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## Supplementary Report or Ernst &(and) Ernst on the Determination of a Uniform Compensatory Mail Rate Structure for the Domestic Airlines

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# FEDERAL

## SUPPLEMENTARY REPORT OF ERNST & ERNST ON THE DETERMINATION OF A UNIFORM COMPENSATORY MAIL RATE STRUCTURE FOR THE DOMESTIC AIRLINES<sup>1</sup>

**A**S indicated in our "Report on Survey Covering Certain Aspects of Separation of Compensatory Mail Pay From Total Mail Payments to Domestic Airlines," under date of April 9, 1951, carriage of passengers and transportation of mail are the primary services of the domestic carriers and are rendered jointly, passengers contributing more than 85% of the total revenue and mail approximately 6%.

In this report it was stated that the rates paid for carriage of mail should be related to first class passenger fares, varied only to reflect the cost differential existing because of the exclusive passenger or exclusive mail costs involved. Also, it was stated that, for combination carriers (those carrying express and freight in conjunction with passengers and mail), cargo should be considered as a fill-in service at rates in excess of the actual additional cash outlay occasioned, but at rates not less than those which will permit satisfactory operating results for carriers of cargo exclusively.

While analysis of expenses of the trunk line carriers for the year 1949 indicated that approximately 85% of all operating costs were joint costs applicable to all services, the records of these carriers did not contain an exact segregation of those few items which do bear direct relationship to the individual services. Our report contained recommended revisions in the Uniform System of Accounts used by the carriers and in the preparation of certain statistics which will permit a more exacting determination of first class one-way revenues and the limited amount of the specific service costs in the future. However, from the data available for the year 1949, a uniform discount percentage to cover exclusive passenger expenses to be deducted from the first class passenger rates was developed, and it is our opinion that the resultant percentage is sufficiently accurate to represent a reasonable portion of the first class passenger rate structure that should be eliminated in determining the rate of compensation for the carriage of mail.

The discount percentage developed can be accepted as being subject to adjustment annually and future calculations thereof can be refined to reflect additional data which should then be available. However, it must be recognized that the development of a uniform discount percentage applicable to all carriers will always contain an element of judgment as to the reasonableness of amounts, adjustments to normal load factors, and the nature of the expenses to be considered in the calculation, and cannot represent an exact arithmetical determination.

Before outlining the procedures followed in the determination of a discount percentage applicable to the first class effective passenger rates, which we deem appropriate for all carriers, attention is called to certain pertinent facts developed from the data obtained from all carriers for the year 1949. It was found that

The Big Four (American, Eastern, TWA and United) carried approximately 71% of the passenger traffic, the other twelve trunk line

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<sup>1</sup> When Ernst & Ernst submitted its final report (18 J. Air L. & Com. 206 (1951)) Senator Johnson of the Interstate and Foreign Commerce Committee requested the preparation of this report.

carriers slightly over 27%, and the seventeen local service carriers a little less than 2%.

The Big Four contributed approximately 80% of the air mail ton miles the other trunk line carriers approximately 19% and the local service carriers about 1%. The Big Four operated during 1949 at an average passenger local factor of 62.3%; the other trunk line carriers at an average of 51.9% and the local service carriers at an average of 28.2%.

Within the Big Four, 78.2% of the total ton miles represented passenger traffic, while 5.6% represented mail.

As disclosed in our report dated April 9, 1951, if two of the Big Four (accounting for more than one-half of the total volume of the group) are compensated for mail service on a basis related to the passenger rate structure, the operating results for 1949 indicate only a slight deficiency in profits from what might be considered a fair return on investment. Only a small increase in over-all volume at the same revenue rate structure will remove this deficiency. Thus, the passenger rate structure, applicable to more than 78% of the total ton mile volume, bears a sound relationship to over-all operating cost and can equitably serve as the starting point for the compensatory mail rate structure, which applies to only 5.6% of the total ton miles and which is a primary service performed jointly by the carriers.

