

 **American Bar Association**  
Section of Public Utility, Communications  
and Transportation Law

**REPORT OF THE  
AVIATION COMMITTEE**

2003 Spring Council Meeting

Chair: Frank J. Costello

# REPORT OF THE AVIATION COMMITTEE

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# REPORT OF THE AVIATION COMMITTEE

Paraphrasing the melancholic anthem of the Depression:

Once I built an airline, made it run,  
Made it race against time.  
Once I built an airline -- now its done,  
Brother can you spare a dime.<sup>1</sup>

The U.S. airline industry is down to its last dime. The major airlines reported a loss of \$11.2 billion for calendar year 2002, and the situation is getting worse. Two major airlines, United and US Airways, presently are in Chapter 11 proceedings, and several other major airlines have indicated that they are close to filing for bankruptcy protection. Approximately 100,000 airline employees have lost their jobs and several hundred thousand more people have lost their jobs in aviation-related businesses. And there is more bad news to come, namely, the probability of a second Gulf War.

Is there any room for optimism? The answer is "yes," for three reasons. First, air transportation has not been overtaken by technology or by other modes of travel. It remains an essential part of the national infrastructure. Second, there will be survivors among the major airlines, and those survivors will enjoy market share premiums. Third, the crisis is provoking a fundamental reform of the industry's labor cost structure. It is this development that offers the most hope for the future of the industry. It also provides the focus for this Report.

## **The New Math of Airline Labor**

The seminal date for the U.S. airline industry generally is assumed to have been October 28, 1978, the day the Airline Deregulation Act became effective. But that may be overtaken by December 9, 2002, the day that United filed its Chapter 11 bankruptcy petition.

**1. Seven decades of accretion.** The role of organized labor in the airline industry is a complex one that requires historical perspective.<sup>2</sup> It starts with the concept of a pilot as a professional. That was not always as obvious as it seems today. The most famous U.S. pilot in

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<sup>1</sup> "Brother Can You Spare A Dime?" E.Y. Harburg & J. Garney (1930).

<sup>2</sup> The best early history of organized labor in the airline industry is Hopkins, George E., The Airline Pilots, A Study in Elite Unionization (Harvard University Press, 1971).

World War I, Eddie Rickenbacker, was a former racing car driver who had not finished the seventh grade. The idea of commissioning pilots was anathema to senior career officers, but once that decision was made, largely to conform to the practice of our British allies, it never was questioned.

After the war, the nascent airline industry saw the value of pilot professionalism in instilling public confidence in flying. A Pan American captain and crew standing at attention as passengers came on board was a powerful contrast to the image of barnstorming daredevils. By 1930, the airlines, and there basically were four at the time, were earning as much carrying passengers as they were carrying mail. The pressure to drive down costs led to proposals to change the basic pay measure from miles to hours. That led a United pilot, David Behncke, to form a unique union of professionals, the Air Line Pilots Association, in 1931. ALPA was a small union -- there were only about six hundred pilots employed by the airlines at the time -- but it enjoyed substantial prestige.

From the beginning, airline pilot salaries were high. The Department of Commerce estimated that the highest paid airline pilots earned approximately \$1,000 per month in 1931. As aircraft increased in speed and size, the airlines intensified their effort to get an hourly-based pay scale that would reflect the increased productivity. In 1933, ALPA, now affiliated with the American Federation of Labor and with strong connections to the Roosevelt administration, succeeded in having the dispute referred to the National Labor Board. Early the next year, the NLB issued Decision 83, a compromise that combined mileage pay with an hourly pay rate that increased as the speed of the aircraft increased -- in other words, a victory for ALPA. ALPA's political strength led to Decision 83 being included in both the Air Mail Act of 1934 and the Civil Aeronautics Act of 1938 (the precursor to today's Federal Aviation Act). In 1935, ALPA succeeded in having the Railway Labor Act amended to include airline employees.

After World War II, the airline industry was flush with new technology and new pilots. It also was subject to pervasive federal regulation. What happened next with respect to labor can best be called the process of accretion. It happens with all institutions that are not subject to outside pressure. As airlines grew, they continued to pay their employees well, building on the base that had been established in the pre-war years. All classes of employees, and not just the pilots, benefited. Wages went in only one direction, up, and work rules were expanded rather than contracted. While the airlines had a Mutual Aid Pact that allowed a carrier on strike (most often Northwest) to recover some of the additional revenues enjoyed by its competitors, the ability to pass on additional costs to passengers through federally mandated pricing was a powerful disincentive to taking a strike.

The process of deregulation started in 1978 and, in theory at least, a more businesslike environment was created. The Mutual Aid Pact was gone, and all of the pressure on fares was downward. But labor costs continued to increase, at least at the major airlines. There is no easy answer for this phenomenon, other than to note that no airline wanted to risk an extended shutdown when competition was so intense, resulting in a continuation of carrier-by-carrier stair-step increases.

