Journal of Air Law and Commerce

Volume 12

1941

# Economic Regulation of Air Transport

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# ECONOMIC REGULATION OF AIR TRANSPORT

By Selig Altschul

With the passage of the Civil Aeronautics Act of 1938, the air transport industry was given a new lease on life. Prior to this event the industry was rapidly approaching financial ruin. At that time it was estimated that of the $120,000,000 of private investment made in American air transportation, over $60,000,000 was gone. Moreover, the equity of the entire industry was valued at less than $40,000,000. Today, financial stability has been introduced in the air transport group—and despite its problems arising from the national defense effort, it is firmly established as America's coming new industry.

Prior to the Civil Aeronautics Act of 1938, aviation's many problems had been parceled out piecemeal to whatever Federal agency seemed best suited to cope with them. The Post Office Department awarded mail contracts, the Interstate Commerce Commission fixed rates, the Department of Commerce handled airways and safety regulation, the Department of Agriculture provided weather reports and the Departments of State, War, Navy and Treasury all participated to varying degrees. Under such circumstances it was only a natural expectancy that chaotic regulations would prevail. Transport companies, in the struggle to obtain control of new air routes, had been bidding so low that about four-fifths of them were estimated to have failed. The obvious need was for a single agency, primarily concerned with the development of civil aviation—with both the power to regulate and assist this development. That agency appeared in the form of the Civil Aeronautics Authority.

It is important to note, however, that the Civil Aeronautics Act did not automatically or with a magician's wand create a new golden era for the air lines. Congress through the Civil Aeronautics Act merely provided constructive public machinery and broad policies through which the strong growth characteristics of the industry could be channelled. No longer, for example, were air lines permitted to bid or compete on any bases that would lead to insolvency. An effort was to be made to provide compensation to the extent deemed necessary for proper service and growth.

It was through the power to fix fair and reasonable rates for the carriage of mail, however, that the Authority began to exercise potent

economic regulation of the air transport industry. This regulation and responsibility is well expressed by the General Counsel of the Authority in testifying before the Subcommittee of the Committee on Appropriations, House of Representatives, on the Independent Office Appropriation Bill on January 25, 1939. General Counsel Guthrie stated:

"The Civil Aeronautics Authority comes in charge with the responsibility for fixing the compensation of the air carriers for carrying mail without any limitations whatsoever except, first, that they must do that with due regard to the honesty, economy and efficiency of the management, pay the carriers a compensation which will take care of all their service to the public. Compensation is not to be fixed solely with reference to the amount of mail that they carry, or the service to the Post Office Department. The Authority is required to look after the entire enterprise."

While this broad objective may appear to be a simple attainment, complications arise in view of the admixture of several seemingly extraneous factors. The air mail carriers, for the most part, since their inception, have been engaged in the business of carrying passengers and express. At the outset, the latter named services entailed substantial operating losses. In view of such circumstance, Congress showed some inclination to foster air transportation but tried to avoid any subsidy. This is evident by the fact that in its appropriations, Congress tried to make certain that the service would be conducted at no net loss to the Government. This was done by the simple expedient of limiting payments to air mail contractors to the extent of postal revenues derived from the sale of air mail service to the public. Table I illustrates this Congressional philosophy as well as the trend of air mail operations.

TABLE I*

DOMESTIC AIR MAIL PAYMENTS

| Fiscal Year Ended June 30 | Revenue-Miles Flown (000 Omitted) | Pound-Miles Flown (000,000 Omitted) | Air Mail Postage Revenues (000 Omitted) | Pay to Air Mail Contractors (000 Omitted) | Pay Per Plane-Mile Flown | Pay Per Pound-Mile Flown (Mills) |
|---|---|---|---|---|---|---|
| 1940 | 59,191 | 18,675 | $19,122 | *$18,679 | $ .316 | .98 |
| 1939 | 52,049 | 15,818 | 16,326 | * 16,768 | .322 | 1.05 |
| 1938 | 46,166 | 14,137 | 15,301 | 14,741 | .319 | 1.04 |
| 1937 | 39,959 | 12,732 | 12,440 | 13,166 | .329 | 1.03 |
| 1936 | 38,701 | 9,772 | 9,700 | 12,178 | .315 | 1.25 |
| 1935 | 31,149 | 6,790 | 6,590 | 8,835 | .284 | 1.30 |

* Subject to final adjustment.