The extremely small percentage of passenger traffic (less than 2% of the total) and of air mail ton miles (about 1% of the total) handled by the seventeen local service carriers would not seem to warrant exhaustive research in attempting to arrive at further refinements in a compensatory rate structure which is acceptable to the Big Four, which handle 73%, and the other trunk line carriers, which handle 25% of the total traffic. The additional government support of the local service carriers in 1949 over the reasonable assumed compensatory mail pay was more than ten times the amount of such compensatory pay.

#### *Three Carrier Groups Used*

For purposes of developing the discount percentage, carriers have been treated in three groups: the Big Four, the twelve other trunk lines, and the seventeen local service carriers. The discount percentage applicable to the first class passenger rate structure reflected in the attached schedule, "Determination of Uniform Discount Percentage Applicable to All Domestic Air Carriers to Cover Additional Passengers Expenses to be Excluded from First Class Passenger Rate Structure, For the Year Ended December 31, 1949," was determined as follows:

Reductions from the first class fare structure to cover round trips, coach fares, etc., have been included as a portion of the discount percentage.

All passenger expenses comprising the "Passenger Service" group (6300) in the Uniform System of Accounts and a substantial portion of the "Traffic and Sales" group (6400) were held to be unquestionably additional expenses beyond joint operating costs which are occasioned by passenger traffic. These include all flight attendants, passenger food costs, ticketing expenses, reservation costs, agency commissions, etc.

Advertising and promotional expenses have been set forth separately, as we believe that these items should not be considered as being recoverable in the passenger rates only, since they represent the cost of building up and maintaining the higher traffic volume. This higher volume in turn serves to lower the over-all unit operating costs of the carriers, and the reduced unit operating costs make it possible to operate profitably at the existing basic first-class passenger rate structure.

To represent sound expenditures these promotional activity costs in reality must be more than equalled by the resulting unit cost reductions effected by absorbing fixed expenses over an expanded volume.

As disclosed by the accompanying schedule, the major portion of the expenses classed as additional cost of passenger service are of a fixed nature. It would be inequitable to include in the discount percentage arrived at to cover additional passenger traffic costs, that portion of fixed expenses which in reality is available for a higher passenger traffic load than that actually experienced. Thus, for carriers other than the Big Four, in expressing the relationship of these fixed expenses to the passenger revenues reflected at first class passenger rates, the volume of passenger traffic was adjusted to a load factor comparable with the average experienced by the Big Four. When the first class passenger revenues of the other trunk line carriers and for all local service carriers are adjusted to reflect load factors experienced in 1949 by the Big Four, the respective ratios of excludable expenses to adjusted revenues of these two groups compare favorably with the discount applicable to the first class passenger fares of the Big Four. Therefore, the discount developed as being equitable for the largest carriers should be an acceptable factor for the use of all carriers.

In our report of April 9, 1951, recommendations were made regarding use of a minimum weight of 100 lbs, for each trip, this weight being comparable to the minimum unit of weight (one-half fare) covered in the passenger rate structure. In developing the profit and loss statements for each station served during the year 1949, it was found impracticable to adjust the weight of each mail load carried between stations and, consequently, we used an average minimum load of 100 lbs. for those carriers where the over-all average load in flight was less than 100 lbs. This method, of course, does not compensate the carriers to the same extent as the use of a minimum of 100 lbs. on each inter-station trip. We believe that the 100 lb. minimum load for each inter-station trip should be introduced in compensating all carriers, with the understanding that it will be subject to future adjustment.

#### *Suggestions On Discount Application*

In our previous report it was stated that, by relating a compensatory mail rate to the first class passenger rate structure, through the introduction of a uniform discount to cover those passenger expenses to be eliminated from that structure, any refinements in the basic passenger rate structure would thus be automatically covered in the compensatory mail rate. Accordingly, to the extent that it becomes practicable in the future to recognize in the passenger rate the difference, for example, of the increased cost of short hauls as compared to long hauls, this difference also would be recognized automatically in the compensatory mail rate, since the latter will represent a fixed percentage of the resultant effective first class passenger rate structure.

