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# AIRLINE SUBSIDIES— PURPOSE, CAUSE AND CONTROL

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## PART II

### PREFACE

THE *purpose* and *cause* of subsidy devoted to the support of scheduled airline services were outlined in Part I of this article.<sup>1</sup> *Subsidy control*, or *reduction in subsidy dependence* is the subject of this second part.

The common objective, whether speaking of subsidy control, or of reduced dependence, is obviously to reduce the total subsidy bill and to ultimately eliminate it. In a sense, the two terms are synonymous, since either would achieve the objective; but when related to the *methods* or philosophies to be employed, the two terms are diametrically opposed under today's connotations.

*Control* connotes an arbitrary approach to the question, where the objective is a fixed limit on subsidy *without* eliminating or easing the factors which cause subsidy need. Eliminating or reducing the *need* for subsidy suggests an approach which

- Anticipates additional commercial revenues in excess of the costs incurred to produce it, and
- Anticipates a reduction in costs.

One thing is very clear—*any program designed to reduce and hence to control the subsidy required for services to the small and intermediate size cities must be predicated on the proposition that the local airlines must be afforded increased opportunity to generate more commercial revenue in sizable amounts*. In the alternative, and possibly in addition to this, there must be realistic bench marks established to determine community eligibility for subsidy.

This approach to reduction in subsidy dependence is essential if control is to be achieved; without it, there is little hope of changing the current trend. It is here recommended that the following program be adopted by the Board:

1. removal of all local service operating restrictions so as to permit local carriers to share in the revenues of short to medium range dense travel markets.
2. elimination of unproductive competition between local and trunk carriers, and suspension of unused trunk certificates.
3. establishment of a system of mail rate payments that will clarify and define the government's liability for subsidy support.
4. establishment of firm standards of initial service eligibility and service retention by a community.

This program is consistent with the needs of not only the Board for an effective program of subsidy control, but equally important, the public will benefit greatly from the improved services which the local carriers will be in

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<sup>1</sup> Vol. 26, Autumn 1959, No. 4, THE JOURNAL OF AIR LAW AND COMMERCE.

a position to provide in dense short haul travel markets. It is a program geared to a modern air transportation role for both divisions of the industry. Furthermore, it is a program which can be implemented within the statutory latitudes available to the Board under existing law.

#### ELIMINATION OF OPERATING RESTRICTIONS

It is proposed that—

The Board remove all local service operating restrictions so as to provide the opportunity for equal participation by local carriers in the dense, short to medium range travel markets, and that such action be taken by the Board as a matter of policy, pursuant to its exemption powers under Section 416 of the Act.

*Discussion:* A successful penetration by the local airlines in such markets would

1. increase commercial revenues per mile operated
2. reduce operating expenses per mile operated
3. reduce the subsidy dependence of the local industry.

Removal of operating restrictions should, however, carry with it these two important corollary policies:

1. That both minimum and maximum standards of subsidy eligibility be established to the intermediate points certificated to the local airlines, thus insuring a proper fulfillment of the local service function.<sup>2</sup>
2. That competitive services resulting from a blanket removal of restrictions be considered *permissive* authorities and, therefore, ineligible for subsidy support *as opposed to* those competitive certifications or responsibilities resulting from specific findings of public convenience and necessity.

Implementation of this proposal and the related provisos are in part dependent upon the modernization of the Board's mail rate policy. Both the proposal and the corollaries are based on the position that the Federal Aviation Act provides the Board with all the authority it requires to differentiate between those services *eligible for subsidy and those which are not*.

In conjunction with this the mail rate policy must be reoriented toward the local carriers. It should include a clearly defined set of standards which permit experimentation *without penalty* but at the same time incurs no assurance of or responsibility for subsidy support in the event of managerial miscalculation.<sup>3</sup>

Under the original operating certificates, the local airlines were granted little, if any, over-fly or "skip-stop" privileges. Each flight was, therefore, required to stop at each point on the route, regardless of the revenue generating characteristics of each point. This rigidity proved to be both costly and unnecessary, resulting in over-scheduling at the weaker or smaller points, and under-scheduling plus an unnecessary down-grading of services at the more productive points.

The requirement to make all stops was apparently bottomed on one or both of the following considerations:

1. The local airlines were created to serve cities which either would not or could not be served by the trunk airlines. Requiring the locals to stop at all certificated points "insured" their attention to these com-

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<sup>2</sup> Recommendations to implement this policy are reflected in Proposals 3 and 4 herein.

<sup>3</sup> See discussion, *infra.*, concerning mail rate policy.

munities and indirectly prohibited any participation in the trunk line terminal-to-terminal business.

2. The trunk airlines, at the time, were themselves subsidized for the most part.<sup>4</sup> Restrictions on the locals thus minimized any significant diversion of commercial revenues from the trunks.

From this it would appear that the primary purpose of the restrictions was to both insure the "character" of the locals and to protect the trunks.

But the emphasis on differentiating between the classes of airlines went beyond this. Until recent years, the Board would not permit both local and trunk airlines to participate as applicants in the same route proceeding.<sup>5</sup> This policy has gradually been modified.<sup>6</sup>

The over-all guiding philosophy of the Board in the past has seemingly been that the local airlines should not be permitted to participate or compete directly with the trunks in what was loosely termed a "trunk line market." Undoubtedly, the original prohibition was based in part on the reasons given here; but it is also probable that the foundation for this exclusion lay in a general uncertainty regarding the future role and competitive capabilities of the local airline group.

