AMERICAN AIRLINES SYSTEM

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March 21, 1947

TO THE DIRECTORS OF AMERICAN AIRLINES, INC.:

Attached is a copy of the statement made by Mr. C. R. Smith to the Civil Aeronautics Board in connection with airline fares. You will recall that this subject was discussed at last Wednesday's directors meeting.

This statement was not given distribution outside of the company and the Board. It should, therefore, be treated as confidential.

C. W. Jacob,
Secretary

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<u>SHOULD AIR PASSENGER FARES BE INCREASED?</u>

Statement of

C. R. Smith, Chairman of the Board
American Airlines, Inc.

before

The Civil Aeronautics Board
Washington, D.C.

March 10, 1947

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This is an industry meeting, called by you for the purpose of discussing the level of air passenger fares which, together with revenues from other transportation services, will best provide the air carrier industry with continued ability to perform public service of high standard.

The specific question is whether or not we shall petition the Board for authority to increase present air passenger fares. If the question is decided in the affirmative, we must decide what increase to recommend, and give logical reasons for the recommendation.

These are important questions, bearing directly upon the growth and future welfare of air transportation. For that reason, their consideration deserves an atmosphere which will permit the exercise of sound judgment, with due regard for future potentialities, both short range and long range.

We meet here in a period of difficult conditions. The winter of 1946-47 has been a most severe one, characterized by flight interruptions and declining load factor, both of which have had direct effect upon the profit and loss account and on the financial condition of the carriers.

We are most apt, unless we proceed with caution, to permit the acute consciousness of the problems of today to warp our judgment of future opportunity and prospect; we may be prone to accord undue weight to the remedies which indicate immediate promise. We must make sure that any modification of the rate structure, even on a temporary basis, will have long range benefit, and will contribute to the continued growth and orderly development of air transportation.

On the long range basis there are few, if any, who will disagree with the premise that the future of air transportation lies in making the inherent advantages of air transportation available to a greater number of people. The economic status and purchasing power of the potential user of air transportation is a factor which we must continue to keep in the foreground in our thinking and in our planning. It is an inescapable conclusion that the price of our product, and the consequent ability of the average man to purchase our product, is the most important single factor in the broadening of our market for air transportation.

The future lies in continued growth; the ability to increase the number of aircraft in operation, the ability to secure the economical benefits of quantity production and the ability to operate with profit with lower fare levels.

The longtime trend in the level of our fares has been constructively downward, and no one can successfully dispute that the public stature of air transportation has grown correspondingly. Whatever course we take at present time, we should not reverse that long range trend. So far as American Airlines is concerned, we will welcome the day when the status of the industry will permit further fare reduction.

The short range objective is to increase gross income for the seat capacity now in operation, or soon to be in operation. That can best be accomplished by increasing the number and the percentage of seats occupied by fare-paying passengers.

If we are to increase the business volume of air transportation, and thereby increase the load factor, that must be accomplished in a highly competitive transportation market. We must have a product which will bear critical price scrutiny and come out well in competitive comparison. The price of an air ticket and comparison of that price with the price of a rail ticket will directly affect the load factor.

When air transportation was sold at 12¢ a mile we operated a business with limited customer appeal, and with a limited number of customers. One of the basic deficiencies of air transportation was that its cost could not be laid alongside the cost of a rail ticket and bear comparison on the basis of price alone.

But, air transportation is no longer transportation of limited appeal; the traffic figures give clear proof of that assertion. We have today the opportunity of direct cost comparison and it is that opportunity which has permitted the air carriers to attain passenger income status comparable with class one rail roads. Is this position, the one we have labored so long to gain, going to be evacuated without effort to hold it? The easiest way to lose the position is to price air transportation out of the reach of the average citizen, and that we should not do.

Air transportation entered, for the first time, the field of direct cost comparison when air passenger fares were established at four and one-half cents a mile, the present level. But, even then, the area of comparison was an especial one; the cost of one way rail, plus lower berth. And this is an especial area for,as our friends in the rail road business have pointed out, most people travel in both directions, and can secure round trip discount, and not every Pullman passenger travels with the intention of stretching his frame out in a lower berth.

On the whole, air transportation is in the field of direct cost comparison, but barely in. We will be well established in the field of direct cost comparison only when the cost of the air ticket can favorably compare with the average first class rail ticket for the comparable journey. That will mean comparison with averages of first class rail fares, averaging <u>in</u> some of the round trip discount, and averaging <u>out</u> some of the lower berth charge.

At what level in our fare structure do we price air transportation out of the field of direct cost comparison?

At four and one-half cents a mile, air transportation is directly competitive with one way rail, plus lower berth. At four and three-quarters cents per mile, something like fifty per cent of the air tickets may exceed the comparable cost of rail transportation. At five cents a mile, more than seventy five per cent of the air tickets will exceed in cost the comparable rail ticket. Thus, at the extreme rate of five cents a mile, we seem, evidently, to have priced air transportation out of the field of direct cost comparison.

These comparisons relate to the cost of one way rail, plus lower berth. If, at five cents a mile, we have priced air transportation out of the field of direct cost comparison on that basis, it is entirely clear that we have priced it out at a lower level if the comparison be with round trip rail, or with one way rail without lower berth.

But, some will say, we have not given consideration to the projected raise in rail rates. That is true, but we should deal with actualities, and there is no surety that there will be an increase in rail passenger rates. If there is, well and good; should we object if the rail roads explore ahead of us the area of diminishing return. We would be in good relative position if, by requirement, we should raise our rates one-quarter cent and the rail lines should raise their rates one-quarter cent; we would thereby have retrieved our competitive position.

