dozens of MD-80 jets from service for wiring modifications. Then came a two-day grounding of United's Boeing 777s; then the industry's largest grounding ever when American again pulled its MD-80s out of service, this time canceling some 2,000 flights.[81]

A SLIPPERY SLOPE

U.S. airlines have an excellent safety record, over all. They have achieved that record partly on the strength of federal regulation, and partly through their own high standards and those of aircraft manufacturers. Today's planes are generally outfitted with sophisticated collision avoidance systems that are believed to have been a key factor in lowering accident and fatality rates.

Under deregulation, however, some airlines have taken steps that are deeply worrisome from a safety standpoint. Regardless of a company's motivation, the outsourcing of heavy maintenance poses serious oversight problems for the airlines themselves as well as for the FAA. By forming alliances with regional carriers, the airlines add more layers of complexity to these situations. On January 8, 2003, an Air Midwest commuter plane—carrying the emblem of US Airways Express—crashed on takeoff from Charlotte, North Carolina, killing all 21 aboard. The pilot had evidently lost control of the airline's pitch as a result of a malfunctioning elevator control system; that system had been incorrectly adjusted during a maintenance check at a contract repair facility. The National Transportation Safety Board criticized Air Midwest for inadequate oversight of the facility. As the NTSB noted, the story involved a three-stage delegation of responsibility. US Airways had contracted the flight out to Air Midwest, which had contracted the work out to an FAA-monitored repair station; that repair station, in turn, had subcontracted with another, non-FAA-monitored shop.[82]

The regional partnerships are problematic in another way. By substituting smaller regional aircraft for mainline service, the legacy airlines cut their own costs while adding to the burden on the air traffic control system, which must deal with a larger number of planes operating in the same airspace. This has led to increased delays: the Air Transport Assocation estimates that in the fiscal year 2008 there were 138 million flight delays caused by the inability of the ATC system to handle the volume of activity, resulting in a $10 billion increase in air-carrier operating costs.[83]

The deregulators of the airline industry believed they could end government oversight of routes, fares, labor practices, and customer-service standards, without touching safety. Over time, however, financially-pressed airlines have become caught up in a frenzied competition to reduce costs, which has led to practices that no one could have anticipated 30 years ago.

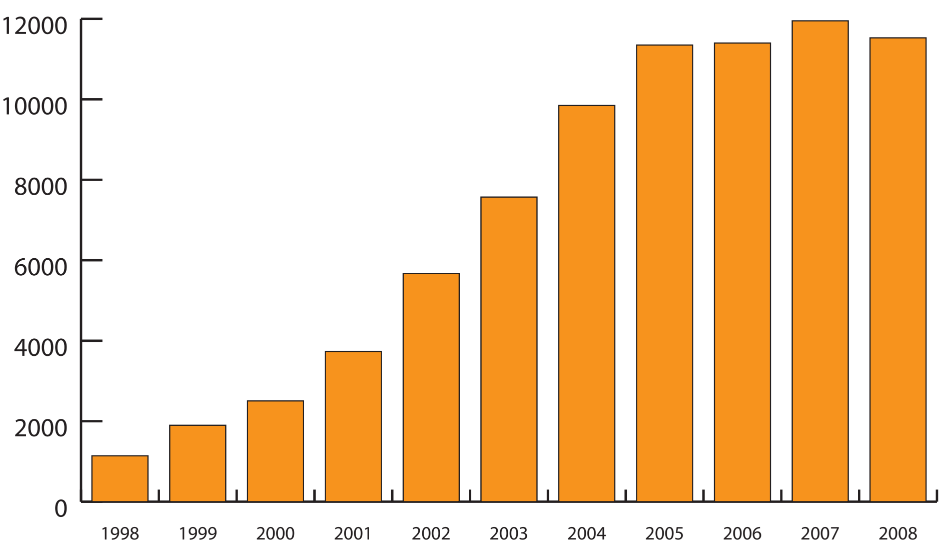
DEREGULATION...HAS NOT SPELLED AN END TO GOVERNMENT INVOLVEMENT... IT HAS LEFT US WITH THE PROBLEMATIC COMBINATION OF SUBSTANTIAL PUBLIC SUBSIDY AND LITTLE PUBLIC INPUT.

Through a series of seemingly small compromises, the airlines have placed themselves in the position of encouraging passengers to entrust their lives to less experienced, less-well-paid pilots, and to travel in planes that have not always received the same high level of care. "If you talk to retired airline CEOs," says Kevin Mitchell, chairman of the Business Travel Coalition, "they'll tell you that in previous cost-cutting environments through the years there was always one sacred cow: maintenance and safety. Now everything is on the table and there are no sacred cows."[84]

Most people, of course, have only a general impression of the industry's normal safety precautions. But, as Mitchell points out, passengers generally assume that the same standards apply with all the flights of all the major airlines. Mitchell argues:

