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WHY TIE AIRLINE FARES TO SUBSIDIZED RAILROAD PASSENGER RATES?

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WHEN U. S. commercial air transport had its humble beginning back in 1926, the chief concern of the operators was flying the mail. Ultimately, it was thought, passenger planes would link our major cities, but it was not until Congress passed the Watres Act of 1930 that regular passenger service received its real impetus. For the first time it was recognized that carrying passengers could lower the cost of mail service. The Watres Act provided "bonuses" to mail contractors for acquiring aircraft which could accommodate both mail and passengers. With this incentive passenger service began to be pushed more aggressively. In 1930 air fares averaged a little over eight cents a mile compared with ten to twelve cents or more previously.

AIR FARES LIMITED BY RAILROAD FARES

Gradually it came to be recognized that to develop any appreciable volume of passenger traffic, rates would have to bear some reasonable relationship to railroad passenger fares. Of necessity, therefore, the upper limit of air fares was largely determined by railroad competition. Thus first class rail fares (including Pullman charges) plus some allowance for speed and novelty became the effective ceiling on airline passenger fares.

Although such rates were obviously insufficient to support passenger service independently, they did achieve one of the primary objectives of the Watres Act by reducing the cost of the airmail service to the government. Except for relatively small ups and downs this cost has declined steadily. The rapid growth of air travel which followed has frequently obscured this basic purpose for which our commercial air transport system was founded, namely, to fly the mail.

Without such a historical perspective many have been led to believe that "the cart came before the horse" or, in other words, that airmail payments to the carriers were devised just to make passenger service possible. Thus the easy conclusion follows that such service is subsidized. To the extent that one economic activity tends to support another, there may be an element of "subsidy" in such a relationship.

Perhaps the day has arrived when public policy should dictate that air passenger service support airmail. If so, the priority which airmail

now enjoys over any other type of air service would give way to the "when, as, and if" basis assigned to air freight. Such a system would be inconsistent with all previous concepts of expediting the mail. Moreover, it would be incongruous to expect the airlines to haul the mail at a rate applicable to that of the lowest commodity classification when other transport agencies charge the government up to ten times as much for mail as for many classes of freight. Recent studies have shown that rates paid the airlines for carrying six-cent air mail are closely comparable to that paid the railroads for carrying three-cent mail.

To say that development of our air passenger service to its present high state has not been assisted in some measure through early mail payments would be a gross error indeed. However, to those who have contended that it is heavily subsidized, the question might fairly be asked as to what it would cost to maintain and operate a fleet whose sole purpose was to fly the mail. Even the most conservative cost estimate for a service resembling present standards would undoubtedly be several times total mail payments to the domestic trunk lines.

QUESTION POSED BY SUBSIDIZED RAIL PASSENGER SERVICE

But regardless of the pros and cons of these and other points, there is one very significant factor which deserves serious examination in any consideration of "subsidy." This concerns the general subject of competing transport fares. It has been shown that air passenger fares have been historically related to those of first class rail service in that generally air fares equalled first class and Pullman charges plus a premium for speed and novelty. Inasmuch as maintenance of this relationship initially had a obvious bearing on traffic generation, the question might be raised as to the derivation and adequacy of railroad fares. Here our concern is primarily with adequacy. If, for example, rail fares are artificially low it would seem to indicate that perhaps airline fares are, of necessity, kept lower than would otherwise be the case. To what extent is this true?

Examination of the record clearly shows that passenger train service, in most cases, is unprofitable. It is fairly well known that most suburban commuter service is conducted at a loss, yet it is seldom recognized that on intercity passenger service most railroads operate at a deficit or else barely break even. Despite retroactive mail pay increases last year, not a single railroad showed a profit in its passenger division. In fact, passenger train operating ratios ranged from just under 100% (before rents, fixed charges, etc.) to as high as 192%. For all class one roads the average was 124%.

As the following table indicates, this condition was not peculiar to 1950. It has been true for many years with but a few exceptions, such as the heavy troop and civilian movements during World War II which were fairly profitable.