In addition to the footnoted exceptions to this broad philosophy, the Board has, in recent years, progressively but cautiously relaxed the restrictions imposed on the locals. With these—and a few other—exceptions, the policy today embraces the following general principles:

1. Between non-competitive route terminal points non-stop operations are permitted—usually after assuring that each intermediate point on the route has received two round trips daily.
2. Between competitive route terminal points, a one-stop or two-stop requirement remains, depending apparently upon the distance (not defined) between the terminals.
3. Between a competitive intermediate point and a terminal point, the policy is less clear. In recent cases, the Board has removed one-stop

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<sup>4</sup> For example, in fiscal 1951, the domestic trunklines required approximately \$17,000,000 of subsidy, about the same amount as was required for local service carriers. See "Service Mail Pay and Subsidy for U.S. Certificated Air Carriers," published by CAB, January 1960.

<sup>5</sup> The first significant departure from this policy occurred in the *New York-Chicago Service Case*, Docket 986, *et al.*, decided Sept. 1, 1955. There Mohawk Airlines, a local carrier, sought applicant status for Syracuse-New York non-stop authority, was denied hearing, and limited to the role of an intervenor. In its decision in this case, the Board deferred decision on the issue of New York-Syracuse authority and set this portion—including Mohawk's application down for a new hearing. Mohawk and Eastern became the primary applicants for this route, with the award ultimately going to Mohawk, the only local airline involved in the proceedings. Mohawk thus became the first local airline to be granted unrestricted operating authority in what was generally recognized at the time as typifying a trunk line market where Mohawk now competes with American Airlines. *Syracuse-New York City Case*, Docket 6179, *et al.*, decided March 27, 1957.

<sup>6</sup> See, e.g., *Piedmont Area Local Service Investigation*, Docket 5173, *et al.*, where Eastern and Allegheny are applicants for non-stop authority between Norfolk and Philadelphia. In the *Buffalo-Toronto Case*, Docket 7142, *et al.*, Allegheny and several trunklines are applicants for nonstop rights between Buffalo on the one hand, and Philadelphia, Baltimore, Washington and Pittsburgh on the other. In the *Northeastern States Area Investigation*, Docket 6436, *et al.*, applications of Allegheny and Mohawk for new authority between Pittsburgh and Syracuse were consolidated. Eastern also sought consolidation of an application for similar authority but was denied. On Brief to the Board Eastern urged that it was entitled to a hearing on its application under the doctrine of the *Ashbacker* case (*Ashbacker Radio Corp. v. F.C.C.*, 326 U.S. 327 (1945)). The Board decided in favor of Eastern and re-opened the record to permit Eastern to present evidence in support of its application. *Pittsburgh-Syracuse Service Case*, Docket 7263.

restrictions where the local carrier has made a substantial penetration in the market. But in awarding *new* routes, the imposition of a one-stop restriction appears to be more the product of representations and urgings by the affected trunk lines than by any specific criteria relating to city or market size, schedules and service patterns provided by the trunks already certificated, or specific anticipations of the local airline seeking certification.<sup>7</sup> Such restrictions once imposed generally remain until the local airline or community can demonstrate either a substantial penetration in a given market or a need for relief.

In recent trunk line or long haul route cases, the *only* restrictions imposed by the Board on a trunk airline have generally been the so-called "long haul" restriction. Under this type restriction a flight must be originated or must terminate at a point *beyond* a given intermediate point on that route. An airline, so restricted, is thus effectively prohibited from engaging in a turn-around or shuttle operation between given pairs of cities. The "minimum stop" type of restriction has not been placed on trunk carriers in new markets which are incidental to long-haul flights. Thus, extension of trunk airline services has resulted in certification of nine trunk carriers with non-stop authority between Washington and New York.<sup>8</sup>

The "minimum stop" type of restriction, common in local airline certificates, while unnecessary, is not particularly harmful in a non-competitive market. *But it is deadly in a market where another airline has non-stop rights even though these rights are not being exercised.* The reason for this is obvious—a one-stop, or even a two-stop service, operated at optimum times of the day will develop a non-competitive market; but it is impossible to hold that market or maintain a position in it against well-timed, non-stop services later inaugurated by a previously dormant competitor.

Thus, in markets receiving inadequate or token service by a trunk airline, a local airline with a minimum stop restriction is at an initial and lasting disadvantage. While the local can develop the market under these circumstances, *it cannot hope to maintain a position in the market should the trunk be attracted by the results achieved by the local.* This result is inevitable against non-stop competition regardless of the equipment used by the local, the procedures employed or the fares charged. Such is the magnet of non-stop flights.

Under these conditions, a local carrier must be extremely reluctant to expose the necessary investment to develop a market it could not protect or expect to maintain satisfactorily against competition.

There are numerous pairs of cities today where a paucity of trunk line service exists. As the trunks increase their jet or long-haul fleets and continue their disposal of short to medium range aircraft these service voids will increase. *Restrictions on the local airlines in these markets are harmful and unnecessary hindrances to their development in a logical specialist role—commuter air service.*

Moreover, the cities involved cannot obtain immediate relief when trunk line interest wanes or fails to keep pace. These cities are, therefore, deprived of reasonable competitive service and in some cases even adequate monopoly service. Relief under Section 404 of the Act, when sought, is both expensive

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<sup>7</sup> For example, in the recent *Northeastern States Area Investigation*, Docket No. 6436, *et al.*, the Board imposed a one-stop restriction between Hartford and Washington, but no restriction between Providence and Washington, despite similar services by the trunks in both markets.