Yet, a Civil Aeronautics Authority General Counsel in speaking of the Authority's responsibility in the fixing of mail compensation states, "It is pretty frankly a subsidy to the industry that is to be granted on the bases of economy, efficiency and honesty with which the business is run."

This realistic attitude is generally accepted by all concerned. The air lines themselves, however, have no desire for any permanent subsidy. This was clearly indicated by Col. Gorrel, President of the Air Transport Association of America, when at the House hearings preceding the enactment of the CAA; he said: "This industry does not desire to be permanently subsidized. We wish to stand on our own feet financially, with private capital."

The fact nevertheless remains that regardless of the equity in air mail compensation, the industry will have the tinge of public subsidy through federal airway aids, airports and similar facilities. However, these are no greater subsidies than land grants were to the railroads, highways to the automobile industry and reduced postal rates to newspapers and magazines.

In any event, the Authority has the responsibility of determining fair and reasonable rates for the carriage of air mail.

It is obvious that there is no necessary relation between the actual cost of flying the mail to the carrier and the postal receipts derived by the Government. As a public service, much of the mail is carried at a substantial net loss to the Post Office Department. It is virtually impossible to determine the actual costs for flying the mail; hence it is difficult to apply compensation on this basis. It is known, however, that there are no lines today that can haul mail for the same price that they can haul passengers or express.

The difficulties encountered in determining equitable methods of compensation for railroad mail rates can well indicate the manifold problems involved where the transportation of mail is concerned.

Costs of carrying the mails by the railroads are ascertained upon a space basis and the carriers receive payment predicated on that method. Moreover, mail rates have been established for separate territories and consideration given the length of the railroad's run. Distinction is also made and rates vary as to mail being carried in closed pouch space, storage space, storage car, apartment car or railway postoffice car. Considering all these factors, the Interstate Commerce Commission established a schedule of rates for each mile of service ranging from 3.5 cents for mail carried in a 3 foot storage space to 91 cents for mail transported in a 60 foot railway postoffice

car. Although this schedule of rates was determined after a very extensive study analysis made by the I.C.C. in allocating costs and differentiating services, the magnitude of the problems involved and the shortcomings of this approach is best illustrated by Commissioner Eastman who stated, "I am not satisfied that our analysis of costs has been sufficiently penetrating."

The railroad industry loudly complains that through various Interstate Commerce Commission rules and regulations, it is difficult for management to exercise very many managerial perogatives and demonstrate efficiency of operation. The revised Section 15(a) of the Transportation Act, for example, directs the I.C.C. to give "due consideration to the effect of the rates upon the movement of traffic." This direction has the tendency of converting regulation into management.

Rate making and regulation of any industry touching upon the public interest, at best is an involved and complicated process. For over 250 years, since the time of Lord Hale, it has been the law of the land that where any service rendered is a public one, property rights are of a qualified nature.

It can thus be seen that mere precedents in other fields of transportation will not suffice as a basis for rate regulation of the air carriers.

It is of more than academic interest to briefly trace the evolution of rate-making as it pertains to the air lines. The first Air Mail Law, 43 Stat. 805 (1925) gave the Postmaster General the bare power to let air mail contracts. The Act also provided that the contract rate should not exceed four-fifths of the revenues. In view of the inherent complications present, however, the method of compensation was changed to a weight basis, before the service was begun, with a top limit calculated to be within the anticipated receipts. As contained in the 1926 amendment, 44 Stat. 692 (1926), the contractor was to be paid a flat base rate not to exceed $3.00 per pound for the first 1,000 miles of carriage with each additional 100 miles at the rate of 10 per cent of the base rate. It is self-evident that this method was unsound as no allowance was made for the distance factor. This led to the establishment of many uneconomic short routes. It was not until the pay unit was changed from pounds to airplane-miles and allowance made for the weight differential by the use of a minimum weight-space, that some correction of basic errors was effected.