Although there appeared to be some improvement in 1950 it should be noted that last year's loss of \$509,000,000 had been reduced by \$107,000,000 of mail pay awarded in December but which was applicable to the years 1947, 1948, 1949. Otherwise the loss amounted to a near record of \$616,000,000.

How have the railroads been able to withstand losses of such magnitude? Evidently freight service has absorbed the loss. Last year net operating income from freight trains amounted to \$1,547,000,000. After absorbing the adjusted \$616,000,000 deficit incurred in passenger train service, net earnings before fixed charges, etc. were reduced to \$931,000,000. Deducting such charges, the return on net investment amounted to 3.8%. The trend over the last fifteen years has been as follows:

TABLE I
PASSENGER TRAFFIC, REVENUE AND OPERATING INCOME—
CLASS I RAILROADS

	<i>Revenue Passenger Miles (billions)</i>	<i>(a) Passenger Revenue (millions)</i>	<i>Net Operating Revenue Passenger Division (millions)</i>
1936	22.4	\$ 412	d \$233
1937	24.7	443	d 242
1938	21.6	406	d 255
1939	22.7	417	d 251
1940	23.8	417	d 262
1941	29.4	515	d 226
1942	53.7	1,028	89
1943	87.8	1,653	280
1944	95.5	1,790	234
1945	91.7	1,716	230
1946	64.7	1,259	d 140
1947	45.9	963	d 427
1948	41.2	964	d 560
1949	35.1	861	d 649
1950	31.8	813	d 509

(d) Deficit. (a) Excluding sleeping accommodation charges received by Pullman Company. Source: Association of American Railroads.

In this table the data has been taken from reports of the Association of American Railroads. It reflects the long-accepted accounting system prescribed by the Interstate Commerce Commission. Some have argued that this system does not present a true picture because of the basis of allocating joint costs. It is contended that passenger train deficits are not cash losses. Actually, this is true to only a very limited extent since nearly 75% of expenses charged to passenger trains are direct costs. The other 25% represents the passenger portion of expenses common to both passenger and freight services.

Thus, if all passenger trains had been discontinued last year, the adjusted \$616,000,000 loss absorbed by freight service profits would not have disappeared automatically. A portion of overhead and fixed charges were incurred on behalf of the passenger service but these would continue whether passenger trains were operated or not. Regardless of how fine a distinction is made over allocation of joint

expenses, it is clear that passenger train service represents a substantial financial drain. Whichever way the "cake is cut" the results are the same — a relatively low rate of earnings on investment. Table II, which also presents data taken from reports of the Association of American Railroads, shows that this return over the last four years averaged less than 3.8%. By all known regulatory standards, such a rate of return is inadequate.

TABLE II
NET OPERATING INCOME AND RATE OF RETURN—
CLASS I RAILROADS

	Net Railway Operating Income			Rate of Return
	Freight Division (millions)	Passenger Division (millions)	Total (millions)	
1936	\$ 892	d\$ 233	\$ 667	2.88%
1937	827	d 242	590	2.56
1938	626	d 255	373	1.62
1939	838	d 251	589	2.55
1940	943	d 262	682	2.93
1941	1,223	d 226	998	4.28
1942	1,394	89	1,485	6.30
1943	1,080	280	1,360	5.71
1944	871	234	1,106	4.71
1945	621	230	852	3.77
1946	760	d 140	620	2.75
1947	1,206	d 427	781	3.41
1948	1,561	d 560	1,002	4.24
1949	1,335	d 649	687	2.86
1950	1,548	d 509	1,040	3.99

(d) Deficit. Source: Association of American Railroads.

IMPACT ON AIRLINES

The implications of artificially low railroad fares now become apparent. RAILROAD PASSENGER SERVICE IS VERY LARGELY SUBSIDIZED BY FREIGHT. To the domestic airlines this means that for a long time air travel, with its fares based on rail fares, has also been under-priced. It is reasonable to conclude, therefore, that more realistic pricing of rail passenger service undoubtedly would have made possible a healthier basis for the fare structure of the airlines. Thus, despite the historical fact that the nation's commercial airlines initially were organized to fly the mail, air passenger service would have been able to achieve greater independence from whatever government assistance it received before now.