<sup>8</sup> Allegheny, the only local carrier in this market, has a one stop restriction.

and time-consuming, and frequently inconclusive.<sup>9</sup> Of equal importance, is the fact that relief under Section 404(a) represents only a *minimum* standard of service which the carrier is legally obligated to provide and which the Board will undertake to enforce.<sup>10</sup>

The basis for imposition of operating restrictions has diminished to the point where the Board should remove such restrictions, since

1. the Board can assure service, and, therefore, original purpose, by defining and requiring minimum service standards to a smaller intermediate city *before permitting over-flying that city*. In recent cases it has done this and a well-established pattern therefore exists.
2. the trunk airlines no longer require "protection." Significantly, the Board has not in any recent case, advanced "protection" or "diversion from trunks" as a primary reason for imposing restrictions over a route also served by a trunk airline. This policy was clearly enunciated by the Board in the *Seven States Area Investigation* in these words:<sup>11</sup>

"And, insofar as the protection of the trunklines is concerned, we are fully convinced that they are not entitled to any more protection from the local service carriers than we are providing. The simple fact is that the trunkline carriers have in a real sense, come of age, and they are fully capable, in an economic sense, of coping with the limited amount of competition from the local service carriers which we are authorizing. To begin with, the trunkline carriers are, for all practical purposes, no longer dependent upon Government subsidy. \*\*\*\*\* The mere fact that a trunkline carrier has preceded a local carrier in a given market does not *ipso facto* entitle the trunkline carrier to immunity from competition by a local carrier in that market. Our main objective in placing a one-stop restriction on flights between competitive terminals is not so much for the protection of the trunkline carriers, as it is to exclude the local service carriers from participation in markets where the need for direct competitive service has not been shown and *where the likelihood is that the effort by the local carrier to compete would jeopardize the soundness of the local carrier's operations.*" (Italics added.)

3. Finally—the Board has made a sufficient number of departures from the "dividing-line" theory as to no longer justify a concept that locals and trunks should not mix.<sup>12</sup>

In light of the above considerations, it must be concluded that continued adherence to a policy of imposing restrictions on local carriers does not stem from considerations related to service to the public.

As suggested by the italicized quote above, it must appear that *the primary deterrent to removal of all local airline operating restrictions relates to concern over the effect such removal would have on subsidy*. In the absence

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<sup>9</sup> The Board has experienced an increasing number of complaints concerning inadequate service under Section 404 of the Act. The *Baltimore Adequacy Case*, Docket 8148, *et al.*, commenced on January 27, 1957 and was not decided until April 29, 1960. The *Fort Worth Investigation*, Docket 7382, commenced on February 14, 1956, and was not decided until September 23, 1958, more than 2½ years later. The Board there found existing services at Fort Worth adequate, but retained jurisdiction to insure that services would continue to be adequate. Just recently the Board re-opened this proceeding to re-examine services of American and Braniff (Order to Show Cause, E-14973, dated March 1, 1960).

<sup>10</sup> *Fort Worth Investigation*, Docket 7382, decided September 23, 1958.

<sup>11</sup> *Seven States Area Investigation*, Docket 7454, *et al.*, Order E-13254, p. 145.

<sup>12</sup> The historic dichotomy between trunkline and local service carriers has been reflected in the CAB's own alignment of staff functions within the Bureau of Air Operations, where trunkline services and local services are processed by separate sections. With the intertwining of local and trunk matters as now exists, this split personality within the Board's own staff may no longer be warranted.

of a clearly defined policy on subsidy eligibility this is probably a well-founded concern.

But by the same token there is no valid or apparent reason why the question of subsidized competition cannot be met head-on and why it should not be dealt with. Basically, the Board has but two primary concerns or questions:

1. To what extent, *if any*, should subsidy be used to support a competing airline service in a major market? Is it consistent with the statutory objectives of section 406(b) of the Act?
2. If the local airlines are allowed to compete in major markets, and if such competition is not successful, then to what extent is the Board, by permitting competition, incurring additional subsidy liabilities?

In dealing with these questions, certain distinctions should first be drawn. First of all, *competition created as a by-product* of other public convenience and necessity objectives should be distinguished from those circumstances where the *creation of competition* was the primary purpose of certification.

Two examples of competition as a by-product would be:

1. Where competition is largely confined to "entry" mileage to a terminal, or where the purpose of certification was primarily and largely to non-competitive intermediate points. Frequently certification in these cases will, or may, result in the creation of competition over one or more other portions of the route.
2. Where certification occurs as a result of findings that an *already certificated carrier was not adequately serving the city or route*, or where services being offered by that carrier were of a "token" or non-commuter nature.

Both these examples warrant subsidy support if such support is required.<sup>13</sup>

The *creation of competition* as the primary purpose of certification is the circumstance under which the question of subsidized competition is brought into sharp focus. By the same measurements, *permissive competition* resulting from the arbitrary removal of operating restrictions falls precisely into the same category.