Today, employees of airlines are compensated at a level nearly twice the average for all U.S. industries. Pilots also rank among the highest paid professionals. Last year, the Department of Labor's Bureau of Labor Statistics conducted a survey of earnings in 437 professions. The two highest paid professions were airline pilots and doctors, and they were comparable, at least in terms of dollars. However, doctors averaged 41 hours per week while airline pilots averaged 22 hours per week.<sup>3</sup>

This is not to pick on pilots or any other employee group. There are two signature lines at the bottom of every collective bargaining agreement. The fact is that nearly seventy years of accretion, acquiesced in by both management and employees, created a labor cost structure that no longer could bear its own weight. Labor costs now account for 36% of all major airline costs, with the next highest cost, fuel, at 13%. If the industry is to find a rational business model, it has to start by addressing labor costs.

**2. The reality of Chapter 11.** US Airways filed in Chapter 11 on August 11, 2002. It was not a prepackaged bankruptcy, but it was carefully orchestrated. A picture quickly emerged of a smaller, lower cost airline that would require substantial concessions from its workforce to emerge from bankruptcy.

When United filed on December 9, it was in an even more desperate situation. On December 4, the Air Transportation Stabilization Board turned down United's request for a \$1.8 billion loan guarantee, finding that "United's management presented a business plan that does not position the company to meet the challenges of the current airline industry environment and to achieve long-term financial stability." This was a message, to the entire industry as well as to United, that the federal government was not going to help unless labor costs were fundamentally restructured. United was about to run out of cash. It was down to \$800 million on hand, and it was going through that at a rate of \$20 - \$22 million per day. United's plan for reorganization was less clear, but one thing was certain -- it, too, would require substantial concessions from its workforce.

At this point, the reality of a Chapter 11 proceeding emerges. First, under section 1113(c) of the Bankruptcy Code, 11 U.S.C. § 1113(c), a bankruptcy court can reject a collective bargaining agreement and leave the company free to impose its own terms. Second, and probably more important, is the need for interim financing. United and US Airways were able to continue operating only because they received debtor-in-possession financing. The institutions providing the DIP financing received priorities that reduced their risk, but they also subjected the loans to substantial performance covenants. In United's case, any DIP financing past mid-March will require United to demonstrate that it has significantly lowered its costs to meet specific benchmarks. No DIP financing, no airline. That is a strong incentive for labor concessions.

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<sup>3</sup> BLS National Compensation Survey (August 2002). The survey included all doctors but it also included lower paid regional, commuter and business aviation pilots. As a yardstick, lawyers ranked 21<sup>st</sup>, flight attendants ranked 45<sup>th</sup> and aircraft engine mechanics ranked 120<sup>th</sup>.

Both United and US Airways have received interim concessions, but much more is needed. United is looking for \$2.56 billion in annual cost cuts from its employees, with 44% of that amount coming from its pilots.<sup>4</sup> Wage levels, however, are the lesser part of that story. While United did grant substantial pay increases to its pilots, flight attendants and mechanics in the two years prior to its bankruptcy,<sup>5</sup> the larger issue is productivity. To understand this, you need some understanding of airline work rules.

The FAA establishes the overarching work rules. No pilot may fly, in any commercial service, more than 1,000 hours in a calendar year, 100 hours in a month or 30 hours over seven consecutive days.<sup>6</sup> Next is a complex system of duty period and rest requirements that apply to both pilots and flight attendants.<sup>7</sup>

Within this framework, the individual collective bargaining agreements -- carrier by carrier and class by class -- establish rigid sets of restrictions on productivity. United's examples are striking, but they exist with variations at most major airlines:<sup>8</sup>

- minimum monthly pay guarantees;
- vacation override policies that allow pilots to turn a ten-day vacation into a month off with full pay;
- scope clauses that restrict the use of smaller, and more cost-efficient, regional jet aircraft;
- clauses that prohibit or limit furloughs;
- clauses that limit code-sharing; and
- clauses that limit outsourcing.

The differences are astonishing when compared to Southwest, the largest, oldest and, therefore, the highest cost of the "low cost" airlines.<sup>9</sup> In 2001, Southwest's pilots averaged 62

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<sup>4</sup> By comparison, the temporary wage cuts now in place would amount to only \$840 million in annual savings.

<sup>5</sup> In October 2000, the pilots received a 23% increase retroactive to April 2000, with 4.7% increases in 2001 and 2002; in March 2002, the flight attendants received a 2% contract increase plus a 5.5% increase from an arbitration award; and in March 2002, the mechanics received a 25% increase retroactive to July 2000 as a result of a Presidential Emergency Board determination.

<sup>6</sup> 14 C.F.R. Parts 121.470, 471 and 480 et seq.