The Watres Act, 46 Stat. 259 (1930) made this adjustment as well as establishing a base rate of 30 cents per airplane mile for

the first 100 pound unit, with a graduated increase in base rate for every additional 100 pounds. Congress, however, ever mindful of having mail pay maintain a relation to postal revenues, set a top limit of $1.25 per airplane-mile. This new rate formula represented a new approach as a carrier was paid for a minimum weight space per mile regardless if any mail was carried. It also became apparent to Congress that the $1.25 limitation was meaningless and accordingly established an arbitrary limit of 15 million dollars for air mail payments during the fiscal year 1930-31.

After the abrupt cancellations of contracts and the subsequent passage of the Air Mail Act of 1934, regulation of the industry took another turn. Many of the provisions of the previous law were retained, but the Act of 1934 made further changes in the rate structure. Under this law, air mail compensation was paid at fixed rates per airplane mile, which in no event was to exceed 33 1/3 cents. This base rate was increased on a sliding scale of 10 per cent for every additional 100 pound unit carried over the minimum load of 300 pounds. Regardless of the amount of mail carried, compensation in no event could exceed the limit of 40 cents per plane mile.

As previously indicated, up to this point rates were fixed by the Interstate Commerce Commission while air mail contracts were awarded by the Post Office Department as a result of competitive bidding.

The constructive legislation incorporated in the Civil Aeronautics Act of 1938, among other things, also made possible further progressive steps in the realm of rate regulation.

As the Civil Aeronautics Authority, and following the President's Reorganization Order IV, effective July 1, 1940, the Civil Aeronautics Board, this agency has been fairly consistent in its decisions pertaining to rate regulation.

In its very first rate decision issued in April 1939, in the case of Mid-Continent Airlines, the Board established a general formula for rate making which it has followed ever since. In this instance the air carrier was given a base rate of 38 cents per plane mile for an average monthly load up to 300 pounds of mail and 2.5 per cent of that rate for each additional 25 pounds. Such rates applied on direct airport-to-airport mileage without reference to any base mileage.

The Board granted Mid-Continent an increase in rates based on that carrier's "need" as defined in the law because the line was able to prove that its operating deficits were largely due to insuffi-

cient revenues. As a fundamental philosophy of regulation is contained in this decision it may be well to examine it at some length. The opinion stated: "The air mail rate in each case is to be gauged in terms of compensation" which will suffice to insure the performance of mail service and with all other revenue enable the carrier under honest, economical and efficient management to maintain and continue the development of air transportation as required by the Commerce, Postal Service and national defense.

The opinion is also clear in that mail compensation should not cover costs resulting from mismanagement. However, there appears to be no intention to superimpose governmental management upon the management of air carriers. The main idea seemingly is that managerial policies are to be so guided either by the carrier or by the Board that public expenditures for air transport may yield the greatest possible results for the public interest.

The decision in this and subsequent rate cases is remarkably clear in that the policy of rate determination should recognize managerial efficiency and "permit benefit therefrom to redound to the carriers, thus providing an incentive to management for further development."

In the Northwest Airlines case, announced in July 1939, an additional element in rate making was introduced. In this decision, the system of weight-credit trips, previously in effect as a carryover from the old Air Mail Act of 1934, was abolished. Starting with this case all subsequent decisions determined a rate of compensation based upon the entire mileage flown with mail by the carrier, rather than a certain selected portion of such mileage. While lowering the unit rate of pay, the broadening of the mileage base was generally without effect upon the total amount of the carrier's compensation.

Throughout its decisions and in its first and second annual reports the Civil Aeronautics Authority has constantly reiterated its belief as to the ". . . desirability of approaching as rapidly as possible the time when no supplemental payments, in addition to such reasonable payments for transporting the mail by air, will be paid to air carriers generally and, . . . . . to fix air-mail rates which will enable the air carriers, under honest, economical, and efficient management to maintain and continue the development of an air transportation system of the character and quality required for the commerce of the United States, the Postal Service, and the national defense."

In other words, it is the clear-cut policy of the Board to reduce air mail compensation as the air lines become more self-sufficient.

Fortunately, the industry is becoming less dependent upon air mail payments. Table II shows this trend for the industry.