Within an individual carrier, the first class passenger rate structure can be converted to a rate per pound for the carriage of mail, either on an over-all effective average first class rate or at an individual pound rate established in relation to the effective first class passenger fare between two specific points on any route or segment. The latter method would seem to be more acceptable if refinement of the passenger rate structure eventually recognizes the higher cost of short hauls as the primary consideration in a varying mileage rate. Under these conditions, the actual weight (subject to the 100 lb. minimum) would be compensated for at the complement of the discount percentage applied to the specific pound rate prevailing for the first class passenger fare between two points, based upon a standard passenger weight applicable to the carrier to convert to a pound rate.

If the over-all effective average first class passenger rate basis be used, the computed total first class passenger revenue can be converted to an average amount per ton mile and this amount reduced by the discount. In 1949 the average of the effective first class passenger ton mile rate for the Big Four carriers and for the other trunk carriers was approximately the same (65 cents). The average effective first class passenger ton mile rate for the local service carriers for 1949 was less than that experienced by the larger carriers, which would indicate that the local service carriers' passenger fare structures are influenced to a greater extent than the larger carriers by competition offered by other forms of transportation. The application of the developed uniform discount to the lower effective first class passenger ton mile yield of the local service carriers might seem to inflict a penalty on them. Inasmuch as the additional government support required by these carriers is greatly in excess of any reasonable compensation for the carriage of mail, it would seem equitable to compensate them at a mail rate based on the passenger ton mile yield experienced by the Big Four, since such average exceeds their individual effective passenger ton mile yield.

Based on the results for the year 1949 as disclosed by the accompanying schedule "Compensatory Mail Rates," 50 cents per ton mile (65 cents less a 23% discount) would appear to be an equitable uniform rate since, in our opinion, the promotion and advertising costs should be considered as applicable to all services. If advertising and promotional expenses are required to be recovered in the passenger revenue only, the ton mile mail pay rate would then be reduced to 46 cents (65 cents less 29%).

The portion of the discount percentages covering fixed expenses, based on 1949 figures, would decrease with increased volume. However, increased volume, brought about through reduction of the over-all first class passenger fares or through increases in the discount percentage to cover greater amounts of coach fare, etc., will serve to reduce the passenger rate. Thus, a lower discount percentage covering the fixed expenses would be applied to a lower effective first class passenger rate, or be offset by a higher discount percentage to cover increased coach operations, etc., with only the net difference affecting the compensatory mail rate per ton mile.

#### *Continuing Government Support*

The preceding comments pertain to the development of a reasonable compensatory mail rate structure. Additional government support must continue to be provided to those carriers the combined revenues of which are insufficient to yield a reasonable return above the cost of efficient operation, so that essential operations are assured in the public interest and for national defense. Provision for the payment of air mail service at compensatory rates related to the passenger rate structure inflicts no penalty on any carrier if its combined revenues, including mail revenue computed at the compensatory rates, are inadequate to meet its requirements.

This practical approach to a compensatory mail rate structure, should however eliminate the need for costly and prolonged allocation processes and attempted segregations as to the total cost of the various services rendered by the carriers. It should also provide an incentive to the carriers to which the rates of activity reach the point of producing profitable operations without additional government support. A relatively small increase in total volume of the major carriers over that experienced in 1949 should serve to eliminate the need for government support beyond the compensatory mail pay earned.

In the case of those carriers where over-all operations continue to justify government support beyond the amount earned for carriage of mail, the use of a compensatory mail rate structure comparable to that paid the larger carriers in substance merely serves to separate equitably the total amount received from the government.

**DETERMINATION OF UNIFORM DISCOUNT PERCENTAGE APPLICABLE TO ALL DOMESTIC CARRIERS TO COVER ADDITIONAL PASSENGER EXPENSES TO BE EXCLUDED FROM FIRST CLASS PASSENGER RATE STRUCTURE**