Authority to conduct competitive non-stop services created through removal of restrictions should be considered a permissive authority. This is to say that non-stop operations would not be, under these circumstances, required. *Neither should such operations as a general rule be considered eligible for subsidy support* since they would be operated at the discretion of the airline management.<sup>14</sup>

On the question of whether subsidy support in a competitive market is *justified*, there are, of course, circumstances which generate exceptions to the rule. Two specific exceptions come readily to mind:

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<sup>13</sup> Subsidy payments in such cases have not been challenged in the past, nor has the Board denied subsidy support where required, provided "over-scheduling" by the local airline had not been evident. Even so, as suggested herein at a later point, the subsidy requirement would be substantially reduced if the trunk airline already certificated, but not meeting service requirements, were suspended.

<sup>14</sup> The Federal Aviation Act places *no* limitation on the Board in the matter of subsidy administration. Such is the Board's authority that subsidy support can be given in purely competitive markets at the Board's discretion. Again the over-all philosophy must be, and appears to be based on measurable public benefits not otherwise possible *without* subsidy support.

1. Where competition is required in the public interest even though both or all the airlines involved require subsidy assistance.<sup>15</sup>
2. Where the public interest will be served by experimental services, related to either fare structure or service considerations, subsidy support is justified for specific periods of time.<sup>16</sup>

Subsidy support, if needed, under directed circumstances is, therefore, justified. But in the major domestic short-haul markets discussed here, where competition is a discretionary function of management, *it is neither justified nor required.*

The second and final question concerns the extent to which the Board, by permitting local airlines to compete in productive markets, might be incurring additional subsidy obligations in the event attempts to compete were not successful.

Under the circumstances advocated here, non-stop authorities in competitive markets would be permissive. Thus, a determination to exercise such authority, and in what markets, would be solely a management decision. Presumably, such decisions would be based on at least the following factors:

1. The potential of the market, measured against the quantum and quality of service provided by already certificated carriers.
2. The schedule pattern of the moment and the historic trend of that pattern followed by the trunks in that market.
3. A judgment of the company's ability to penetrate and *maintain a position* in a given market based on its own equipment program measured against the anticipated program of the trunk line, the evolution of new methods and procedures by the local, and the likelihood of the trunks adopting these procedures.

It is clear that the Board does not assume any obligation to provide subsidy support for those services not required or deemed necessary in the public interest in determining "need" under section 406(b) of the Act. The Board historically has refused to underwrite schedules which it deems excessive, under the "honest, economical, and efficient" criteria in section 406(b).<sup>17</sup>

There appears to be no reason, therefore, to conclude that the Board has assumed any subsidy liability in the event of managerial miscalculation occurring under the permissive authority discussed here. The granting of a non-stop authority does not require the operation of non-stops, and never has.<sup>18</sup> A management decision to conduct non-stop services should be later judged on the basis of the economic results produced—certainly a normal process in any business. Possible miscalculation of a market potential is a

<sup>15</sup> For example, the Board has subsidized two carriers providing inter-island services in Hawaii (Aloha and Hawaiian Airlines). See *Trans-Pacific Airlines, Ltd., Renewal Case*, Docket 6434, *et al.*, decided May 3, 1955, approved by the President July 11, 1955, where the Board stated, "The cornerstone of our decision herein is the imperative need for competitive air service in the Hawaiian Islands." (Order E-9375.) Another example of this policy is the Board's underwriting of competitive Trans-Pacific services by Pan American and Northwest Airlines.

<sup>16</sup> Conceivably, certain "special" services might be authorized to a willing carrier with subsidy guarantee if necessary. By and large, the Board has tended to encourage experimental developmental fares. Too, the Board has, from time to time evidenced uneasiness and concern over the lack of interest by the trunks in developing the low-cost, mass transportation market. Thus, the Board is investigating short-haul coach services in the *New York Short-Haul Coach Investigation*, Docket 9973.

<sup>17</sup> See, *e.g.*, *Trans-Pacific Airlines, Ltd., and Hawaiian Airlines, Ltd., Mail Rates*, 20 CAB 668.

<sup>18</sup> This is not to say, however, that the failure to provide non-stop service in a given market could not be construed as inadequate service under section 404(a) of the Act.



normal management risk. The local airline managements should have the right to take that risk. They do not have it today.

On the basis of the reasoning applied here there appears to be no legal reason for retaining *any* of the local airline operating restrictions excepting possibly those necessary to minimize competition *between local airlines*. Indeed, there are compelling reasons why the public interest would be well served by this Board action.

As demonstrated earlier, the trunk emphasis on long haul markets has resulted in a neglect of the short haul market. And this situation is changing rapidly—too rapidly for the Board to keep abreast of it through adequacy of service cases and formal hearings.

It is in these short haul areas that the great untapped and potentially profitable markets exist. Development of these markets dictates the application of equipment designed or suitable for this purpose, the development of procedures and "cost-cutting methods" designed to produce a profit at reasonable load factors, and a concentration on this particular phase of civil aviation. The local airlines are the ones to do this; the trunks are not *and cannot*. Ample evidence in support of this is provided by consideration of the following factors:

1. The trunk line equipment programs.
2. There is not *one single project* underway by a trunk line which is directed toward maximum development of a single short haul market.
3. The absence—in some cases the presence of a decline—of increased services and seat availability between many city pairs, where new certificates have not been issued.<sup>19</sup>

*Removal of operating restrictions will decrease subsidy dependence and should not or need not increase subsidy liability. The local airline managements can be depended upon to devise new methods and techniques in the development of the short-haul market if given a free-rein to do so by the Board. There no longer exists any reasonable basis for denying them this opportunity.*

#### ELIMINATION OF UNPRODUCTIVE COMPETITION AND SUSPENSION OF DORMANT CERTIFICATES

It is proposed that

1. The Board undertake an immediate study which would include, but not necessarily be limited to, the following:
  - a. analysis of city pairs where competition exists between a local and a trunkline carrier which appears to be economically unwarranted.
  - b. analysis and review of routes where replacement of trunk carriers by locals at intermediate points has been only partially accomplished, but where if fully implemented would both improve service and reduce subsidy.
  - c. analysis of dormant trunkline certifications between short-haul city pairs which offer local carriers a potentially profitable operation.