> *The customer ought to be able to assume that the plane has been overhauled by people who had to pass serious background checks, and that the FAA oversaw the work. People should assume that when an airplane was stripped down to its shell, it was within a secure perimeter, that the parts used to rebuild it were secure, and that the people who went to fetch those parts had been checked out. All this is true in most large maintenance facilities here in the U.S. It is also true in Hong Kong and Toronto. It's not true in a lot of these other places.*[85]

Graphic C: Number of Regional Aircraft, 1999-2008



Source: Official Airline Guide

VI. CONCLUSIONS

"It is time to acknowledge that airlines look and are more like utilities than ordinary businesses. Three decades of deregulation have demonstrated that airlines have special characteristics incompatible with a completely unregulated environment."
—Former American Airlines CEO Robert Crandall[86]

Deregulation was supposed to lead to a dramatically expanded universe of airlines—companies big and small, old and new, competing and innovating for the public benefit. Today's industry is more concentrated than ever, yet lacks the resources and motivation to make crucial investments in equipment, technology, and human capital. Despite brutal cost-cutting, America's airlines have lost tens of billions of dollars since 2000. (They lost over $9 billion in 2008 alone.[87]) Most of the major U.S. airlines appear to have no long-term strategy except more of the same—more outsourcing, more service cutbacks and hidden charges, more wage and benefit reductions, and more consolidation in the hope of surviving long enough to be in a position to turn a profit and expand again during a future economic recovery.

THE WHITE HOUSE AND THE DEPARTMENT OF TRANSPORTATION SHOULD TAKE THE LEAD IN CREATING A TASK FORCE TO EXAMINE THE INDUSTRY'S PROBLEMS AND PROPOSE SOLUTIONS.

GETTING IT WRONG

The deregulators viewed air travel as a naturally competitive industry, mistakenly burdened with rules more appropriate to railroads and gas and electric companies.[88] In hindsight, they made too much of the differences, and too little of the similarities. Founding an airline might not require the construction of a hugely expensive network of tracks, pipes, or wires; there is more room for competition (and more to be gained from competition) in air travel than in those other fields. Nevertheless, air travel, too, is a market characterized by high fixed expenses, by large if not always obvious economies of scale, and—absent close oversight—by a propensity for monopoly pricing, on the one hand, and ruinous price wars, on the other.

Summing up the miscalls of the deregulators, Mark S. Kahan, a former CAB official, has written:

> *[They] believed that airline size was not critical to efficient operations. The marketplace, to the contrary, has ruled that bigger is better. Deregulators believed that barriers to entry are low in the airline business. Experience has demonstrated that they are very high. (Another assumption—"that the antitrust laws would restrain competitive abuses"—had been "negated by [a] policy default," Kahan added.)*[89]

The airlines resemble utilities not only in their behavior but in their economic and national-security importance. When a city loses air service—the fate of more than 100 communities over the past decade—the local business establishment and employment base can be severely damaged. The economy of metropolitan Santa Fe, New Mexico, for example, took a hit estimated at $54 million a year after the loss of passenger air service in early 2008.[90] All the major airlines participate in the Civil Reserve Air Fleet, a Cold War-era program requiring them to carry military personnel in times of emergency. This program, on which the Department of Defense relies for most of its soldier transport, has been activated twice in recent years—in the Gulf War of 1990-91 and again during the 2003 operation in Iraq.[91]

Indeed, for all the free-market rhetoric surrounding current policy, government continues to play a large role in the airline industry. State, local and federal programs support the construction and expansion of airports. Airline safety oversight and air traffic control are funded by a combination of passenger fees and federal tax dollars. Since 9/11, security has been a federal responsibility. When most of the industry seemed to be heading over a financial precipice, Washington pulled it back with billions of dollars in emergency aid. Deregulation, in short, has not spelled an end to government involvement. Instead, it has left us with the problematic combination of substantial public subsidy and little public input.

THINKING BIGGER

The industry's troubles have stirred considerable debate in the past several years. But it has been a badly constricted debate. Some advocate a Passenger's Bill of Rights to arrest the deterioration of customer service standards. Others (including Vice President Joe Biden when he was running for president two years ago) call for the creation of an Aviation Consumer Protection Commission. Some hope to head off the prospect of foreign ownership of domestic airlines—a potential upshot of the Open Skies Treaty. None of these well-meaning proposals seems likely to have much effect on the industry's core problems.

The airline industry is a crucial piece of this country's economic infrastructure—one that, like the banking system, has been badly damaged by shortsighted thinking and lack of effective oversight. A few enthusiasts continue to hail deregulation as a success, based on the claim that it has brought prices down. In fact, while airfares fell sharply in the early 1980s, the recent record is less impressive. Since 2004, ticket prices have increased by about 20 percent, due to the rising cost of jet fuel.[92] In any case, low airfares are no bargain if they fail to generate enough revenue to provide for proper maintenance, decent customer service, and sustained investment in new technology.

We cannot (nor would anyone want to) bring back the system that, in the early 1970s, assured a handful of airlines of guaranteed, cost-plus-style profits and virtual immunity from competition. But airline regulation was a policy that had lost its way; it was not a senseless policy. In 1938, when Congress and the administration of Franklin Roosevelt created the agency that would come to be known as the Civil Aeronautics Board, they were responding to conditions similar to those that afflict the airline industry today. Their goals—expanded, safe, reliable service—were sound; so, too, as recent experience has confirmed, was the assumption that those goals could be better achieved through a combination of regulation and competition than through market forces alone.