For year ended December 31, 1949

Line No.	Big Four Trunk Line Carriers	Other Trunk Line Carriers	Local Service Carriers	All Carriers
1	\$306,571,197	\$118,398,379	\$ 7,727,522	\$432,697,098
2	\$306,571,197	\$142,443,424	\$17,059,063	\$466,073,684
	\$ 28,017,779 9.14%	\$ 10,440,314 8.82%	\$ 390,016 5.05%	\$ 38,848,109 8.98%
	\$ 11,985,530 3,253,644	\$ 5,059,501 1,222,406	\$ 288,071 81,109	\$ 17,333,102 4,557,159
	\$15,239,174 4.97%	\$ 6,281,907 5.31%	\$ 369,180 4.78%	\$ 21,890,261 5.06%
	\$ 8,102,851 20,233,443	\$ 3,355,989 10,132,551	\$ 535,457 1,147,796	\$ 11,993,797 31,513,790
	\$ 28,335,794 9.24%	\$ 13,488,540 9.47%	\$ 1,683,253 9.87%	\$ 43,507,587 9.33%
	23.35%	23.60%	19.70%	23.37%
	\$ 9,141,402	\$ 4,668,891	\$ 620,372	\$ 14,480,665
	8,405,825	3,320,965	531,486	12,258,276
	\$ 17,547,227	\$ 7,989,856	\$ 1,151,858	\$ 26,688,941
	5.72%	5.61%	6.75%	5.73%
	29.07%	29.21%	26.45%	29.10%

1 Computed passenger revenue based on use of first class one-way fares

2 Adjusted computed passenger revenue to reflect amount that would have resulted at a passenger load factor equivalent to average of Big Four (62.34%).

Reductions granted from computed passenger revenue shown on line 1, due to lower fares applicable to first class round trips, family plan, coach and excursion trips.

Per cent to amount shown on line 1.

PASSENGER EXPENSES WHICH UNQUESTIONABLY REPRESENT THOSE ADDITIONAL COSTS OCCASIONED BY PASSENGER TRAFFIC

BEYOND JOINT OPERATING COSTS

VARIABLE—

Passenger service (6300 group)

Traffic and sales (portion of 6400 group)

Total

Percent to amount shown on line 1

FIXED—

Passenger service (6300 group)

Traffic and sales (portion of 6400 group)

Total

Percent to amount shown on line 2

TOTAL DISCOUNT PERCENTAGE (not including provision for advertising and promotional expenses)

ADVERTISING AND PROMOTIONAL EXPENSES WHICH, IN OUR OPINION SHOULD NOT BE INCLUDED IN ABOVE DISCOUNT, SINCE THEY ARE INCURRED TO ENLARGE AND MAINTAIN OVER-ALL TRAFFIC VOLUME

FIXED—

Advertising and publicity (6500 group)

Traffic and sales (remaining portion of 6400 group covering soliciting and traffic administration)

Total

Percent to amount shown on line 2

TOTAL DISCOUNT PERCENTAGE (if advertising and promotional expenses are considered as excludable expenses from the first class passenger rate structure)

COMPENSATORY MAIL RATES

Based upon data for year ended December 31, 1949

	Big Four Trunk Line Carriers (Approximately 80% of Total Mail Ton Miles)	Other Trunk Line Carriers (Approximately 19% of Total Mail Ton Miles)	Local Service Carriers (Approximately 1% of Total Mail Ton Miles)	All Carriers (100%)
IF ADVERTISING AND PROMOTIONAL EXPENSES ARE CONSIDERED AS APPLICABLE TO ALL SERVICES				
Average yield from first class one-way passenger fares per passenger ton mile	\$ .6536	\$ .6579	\$ .6005	\$ .6538
DISCOUNT PERCENTAGE (not including provi- sion for advertising and promotional expenses) applicable to average passenger ton mile yield from first class one-way passenger fares	23.35%	23.60%	19.70%	23.37%
Amount of discount	.1526	.1553	.1183	.1528
NET TON MILE RATE applicable to carriage of mail (not considering advertising and promotional expenses as excludable expenses in determining the discount percentage)	\$ .5010	\$ .5026	\$ .4822	\$ .5010
IF ADVERTISING AND PROMOTIONAL EXPENSES ARE CONSIDERED RECOVERABLE FROM FIRST CLASS PASSENGER RATE STRUCTURE				
ADDITIONAL DISCOUNT PERCENTAGE cover- ing advertising and promotional expenses	5.72%	5.61%	6.75%	5.73%
Amount of discount	.0374	.0369	.0405	.0375
NET TON MILE RATE applicable to carriage of mail (after deduction of amount of discount cover- ing advertising and promotional expenses)	\$ .4636	\$ .4657	\$ .4417	\$ .4635