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<sup>19</sup> Some cogent examples are the following: Pittsburgh-Washington frequencies declined from 16 daily round trips in September 1955 to 11 round trips in September 1959. Pittsburgh-Baltimore frequencies were 3½ round trips in September 1955 and the same in September 1959. Baltimore-Buffalo frequencies were 2 round trips in September 1955 and only one round trip in September 1959. Baltimore-Cleveland frequencies were 1½ round trips in both September 1955 and September 1959.

2. Following this study, the Board should institute a series of expedited proceedings to consider additional suspension and replacement of trunk authorities in those areas where the analysis indicates potential financial benefit to local carriers.

*Discussion:* The local carriers have replaced trunklines at a little more than 100 points. In many instances, replacements have been considered on an individual point-by-point basis as contrasted to replacement of whole route segments.<sup>20</sup> Likewise, in most instances replacement has been authorized where the community, the trunk carrier, and the local carrier were in agreement that the trunk should be replaced.<sup>21</sup>

The economic impact of this particular policy has been two-fold:

1. Over a given terminal-to-terminal route which included a number of intermediate cities, suspension of the trunk airline has been authorized for the most part only at those points no longer of interest to the trunk, or more precisely, those points which in the judgment of the trunk, represented a "loss" point.

Thus, although suspended at the less productive points through replacement by a local airline, the trunk airline was permitted to retain the larger, more productive cities, which as the only profitable intermediates on the route had formed the backbone of support to the less productive cities on the same route.

2. In certificating the local service replacement, the new route evolving from the replacement more often than not included also the same intermediates remaining to the trunk airline. Thus, the local airline became a potential competitor with the trunk between the larger intermediate point and the terminal points of the route—a market which in many cases would not warrant competitive certifications.

To guard against competition, the Board imposed certain operating restrictions on the local requiring one or more stops between competitive pairs of cities. Thus, local airline participation was, by this means, diluted to "spill over" proportions, or grew only as the trunk failed to meet the demands of the market.

The effect of this practice on the subsidy requirements of both the trunks and the local airlines is self-evident. *On the one hand*, the trunks, having been relieved of "loss" points and having only the profitable intermediates remaining, have been hastened along their own road to a subsidy-free or self-sufficient operation. At the same time, to insure minimum competition in their remaining markets, they have successfully for the most part, and without fail in almost all cases, urged imposition of operating restrictions on the locals.

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<sup>20</sup> An outstanding exception was the replacement of American's local Chicago-Detroit Route (*Chicago-Detroit Route 7 Local Service Case*, Docket 6411, *et al.*, February 28, 1955). Recent area proceedings before the Board have tended to include more instances where replacement of a whole segment was in issue, as well as isolated points.

<sup>21</sup> Notable as an exception to this general impression was the replacement of United Air Lines at Monterey and Santa Barbara, California, by Southwest—now Pacific—Airlines. Here, in 1952, the Board suspended United over the strenuous objections of both the carrier and the cities, Southwest Renewal—United Air Lines Suspension Case, 15 CAB 61. But, in 1955, following persistent requests by the objecting parties, the Board reversed this decision and restored United to both cities. Pacific's certificate was not changed in the process. This action was taken even though the Board conservatively estimated that the action would divert substantial commercial revenues annually from Pacific, thus *increasing* Pacific's annual subsidy requirement. A more recent exception occurred where Allegheny Airlines replaced American Airlines at Wilmington, Delaware. Here American and Allegheny were in agreement, but the city objected to American's suspension, *Northeastern States Area Investigation*, Docket No. 6436, *et al.*

On the other hand, because of the partial replacement policy and the imposition of operating restrictions, many of the new routes awarded in the past to local airlines have been *pre-destined* to requiring subsidy support.

The logic of that which is past is not argued here. The evolutionary process inherent in attaining the dual objective of freeing the trunk airlines from dependence on subsidy, and providing many new cities with scheduled airline services, undoubtedly required a cautious approach to the change-over. Too, the local airlines during their own growing up process were neither ready nor prepared to replace the services offered by the trunk airlines.

Whatever the reasons, they appear to no longer prevail today. The trunk airlines having been granted extensive new long-haul authorizations no longer require or receive subsidy. Whatever revenue loss would result from implementation of a policy of *complete replacement* represents an almost infinitesimal part of their total revenues. The economic impact, which earlier might have been harmful, would today be insignificant.

Moreover, complete replacement would recognize an increasingly obvious trend—that as the trunk airlines continue to dispose of their two engine or relatively short-range equipment, the quantum and quality of their service to the larger intermediate cities will continue to deteriorate. Thus, both their ability and desire to serve these cities will progressively wane.<sup>22</sup>

With the local service airline transition to modern, pressurized post-war equipment well underway and gaining momentum, they are—in sharp contrast to their earlier years—in an excellent position to replace the trunk lines at intermediate cities *on a complete basis*. They should be permitted to do this.