TABLE II*

PRINCIPAL OPERATING REVENUES OF DOMESTIC AIR CARRIERS

| Fiscal Year Ended June 30 | Passenger Revenues (000 Omitted) | Mail Revenues (000 Omitted) | Express Revenues (000 Omitted) | Ratio of Non-Mail Revenue of Total Revenues (Per Cent) |
|---|---|---|---|---|
| 1940 | $43,587 | $18,536 | $1,808 | 71.49 |
| 1939 | 28,300 | 16,811 | 1,438 | 64.61 |
| 1938 | 23,382 | 14,742 | 1,215 | 63.28 |
| 1937 | 21,708 | 13,166 | 1,201 | 64.90 |
| 1936 | 17,908 | 12,178 | 805 | 61.93 |
| 1935 | 12,712 | 8,836 | 512 | 61.52 |

It is also significant that considerable emphases in previous decisions have been placed on the national defense. Currently, the normal operations of the air lines are being affected by the national defense program. It is possible that as a direct result, certain of the air carriers may experience operating losses. Is it not reasonable to assume that in subsequent decisions the Board may take this additional factor into consideration when making new rate determinations?

No discussion of the air mail rate structure would be complete without some mention of other proposals in rate-making, which from all appearances, have not been adopted by the Civil Aeronautics Board.

Foremost among these proposals is the suggestion that mail compensation be made on a pound-mile basis. The author showed the implications of such a plan for BARRON'S—May 15, 1939. At that time we stated: "It is generally recognized that a pound-mile rate may be found suitable for the large trunk lines, would fall decidedly short of even sustaining the light-traffic lines."

The pound-mile method of compensation would measure mail payments by the volume of operation. It is this basis which United Air Lines sought in its petition for higher mail pay and which was turned down by the Board.

It would appear that while the pound-mile method of compensation may have certain desirable features, it is much too rigid for widespread application in the industry.

* SOURCE: Annual Reports of the Civil Aeronautics Authority and the Postmaster General.

It has also been suggested that rates be fixed as to provide a return upon the investment. The difficulties inherent in this theory became readily apparent. To begin with, which basis for investment should be adopted: "reproduction cost or prudent invest." Moreover it would also mean tying the industry to a fixed rate base with all of its complications.

It would be highly desirable to prevent the air transport industry from being irrevocably tied to a rate base. The public utility industry illustrates the difficulties and confusion introduced in attempting to find a rate base acceptable to all concerned. The historic *Smyth v. Ames* case decided in 1898 by the United States Supreme Court stands to this day as the basis in which *current cost of reproduction was declared to be a primary utility valuation factor.* Under this theory, the objective is to estimate the present value of the property and not its actual aggregate cost, or its value at the time of construction or acquisition. Such a determination, it is argued, opens up a fruitful field of endless controversy as to what should and should not be omitted from the multitude of component parts of the complicated process of evaluating a public utility. A period of 12½ years elapsed before the Illinois Bell Telephone Company had its properties properly evaluated for rate making purposes. It is argued further, that the reproduction cost theory in rate regulation is too complicated, conjectural, expensive, unsatisfactory and unworkable and regulatory bodies therefore in many cases are forced to give mere lip service to its observance in order to conform to legal formula.

To simplify the evaluating process and at the same time lower the rate base, it has been recommended that the "prudent investment" theory of rate making be adopted.

Interestingly enough, a present member of the Civil Aeronautics Authority while General Counsel of the Federal Power Commission argued in behalf of the adoption of the "prudent investment" theory of rate making before the Supreme Court, and upon direct questioning by Justice McReynolds defined "prudent investment" as "the actual money investment made in the property used and useful in the public service."

The Transportation Act of 1920, made provision for railroad rates that would be so established as to return a "fair" return on the value of the property. This rate was set at 6 per cent with all excess profits being recaptured by the Government. Not only was proper evaluation of the rate base almost an impossible undertaking, but it is estimated that it cost the Interstate Commerce Commission and

the railroads approximately $178,000,000 to partially complete these valuation studies.

Moreover, for fear of recapture of excess profits, the railroads expended excessive sums towards maintenance and new equipment.

It is noteworthy that while the Board has strongly asserted that it is not dealing with the question of a fixed return upon a fixed investment, each case must nevertheless be examined in terms of the relation of the profit on the investment. A true reward for managerial efficiency should make possible a satisfactory return upon the invested capital.