To illustrate the importance of under-priced rail fares, Table III shows the increases required merely to allow the railroads to break even on passenger service. In 1950, for example, had average passenger fares been about 63% higher there would have been little, if any, drain on earnings from freight operations. Instead of earning an inadequate 3.8% return, earnings on net investment thereby would have become a respectable 6.4%.

TABLE III
ACTUAL AND BREAK EVEN PASSENGER REVENUE —
CLASS I RAILROADS

	<i>Average Revenue Per Rev. Pass. Mile</i>	<i>Ave. Rev. Per R.P.M. Needed to Break Even</i>	<i>Actual Increase</i>	<i>Relative Increase</i>
1936	1.84c	2.88c	1.04c	56.5%
1937	1.79	2.77	0.98	54.7
1938	1.87	3.06	1.18	62.8
1939	1.84	2.95	1.11	60.3
1940	1.75	2.85	1.10	62.9
1941	1.75	2.52	0.77	44.0
1942	1.92	1.75	0.17*	8.9*
1943	1.88	1.56	0.32*	17.0*
1944	1.87	1.62	0.25*	13.3*
1945	1.87	1.62	0.25*	13.3*
1946	1.95	2.17	0.22	11.3
1947	2.10	3.03	0.93	44.3
1948	2.34	3.70	1.36	58.1
1949	2.45	4.30	1.85	75.5
1950	2.56	4.16	1.60	62.5

*Decrease

The full impact of more realistic pricing of rail passenger service is clear. Table IV shows that the airlines would have benefited substantially from being able to obtain a better basis for their fare structure. This table indicates that for some time now, had the airlines raised their fares by an amount equal only to the actual dollars and cents increase needed by the railroads merely to break even, airline earnings would have been enlarged sufficiently to permit a good profit with lower mail pay or even without any whatsoever.

TABLE IV
PASSENGER TRAFFIC, ACTUAL AND ADJUSTED REVENUES AND
AIRMAIL PAYMENTS 16 DOMESTIC AIRLINES

	<i>Revenue Passenger Miles (billions)</i>	<i>(Col. B) Average Revenue Per Rev. Pass. Mile</i>	<i>(Col. C) Col. B Adjust'd To Reflect Actual Increase In Rail Fares (Per Table III)</i>	<i>Additional Annual Pass. Rev. At Rates In Col. C (millions)</i>	<i>Total Domestic Airmail Payments (millions)</i>
1936	0.37	5.70c	6.74c	\$ 4	\$12†
1937	0.41	5.60	6.58	4	14†
1938	0.48	5.18	6.36	6	16
1939	0.68	5.10	6.21	7	18
1940	1.05	5.07	6.17	12	20
1941	1.38	5.04	5.81	11	23
1942	1.42	5.28	5.11	5*	23
1943	1.63	5.27	4.95	4*	24
1944	2.18	5.35	5.10	5*	33
1945	3.36	4.95	4.70	8*	34
1946	5.90	4.63	4.85	13	21
1947	6.01	5.06	5.99	56	29
1948	5.82	5.76	7.12	79	48
1949	6.56	5.76	7.61	121	45
1950	7.87	5.50	7.10	125	46

*Decrease. †Fiscal years.

Except for the 1942-1945 period, an increase in air fares by only the additional amount required to produce break-even rail fares would

have augmented airline revenues substantially. In the earlier years mail payments would have been cut sharply. After World War II the larger revenues were more than double airmail payments on the average.

If air fares had been increased by the same percentage or relative amount required by the railroads to break even, the results would be even more startling. Using 1936 as an example, the actual increase of 1.04c amounted to 56.5% of the average rail passenger mile yield. A similar percentage increase to maintain the same relative ratio would have produced an average air fare equal to 8.90c instead of the 5.70c received. The annual increment would amount to approximately \$12,000,000 as against only \$4,000,000 at the 6.74c rate. The additional revenues exactly equalled total airmail payments. Thus, it can be concluded that our domestic airline service as early as 1936 could have supported itself and carried all the airmail for nothing. Even at today's low compensatory service rates of 45c per mail ton mile, the carriers would have been paid nearly \$2,500,000 in 1936.