The effect on the annual subsidy bill that complete replacement would have would be little short of astonishing. It is probably impossible to forecast to any precise degree the annual amount which could be shaved off the nation's subsidy bill. A *conservative estimate, however, would place these savings somewhere between ten and twenty per cent of the total now required by some of the local airlines.*

#### UP-DATING THE BOARD'S MAIL RATE PROCEDURE AND POLICY

It is proposed that:

1. expedited action be taken to refine the Class Mail Rate Formula and its early adoption by the Board. Properly set up, it will bring stability to a presently unstable segment of the scheduled airline industry.
2. non-stop flights operated between competitive cities deemed to be "permissive" by the Board *not* be eligible for subsidy.
3. flights operated in excess of four round trips over a defined segment be declared ineligible for subsidy but with no other penalty involved.

#### *Discussion:*

Throughout their ten to fifteen years existence, the local airlines have operated more often than not under *temporary* mail rates. Only with rare exceptions has a local airline been able to operate for long on a permanent mail rate. Their mail rate histories unfortunately have generally followed this pattern—

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<sup>22</sup> The decrease in the ability of trunk carriers to meet short-haul service requirements is reflected in the composition of their fleets. As of December 31, 1953, the trunk carriers operated 476 twin-engine aircraft, which represented 51% of the trunkline fleet. By December 31, 1959, there were only 319 twin-engine aircraft in the trunkline fleet, which was only 25% of the total. It is assumed that DC-6, DC-7, Constellations, 4-engine turbo-props and jets are not adaptable to the stage lengths or types of service discussed here.

- An extended period on a temporary rate interspersed with one or more retroactive adjustments or changes.
- A mail rate conference lasting for extended periods of time to establish the amount due for the past period and to determine a final future rate for a prospective future year.
- A short period on a permanent rate or until a new rate or some economic change causes the airline to declare its rate “open,” followed by—
- Another long period on a temporary rate.

A *temporary mail rate* does not include provision for earnings and taxes, although recently provision has been made for interest on debt provided there was no danger of over-payment. Moreover, the temporary rates established are normally less than that actually required, with deficiencies later made up by “retroactive adjustments.” As a basic policy, an adjustment to a temporary rate cannot be obtained prospectively; “need” must be first demonstrated. During such demonstration periods, moderate to heavy losses are incurred.

As a result of these protracted and repeated periods of temporary mail pay status, reported losses in monthly, quarterly and annual statements are commonplace. Yet, by reason of later retroactive adjustments, followed in turn by additional *final* retroactive settlements, *these losses do not in fact exist*. Since acceptable accounting practice does not permit inclusion of anticipated future settlements as an account receivable, there is no acceptable way to temper or compensate for these losses in a financial report. Footnoted estimates of amounts due can be equally misleading because the true amount cannot be determined until the Final Mail Rate Conference has been completed.<sup>23</sup>

This financial instability, represented by violent fluctuations in a company's cash position is without a doubt one of the most damaging influences on the financial integrity and reputation of the local airlines. In a segment of the industry where the average net worth is less than one million dollars, partial retroactive adjustments in excess of the airline's net worth is more often the rule rather than the exception. Total claims are sometimes double this amount!

This “famine and feast” existence is unnecessary; and *it is tremendously wrong*. Wrong because it

- distorts and conceals the value of the individual airline security.<sup>24</sup>
- increases capital costs which in the final analysis are paid for by the Federal Government.<sup>25</sup>
- increases operating costs, also ultimately paid for by the government.<sup>26</sup>

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<sup>23</sup> The airline management and the Board's staff do not always agree.

<sup>24</sup> It must be appreciated that the investing public, except perhaps for the most sophisticated analysts, is completely unfamiliar with the purpose of subsidy, the idiosyncracies of its administration, or the fluctuations in earnings and loss reports as a *product* solely of that administration. The preponderance of investors know only that a company made money or lost money. They do not analyze. Reported losses which do not in fact actually exist, cause them to sell their investment at a deflated price, only to see this same security rise to or above its original cost upon receipt by the company of the retroactive pay due it.

<sup>25</sup> Earnings records and financial responsibility determine interest rates and capital costs. That the Board recognizes this is evidenced by its recent change in earnings policy for the local airlines whereby net after taxes was increased from 8% to 9½%. In Docket 8404 entitled “Local Service Airlines Rate of Return Case,” not yet decided, the Examiner recommended a 12½% return after taxes largely on the basis of higher capital and financing costs.

<sup>26</sup> Delinquent accounts, regardless of cause, result in loss of trade discounts, imposition of COD charges, higher product cost through inclusion of interest as a part of product pricing, higher contract costs due to a poor or slow payment record, and higher administration costs. All these costs are recognized and allowed in the mail rate making process.

The cycle of resource dissipation and replenishment has been repeated time and again with the harmful results itemized here being each time repeated with it. The situation, which has steadily worsened, seems so patently wrong that the question of "why" naturally occurs. It is doubtful that the question can be answered clearly and completely. On the surface, at least, it must appear that

1. There is a tremendous concern that "over payments" will occur and must at all costs be avoided.
2. In the absence of a clear policy with respect to subsidy eligibility by type and quantum of service, there is a general uncertainty as to how much and what type of service should be underwritten and what the resulting subsidy bill will be.
3. The methods for determining mail payments are outmoded and simply not applicable to, nor can it keep pace with the dynamic growth and expansion of the local airlines.
4. Attempts to keep subsidy payments within budget estimates and appropriations.