As we have stated before, our present requirement is to secure greater gross revenue from the airplanes now in operation, or soon to be in operation. To accomplish that we must price the ticket at a level which will bring increased load factors. To do that, we must make sure that we stay out of the area of diminishing return.

And, how are we to determine with preciseness the point at which the customer will invoke the law of diminishing return? The answer to that is this "In no way other than by experience".

It may be that the area of greatest income potential is at present fare level, four and one-half cents. The majority of the industry does not believe that to be true.

At the extreme rate of five cents a mile, I believe that the experienced traffic man would envision a reduction in attainable load factor, for the salesman has lost the benefit of direct cost comparison, and that in a market we have educated, by advertising, to expect direct cost comparison.

At four and three-quarters cents a mile, you will have increased fares by a bit more than five per cent, but you have still retained some ability to make direct cost comparison, and that especially in the Eastern market of relatively high rail rates, a productive market of great potentiality.

It seems to us that the potential consequence of increasing air fares a full half cent, from four and one half to five cents a mile, makes it highly advisable that we approach the problem with caution, and on an experimental basis. Read the newspapers and you will find evidence of mounting consumer dissatisfaction with increasing costs. In view of the industry situation and position, we are willing to participate in a fare increase, provided it is a reasonable increase, provided that it is temporary in nature, and provided the Board finds the increase to be required.

Specifically, American Airlines recommends that the basic fare be established at four and three-quarters cents, that the fare be authorized on temporary basis and that no approval be given for round trip discount. Some may conclude that profitable operation will not be possible with these rates. But, analysis may disclose that the rate is not the difficulty.

The Civil Aeronautics Act does not prescribe that air passenger rates shall be established on the basis of the requirement of the marginal operator. That was the reason, I believe, which actuated the Congress to provide an avenue of income differentials, through the establishment of differing rates of mail pay. The present discussion, while it relates principally to air passenger fares, cannot establish a single structure of air passenger fares which will reasonably guarantee profitable operation to all members of the industry; some of any adjustment required must be accomplished through mail rates. The best that this group can do, and the best that the Civil Aeronautics Board can do, is to authorize and establish a level of air passenger fares designed to accomplish the most overall good for the air transport industry and, thereby, for the best interest of the public.

Another factor which may affect long range thinking is the earning capacity of the Douglas DC3 airplane. On that score we must be realisitc, and recognize the well established fact that this airplane, which served us so long and so well, is, by the standards of today, an outmoded technical instrument and an outmoded source of profitable operation. There is, in our opinion, no air fare level which will preserve for long an earning capacity for the Douglas DC3 airplane, and it is idle to attempt a rate structure to achieve that purpose.

There will be isolated operations which will presently warrant the operation of no airplane other than the Douglas DC3, but this will arise principally from the factors that the airplane is already owned and paid for and the even superior factor that the reason for continued utilization of the DC3 is low traffic density in the area where it is to be operated.

Our plant, if our plant consists of Douglas DC3 airplanes, is out of date, and must be replaced. No long range remedy for the present condition of the industry can be built around a plan which will insure the survival of the Douglas DC3 airplane as a source of operating profit.

Round Trip Discount

American Airlines is basically opposed, and will continue to oppose the granting of discounts for round trip travel; on the basis that this historical implement of sales stimulation is outmoded, unwise, wasteful and not properly designed to accomplish the purpose, increased gross revenues from the operation of transportation services. American Airlines believes, and states its position to be, that permission of round trip discounts would have the effect of reducing its gross income, rather than increasing it.

The volume of air transportation has grown far beyond the days when the major proportion of the business was derived from the solicitation of individual salesmen. The cost of personal solicitation, as the primary tool of business development, is too expensive and consumes too high a proportion of the total dollar sales. There will continue to be many air transportation salesmen, but their job will be principally large account service and not individual trip solicitation. Most of the responsibility for increased sales must be borne by space advertising, rather than by personal solicitation, and we must price our product on a basis which will permit most effective sales effort through space advertising. We believe in the principle of advertising, and salesmanship, which permits you to advertise the price of your product at the lowest price at which it can be obtained, and permits such advertising to be direct. For instance, we would much prefer advertising a fare of $90.00 from point to point, rather than $100.00 in large type, with 10% discount dimly discernible thereunder. Successful merchandisers of national products have adopted this principle of salesmanship long ago and it is with great difficulty that you will find in any advertising publication a recitation of the merits of a product, to which there is appended an arrangement under which a discount is available. Some successful advertisers have even adopted the policy of advertising in large type the basic price, with smaller type recitation of the collateral articles required to be purchased before the article can be placed in operation. In very few industries is the system of advertised discount even a matter of sales debate, much less the established sales policy of the concern.

Some will say that the travel agent desires and requires this "sales tool". Perhaps so, with the belief that the travel agent in New York can stimulate his business to and from Los Angeles by selling the customer at New York a round trip ticket, thus depriving the travel agent in Los Angeles of selling the return space to New York. This is an illusory gain, for while the New York agent is selling a round trip to Los Angeles, the Los Angeles travel agent will have similar opportunity to sell round trip passage from his Western city to New York.

American Airlines is, obviously, interested in any sales implement which will increase its business, and increase the gross revenue from its operation. Were it of the opinion that a round trip discount would contribute to that objective, it would welcome the approval and institution of such practice. It is not of that opinion and considers that a substantial proportion of the round trip discount would be gratuitous, and unavailing as an implement to increase gross revenue.

Provided a round trip discount is authorized by the Board, American Airlines will apply for permission to publish fares established on the basis of basic fares less the discount authorized. To be specific, if a fare of $10.00, with potential round trip discount of 10%, should be available to those utilizing round trip discounts, American Airlines will seek permission to institute a fare of $9.00, without discount, for the same journey.