Both in formulating and in assessing airline policy, the deregulators have placed too much emphasis on the needs of the consumer, neglecting the needs of other stakeholders; and too much emphasis on the dollar cost of an airplane ticket, neglecting other dimensions of consumer experience. America needs an airline industry that can do right by its owners and workers as well as its passengers.

The White House and the Department of Transportation should take the lead in creating a task force to examine the industry's problems and propose solutions. Working with management, labor, and consumer groups, Washington needs to develop a plan to help the airlines achieve stability and extricate themselves from the cycle of under-investment, penny-pinching, and low-road labor practices. The task force should be asked to outline a new set of rules, setting limits on airline behavior to control the crazy quilt of fares and stabilize earnings, wages, safety, and passenger service. In its short- and long-term recommendations, the task force should pay particular attention to these concerns:

Moderating the Booms and Busts. The airline business is hyper-cyclical by nature, overreacting to positive as well as negative economic trends. Air travel is also extremely sensitive to unpredictable world events, including terrorist acts and outbreaks of illness. Part of the policy challenge is to help the industry smooth out its booms and busts and avoid the tendency in good times to create capacity far beyond what is needed in bad times.

Such a plan could entail capital-reserve requirements for airlines. It could require changes in bankruptcy law, making it harder for airlines to continue flying under Chapter 11 protection. This country might do well to follow the example of Australia, where bankruptcy means the virtually automatic ouster of management.

More Efficient Use of Airspace. Major airports are increasingly—sometimes almost absurdly—congested. In early 2008, Northwest Airlines had 56 flights scheduled to depart from Minneapolis/St. Paul during one 15-minute period—three times the airport's capacity.[93] Nevertheless, this country's air-traffic-control system remains firmly moored in the pre-digital era. The long-delayed work of ATC modernization needs to be accelerated, with financing from user fees as well as excise taxes. Fees (both for commercial airlines and for corporate and private planes) should reflect demands placed on the system. The current fee structure, based on airplane weight, encourages the use of small planes, which are less fuel-efficient and just as much of a strain on the ATC network.[94]

But the problem of air traffic control should be viewed in a broader light. While ATC technology is important, we need to bring flight volume into line with what an airport's runways, terminals, and ATC facilities can reasonably handle. The airlines should also be encouraged to make routing decisions without being swayed by the monopoly-pricing opportunities of hubs.

Coordinated Transportation Planning. Decisions involving airport construction and modernization should be coordinated with long-term plans and trends. Hagerstown, Maryland, spent $61.4 million to build a longer runway. By the time the project had been completed, the airport's only passenger airline had pulled out.[95] Lack of national or even regional coordination of transportation policy creates the potential for more planning disasters like this.

High-speed rail could reduce short-haul air traffic on such routes as Detroit-Chicago and New York-Washington. Regulatory policy (as well as public-investment decisions) should be designed to discourage airplane trips of 300 miles or less on routes with traffic levels that make rail a feasible alternative.

A Square Deal for Passengers. The United States should follow the lead of the European Union in adopting a passenger-service code. It should be broader in scope than the current proposal for a Passenger Bill of Rights. An airline should not be allowed to charge twice as much on a route where it faces no competition. No one should have to pay many multiples more than another passenger on the same flight. Passengers used to be able to assume that if a delayed flight led to a missed connection, the airline would put them on the next available flight—one run by a competitor if necessary. That should be standard practice again.

Equitable Labor Practices. The industry should be encouraged to return to the pattern bargaining that existed before deregulation; the National Mediation Board should collaborate with airlines and workers to develop a template for serious, rapid contract negotiations. The aim should be long-term labor agreements with terms linked to company performance. Airline workers should no longer be treated as second-class citizens when it comes to the rules governing air quality and other occupational safety issues. It is simply not in the public interest to have airlines engaged in a race to the bottom on wages, benefits, and working conditions.

Consistent Safety Standards. The rules governing maintenance facilities and mechanics' credentials should be essentially the same, whether the work is performed in the U.S. or abroad, in-house or on contract. An airline that sends its planes overseas to be serviced should not gain a regulatory advantage over one (like American Airlines) that chooses to do its own maintenance. Passengers should be clearly and prominently told the name of the airline that is actually running each leg of a flight.

Competition and Antitrust. The airline industry has been given de facto antitrust immunity for much of the past three decades. It is time to reign in the Frequent Flyer plans, the fortress hubs, the reservation alliances, and the other mechanisms that protect the biggest and oldest airlines from competition. At the same time, regulatory policy should seek to distinguish between routes where meaningful competition is possible, and routes that are incapable of supporting more than one or two airlines. Each type of market should have its own rules—designed to create a level playing field, in the first case, and to prevent monopoly pricing and the other abuses of concentration, in the second.

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