None of these reasons justify the results; nor are they valid as a concern or justified in their continuance.

In the first place, over-payments should they occur, need be handled or viewed no differently than recapture of excess profits or over-payments in military contracts. The same problem of repayment, collection, interest or other charges are exactly the same. The only concern might conceivably rest with the legal concept that over-payments made in connection with a *permanent* rate are not subject to recapture. If this be a valid concern, the solution is simple—call the mail rates temporary until the law can be changed. *But include profit and tax allowances in those rates so the airlines can retain their financial stability and integrity.*

Each of the remaining points relate to standards of subsidy eligibility and methods. The establishment of a workable formula and enunciation of the standards and methods to be used are by no means as difficult as might first appear.

The Board has had before it for some time the vehicle by which each of these are met. This is the so-called class mail rate formula.<sup>27</sup> The principle embodied in the formula meets and eliminates each of the problems causing today's financial instability. As in any new concept, details and specifics must be worked out.<sup>28</sup>

The basic objectives and principles enunciated in the formula are sound. These are:

- a. The establishment of a *maximum* service to be underwritten with subsidy.
- b. Decision to operate more than maximum left to management.
- c. Provision against *over-payment* through return of excess profits on an automatic basis.
- d. Management incentive to *reduce* subsidy support achieved through *profit-sharing* on a progressive basis.
- e. All airlines kept on a current mail pay status at all times.

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<sup>27</sup> First distributed for comment on October 27, 1958; second draft distributed July 22, 1959.

<sup>28</sup> Since the initial draft of this article was prepared, the Board has appointed a staff committee to define details relating particularly to standards and methods. An industry committee has been appointed to work with the Staff Committee. Committee recommendations are to be submitted to the Board as soon as possible.

ESTABLISHMENT OF MINIMUM SERVICE CRITERIA—  
ITS EFFECT ON SUBSIDY

It is proposed that:

1. There should be closer coordination between the FAA, which allocates airport funds and the CAB which must decide whether the airport is to be used as a scheduled service point.
2. Airport funds for airport construction of a size to accommodate airline aircraft should be denied where good scheduled airline service is within 45 minutes to one hour's driving time from the community.
3. Construction of a single all purpose airport (area airports) should be encouraged.
4. The local airline service pattern at all airports or cities within 45 minutes to one hour driving time of a major airport should be investigated regardless of the boarding record per departure achieved.
5. The minimum scheduling standard for a city should be established at two round trips per day.
6. The minimum production standard for a city should be specified in passengers per departure rather than in daily terms. If a reduction in subsidy beyond what such a standard would produce is desired, the standard should be increased. Whatever the standard it should be applied regardless of the number of schedules operated.

*Discussion:* Just as standards are required to determine subsidy levels and eligibility, so also are criteria required for determining *service* eligibility.

Definition of service eligibility standards must consider three separate, but related considerations:

1. Guidance to the community on the initial question of whether it should invest in an airport large enough to receive scheduled airline aircraft.
2. Scheduling standards it may expect from an airline if one is certificated.
3. Minimum revenue production required to both obtain scheduled service in the first instance, and *to retain it* in the second.

The first of these three considerations is basic, because wise counsel to a community considering or planning an airport may well avert later problems relating to either obtaining or retaining service.

Community size is not a complete criterion in itself. A small isolated community may be much more entitled to subsidized air service than is a community several times its size in relatively close proximity to an already established service point. Similarly, these relatively good sized intermediate communities within a peripheral area of 25 to 40 miles certainly are not entitled to service at all three points if one common airport location would suffice for all three.

The community planning an airport program should be first advised on the matter of whether it will be eligible to receive service once the airport is built. All too often the airport is built first, and service sought after the airport is built. This phenomenon, especially in a marginal city is the product either of a calculated gamble or ignorance of basic requisites for service eligibility and retention.

Certainly, a community which has built an airport with 50% of the costs provided by the local business and citizens has a "leg-up" on getting scheduled air service. Perhaps it is *entitled* to anticipate service when the other 50% is provided by the Federal Government from funds administered by the Federal Aviation Agency.

Regardless of the considerations behind final determination to construct an airport, the Board is in a difficult position to *deny* even a trial period in light of public expenditures already committed. The community *must press the demand* for air service because the implied promise of such service was in all probability the basis for local public acceptance of the program at its inception.

This type of public pressure is justified under this set of circumstances. But many of these situations could be avoided if standards were laid down and *applied* as a condition precedent to allocation of Airport Aid Funds. Following are some general rules which could be used as guidance by a community.

1. The community or communities seeking airport aid funds should be at least 45 minutes and more generally at least one hour's driving time away from existing scheduled airline service.
2. Airport sites should be so located as to serve a maximum number of communities from a single airport facility.

The advice and guidance given a community or group of communities should be the product of a closer liaison between the FAA which administers the Airport Aid Funds and the CAB which administers the subsidy funds. Had this type of guidance been available it is probable that a significant number of airports would not have been built and some of today's servicing complexities and subsidy requirements would have been avoided.