<sup>7</sup> 14 C.F.R. Part 121.467.

<sup>8</sup> These examples are taken from an Informational Brief that United included with its bankruptcy petitions. While this document acknowledged that "management must share a large part of the blame," the purpose of the brief was to lay out the case for lowering labor costs either through negotiation or Section 1113.

<sup>9</sup> Jet Blue, for example, has unit costs 15% lower than those of Southwest.

hours of flying per month. The comparable figure for United was 36 hours per month (and American was not much better at 39 hours). This is reflected in their comparative costs. For the first six months of 2002, United's labor costs per available seat mile were 63% higher than the comparable figure for Southwest -- and when adjusted for differences in stage length,<sup>10</sup> the gap was 83%.

**3. The future.** This Report was finalized in early March, at a time when the prospects for United and US Airways were uncertain. It is clear, however, that unless they can substantially reform their labor cost structure on a timely basis, neither will emerge from Chapter 11. Further, if they do emerge, they will look substantially different than they do today, with further reductions in service and a larger emphasis on smaller regional jet aircraft. That is good news for their competitors, subject to the caveat that they must succeed in reforming their labor cost structures. American and Northwest publicly have stated that they are prepared to use bankruptcy if necessary to accomplish that reform, and it is likely that others will follow.

Projecting ahead to a time when the economy has recovered, and most believe that is twelve to eighteen months from now, the airline industry has a new look. Demand has recovered, but it is being met by (possibly) fewer major airlines with labor cost structures closer to the Southwest model. Networking continues but through fewer hubs. Fares are fewer in number and tend toward the middle. Several new entrants emerge to fill in some of the holes. New forms of airline structures emerge, *e.g.* generic airlines that sell their capacity to third-party marketing companies.<sup>11</sup> Most significantly, the airline industry, for the first time in its history, begins to resemble an economically rational business.

This is optimistic, perhaps, but it is a real possibility. Unfortunately, it is a possibility driven by substantial economic pain to airline employees. Granted that the current labor cost structure is irrational, but there is no more dedicated workforce in the world than the employees of an airline. The numbers disguise that pain, but it should not be forgotten. In the end, it is the employees' dime that is being surrendered.

## **Retail Distribution**

**1. Report of the National Commission.** The AIR 21 legislation in 2000 directed the creation of a National Commission to study (i) whether the financial condition of travel agents is declining and (ii) whether there are impediments to obtaining information about the airline industry's services and the effects of any such impediments on travel agents, online distributors

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<sup>10</sup> United, which operates much longer average flights than does Southwest, should, in theory, have lower unit costs.

<sup>11</sup> There are small airlines today that never operate under their own livery, instead wet leasing (aircraft and crew) to other airlines or operating charters for tour operators. A person reselling air transportation is viewed as an indirect air carrier and is subject to minimal economic regulation. One advantage of the generic airline concept is that the DOT has authority to exempt indirect air carriers from the restrictions on foreign direct investment otherwise applicable to the U.S. airline industry. 49 U.S.C. § 40109(a).

and consumers. The Commission was formed on May 16, 2002, held hearings through the summer and issued its report on November 13.

The Commission's basic conclusion was that travel agents are in trouble but that federal intervention would not be prudent:

However, the underlying problem is that the entire travel industry has been transformed by fundamental technological change as well as intense, deregulation-driven airline competition. Agents are caught up in the momentum of a competitive marketplace. Even as agencies suffer, airlines must cope with difficult economic times: they have lost billions of dollars, because of the weak economy, the fallout from September 11<sup>th</sup>, and their own high costs. In this environment, the Commission is reluctant to suggest solutions that would impose additional costs on carriers, or to attempt to regulate a highly fluid and competitive distribution system. Therefore, the Commission is not prepared to recommend new regulatory schemes at this time.<sup>12</sup>

**2. Computer reservation system regulations.** On November 15, 2002, the DOT issued a Notice of Proposed Rulemaking with respect to the rules governing airline computer reservations systems. 67 Fed. Reg. 69366 (2002). The current rules are set forth at 14 C.F.R. Part 255. Comments are due on or before March 15, 2003.

The major players in this rulemaking are: the computer reservations systems, the largest of which, Sabre, is no longer airline-owned; the airlines, who still see the majority of their sales booked through travel agents using these systems; travel agencies who use the systems; and non-traditional travel agencies that sell over the Internet, companies such as Orbitz, which is airline owned, and Travelocity, which is owned by Sabre. While the devil is in the details in the complex world of online retailing, the most important tentative decision in the NPRM is not to extend the rules to the Internet.

## **Security**

The Homeland Security Act, Pub. L. 107-296 (November 25, 2002), will have a significant impact on aviation. It transfers the Transportation Security Administration from the DOT to the new department, effective March 1, 2003. While the TSA will account for about one-third of the new department's employees, TSA, itself, will sunset as a separate entity on the second anniversary of enactment. This is more or less symbolic of a larger problem, namely, the extent to which security is being divorced from the practical necessities of a transportation system and being encompassed in the quite different atmosphere of a law enforcement agency.