At the risk of repetition and to avoid misunderstanding, the emphasis here is confined to those communities which have ready access to larger service points and to those areas where one airport can logically serve more than one community.

The second standard to be established is the minimum level of service a community may anticipate once it is certificated and upon which retention of service is dependent. *Except in those circumstances where service is authorized to meet a specific project or purpose—such as a defense requirement or a large construction project—minimum service should consist of two round trips per day with possible reductions on week-ends.*

One round-trip cannot possibly develop a pattern of use in a short-haul or commuter type service. And it is unfair to expect that a community marginal in the first instance—can justify retention of service under such a pattern. Therefore, if a community warrants even a trial certification, it also warrants that the trial be made with a minimum of two round trips.

This, then is the standard of service which the community should be able to anticipate as the basis for its trial, and it is the standard by which the airline can anticipate payment for services rendered.

The third, and final standard relates to minimum revenue production requirements in order to qualify for *retention of service*. The enunciation of this standard and particularly its general acceptance as a congressionally endorsed standard is of the utmost importance.

Once accepted as a standard by all it would serve to

- Avoid airport construction projects which must ultimately be unused with consequent local embarrassment.
- Avoid costly "trials" practically assured of failure at their inception.
- Establish positive goals *and responsibilities* for retention of service.
- Represents a long stride forward in controlling subsidy requirements.

The Board in its decision in the Seven-States Area Case first enunciated its use-it-or-lose-it policy. Simply stated, this policy establishes that for a community to retain its scheduled services, it must board an average of five

passengers per day; for an airline to retain certification over a given route it must average at least five passengers aboard per plane mile operated.

While this is a significant step toward the objective, it is suggested that the policy has two inherent weaknesses:

—It is based on *daily boardings* rather than *boardings per departure*.

—It functions on the basis of but one round trip per day.

A single round trip over a route stopping at each point obviously produces two departures a day per community served on the route. Therefore, a community must produce an average of 2.5 passengers *per departure* to retain service under this policy.

Unfortunately, the policy does not make this fine distinction between daily and per departure boardings although quite apparently this is the intended criterion. As a result, a community which happens to be a route junction point, may well meet the minimum criterion for daily boardings, but falls *far below* on average per departure. Similarly, a weak-producing community on a route requiring two round trips before being overflowed, while meeting the minimum daily criterion could actually be averaging as low as 1.25 passengers per departure.

It is not the purpose here to specify what the minimum standard should be; nor is it advocated necessarily that it be increased. It is appropriate to point out, however, that *the higher the boarding-per-departure the lower will be the total subsidy bill*.

The minimum standard is for this reason properly a Board/Congress determination.

As the basic conclusion, *subsidy control* as opposed to *reduced dependence* is to be found in this area. The specifics in the policy can be made to produce any level of subsidy desired as a national policy. Of the greatest importance, the application of this policy is not at the expense of those cities which are supporting their local service airline.

### CONCLUSION

The purpose of this article has been to set forth as concisely and as analytically as possible the various factors which in themselves determine what the subsidy level should be, its purpose and its confinement to that purpose, and finally to propose a program which tended to *both* control and reduce dependence on subsidy.

The urge to present this paper was prompted both by a concern—shared by all the airlines—over the rising subsidy trend and the conviction that a carefully compiled documentation of developments and concepts over the past decade was urgently required.

Over the span of the last two years particularly, there have been various proposals made to members of Congress which are designed to limit, curtail, exclude or altogether eliminate subsidy support. As future events unfold, the pressure to enact some form of legislative control will be increased.

In part, this pressure will be bottomed to a large extent on the effects of the severe competitive struggle which will gain its major momentum over the next two years. Receptiveness to proposals to curtail or arbitrarily limit subsidy totals will be governed in large part by understanding of the various factors causing it to exist or increase.

All who are concerned with this matter of subsidy must recognize these inescapable facts:

1. Presuming honest, efficient and economical management within the meaning of Section 406(b) of the Act, *then the volume of subsidy*



*required is related to the quantum and quality or type of service provided.*

2. Reduction in subsidy total as an arbitrary act *without compensating access to additional or offsetting commercial revenue* must inevitably result in either a reduction in service, or a downgrading of service on a "shot-gun" basis, or outright elimination of service, or a combination of all three results. *The degree to which this occurs must be related exactly to a non-compensated reduction in subsidy.*

The recommendations made here have been put forth with the dual objective of reducing dependence on subsidy and bringing a tremendously essential state of financial stability to this segment of the airline industry. All the recommendations made are possible of implementation by the Civil Aeronautics Board within the very broad authority given the Board by Congress, all of which is embodied in legislation enacted no earlier than 1958.

*Additional legislation, therefore, is not required to control, limit or reduce dependence of the local airlines on subsidy dependence.* A positive program is required.

In the President's budget message for Fiscal Year 1961, he expressed concern over the rising subsidy trend. The words used in expressing this concern have a special significance. He said:

"This rise and the prospect of even higher subsidies in the future make necessary the consideration of proposals to *reduce the dependence* of these airlines on the government." (Italics supplied)

*Reducing dependence on subsidy* can be accomplished by only one or both of two methods, again

- Progressive reduction of the service obligations which require subsidy.
- Access to increased commercial revenues.

The proposals made here represent a start toward compliance with the President's directive. With reduction in subsidy dependence, control of subsidy is achieved on a reasoned basis.