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<sup>12</sup> Upheaval in Travel Distribution: Impact on Consumers and Travel Agents, National Commission to Ensure Consumer Information and Choice in the Airline Industry, at 9 (November 13, 2002).

The Act memorialized what in fact was happening with respect to the installation of the expensive and bulky explosive detection systems at airports. It was clear that these systems were not going to be able to screen all bags by the yearend deadline, and the Act allowed that deadline to be deferred provided that bags were being screened by other means. The Act also extended and expanded war risk insurance coverage for the airlines. Finally, and this was one of the most controversial provisions, the Act required TSA to establish a program for arming pilots. The TSA has started the program on a limited basis, in part because no funds were appropriated for the requisite training (intended to replicate the training for federal air marshals). As initially conceived, the program would be run on a lock-box basis, *i.e.*, the pilot would be armed only while on the aircraft.

## **Bye Bye Bermuda**

In 1946, the U.S. was in a position to dictate the terms of post-war international air transportation. With the multilateral Chicago Convention providing a framework, and with the failure of the multilateral Five Freedoms Agreement as background, the U.S. proceeded to negotiate a landmark agreement with the U.K. That agreement, executed in Bermuda, provided for the bilateral exchange of traffic rights on agreed terms and for rights incidental to those operations. Most importantly, it limited the rights granted by the agreement to airlines that were “substantially owned and effectively controlled” by nationals of the two signatory states, the U.S. and the U.K.

The Bermuda-type agreement became the template for hundreds of bilateral, nationality-restricted air transport agreements, and it served the U.S. airlines well. In fact, the U.S. has only one multilateral air transport agreement in effect today. Two years ago, the U.S. entered into a “model” multilateral open skies agreement with Brunei, Chile, New Zealand and Singapore. While that agreement is open to signature by other nations, only Peru has signed to date.

When the U. S. proceeded on the path of international “open skies,” tentatively with the Netherlands in 1992 and as a matter of policy since 1995, it continued to do so using the Bermuda form of bilateralism and nationality restrictions. Indeed, all of the Open Skies agreements entered into by the U.S. are bilateral and contain the Bermuda-type nationality clause.

On November 5, 2002, the European Court of Justice ruled that the nationality clause in Open Skies air transport agreements negotiated by the U.S. violates the Treaty of Rome when an EU Member state is involved.<sup>13</sup> The ruling was expected -- in January the court’s Advocate General had recommended this result -- but nonetheless, it is a major event in the history of international air transportation.

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<sup>13</sup> The decisions are in separate actions brought against Austria, Belgium, Denmark, Finland, Germany, Luxembourg, Sweden and the United Kingdom. European Court of Justice, Dockets C-466/98 through C-476/98.

The European Commission would like to see a U.S.-Europe Open Skies agreement. To date, the U.S. has not been so inclined and some of the EU member states also have expressed concerns in that regard. It is not exactly a standoff as much as it is a standstill.

### **Whither Code-Sharing?**

Code-sharing, the listing of an airline's codes and flight numbers on another airline's flights, has been a common practice in the industry since the mid-1980s. A code-share is a promotional device intended to direct marginal traffic to the combined code. In international markets, code-sharing requires DOT approval, albeit an approval that now is routine absent other aeropolitical issues. Domestically, no approval is required. However, in 2000, Congress added a provision to the Transportation Code, 49 U.S.C. § 41720, that requires domestic code-share agreements to be submitted to the DOT for review. Similar to the pre-merger notification process under the Clayton Act, the DOT can extend the review period for up to six months while it decides whether or not to take action against the code-share under section 41712 as an unfair competitive practice. Complicating matters is the fact that the Justice Department's Antitrust Division also reviews these agreements.

On October 2, 2002, the DOT announced that it had completed its review of a proposed code-share between United and US Airways. Subject to certain minor conditions required by the Justice Department, the DOT did not have a problem with the proposal. 67 Fed. Reg. 62846 (2002). However, the DOT took a different view of a domestic code-share proposed by Continental, Delta and Northwest. On January 17, 2003, the DOT announced that unless the airlines agreed to conditions well beyond those required by the Justice Department -- conditions such as surrendering gates and limiting the number of city-pair markets in which the joint codes could be displayed -- it was prepared to initiate a section 41712 action. 68 Fed. Reg. 3293 (2003). This about face in policy led to a standoff between the airlines and the DOT, with the former threatening to implement the code-share and the latter threatening an enforcement action if they proceeded. This was resolved in early March when the DOT announced that the airlines had agreed to a revised set of conditions. 68 Fed. Reg. 10770 (2003).