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ORIGINAL

Decision No. 80322

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of PACIFIC SOUTHWEST AIRLINES for an ex-parte order or expedited authority to increase its intrastate fares.

Application No. 52970
(Filed November 3, 1971)

Brownell Merrell, Jr., Attorney at Law, for Pacific Southwest Airlines, Inc., applicant.
Edward J. Pulaski, Attorney at Law, and Fred Davis, for Air California; Carl M. Anderson, for Western Airlines, Inc., and Robert W. Russell, for City of Los Angeles; interested parties.
Scott Carter, Attorney at Law, for the Commission staff.

OPINION

In this application, Pacific Southwest Airlines, Inc. (PSA) seeks authority to increase its air fares by 5.5 percent and freight rates by 40 percent between all points served by it. Present and proposed fares and rates are set forth in Appendix A.

Public hearing on PSA's request was held before Commissioner Holmes and Examiner Mallory at San Francisco on February 23, 24 and 25 and March 20 and 21, 1972. Evidence was adduced by applicant and the Commission staff. The matter was submitted upon filing of concurrent briefs by applicant and the Commission staff on April 5, 1972. The staff urges that the application be denied. Other interested parties took no position.

Background

PSA's fares were last adjusted pursuant to Decision No. 77991, dated December 1, 1970, in Application No. 52016 (unreported). That decision stated that the fares authorized therein, estimated to result in a rate of return of 8.8 percent and a corresponding operating ratio of 87.2 percent, would not provide excessive earnings for PSA's airline operations for a 1971 test year. The Commission further found therein that, as measured against a rate of return of 9.35 percent and operating ratio (after taxes) of 83.8 percent previously found reasonable for 1969-1970 fiscal year operation in Decision No. 75899 (69 Cal. P.U.C. 739), the net income resulting from the authorized fares would produce less than maximum reasonable earnings.[1/]

The estimated rates of return, operating ratios and return on stockholders' equity under fare levels authorized in the three most recent PSA increase proceedings are set forth on the following page.

1/ Decision No. 75899 (69 Cal. P.U.C. 739, at page 752) also found as follows:

"11. The record in this proceeding is not sufficiently adequate or complete to enable determination or resolution of the following matters of principle for rate-making purposes:

"(a) Treatment of investment tax credit on an immediate flow-through versus a normalized basis.

"(b) Treatment of income tax savings resulting from use of liberalized depreciation on an immediate flow-through versus a normalized basis.

"(c) Amortization of deferred credits arising from (a) and (b) above, and modification of rate for any unamortized balance which might represent cost free capital financing a portion of such rate base.

"(d) Disposition of gains or losses on sale of air carrier property and equipment, and the income tax consequences thereof.

"(e) Group method accounting for the retirement of air carrier property and the use of straight-line remaining life depreciation method as a corollary to (d) above."

TABLE 1

Decision No.	Date	Authorized Rate of Return %	Operating Ratio (After Taxes) %	Return on Stockholders' Equity %
77991 (unreported)	12-1-70	8.8	87.2	22.2
76447 (70 Cal. PUC 419)	11-18-69	8.58	85.5	18.1
75899 (69 Cal. PUC 739)	7-8-69	9.35	83.8	24.6

In each of the foregoing decisions, federal income taxes were calculated on the basis of an immediate flow-through of the tax savings resulting from use of accelerated depreciation and investment tax credit (Decision No. 75899, supra, 69 Cal. P.U.C., at page 750).

Decision No. 75899 also found that expenses in test-year operating results should reflect the actual scheduling of aircraft contemplated by PSA in that period in order that adequate service may be provided and growth of patronage would continue to be encouraged.

Evidence

Documentary evidence and testimony was presented by witnesses appearing for applicant and the Commission staff. The showings of applicant and staff differ in several material respects. Applicant and staff use different test years for estimating future operating results under present and proposed fare levels; operating results developed by applicant reflect normalization of federal income taxes, whereas the staff computed federal income taxes on a full "flow-through" basis; applicant's projected operating expenses provide for major airframe and engine overhauls which will not actually be scheduled in the test year, but which are generated by that year's flying hours; whereas the staff estimates of operating expenses include provision for major overhauls based on the number expected to be performed in the test year. Other, less significant differences appear in the test year estimates of applicant and the staff.

Revenue, Expenses and Rate Base, Historical Year

The following table contains a summary income statement for PSA's airline operations for the twelve months ended June 30, 1971, as set forth in PSA's Exhibit 1-A:

TABLE 2

PACIFIC SOUTHWEST AIRLINES
Results of Operation For Twelve Months
Ended June 30, 1971 (Adjusted)
(Airline Operations Only)

Number of Passengers	5,378,294
Flight Hours	55,139
System Load Factor	54.2%
Revenues	
Passenger (and charter)	$ 77,414,936
Beverage (net)	755,272
Freight	824,013
Mail, Baggage & Misc.	363,010
	$ 79,357,231
Expenses	
Flying Operations	$ 20,948,882
Direct and Indirect Maintenance	11,136,450
Provision for Pending Airframe Overhauls	1,980,000
Passenger Service	5,813,661
Airport Terminal Operations	8,468,459
Reservations and Ticket Sales	4,131,056
Sales and Advertising	2,315,164
General and Administrative	5,774,199
Depreciation and Amortization	11,611,959
	$ 72,179,830
Income from Airline Operations	$ 7,177,401
Income from Engine Shop Operations	$ 399,173
Provision for Federal Income Tax	$ 1,077,000
Net Income	$ 6,499,574
Rate Base	$ 123,219,489
Return on Rate Base	5.27%
Operating Ratio (after taxes)	91.80%

(The figures set forth in Exhibit 1-A were adjusted to eliminate interest expense in the amount of $5,332,368, in the determination of operating expenses, net income, rate of return and operating ratio.)

The data set forth in PSA's Exhibit 1-A were adjusted by the Commission staff financial examiner to reflect amortization of the net gain on sale of aircraft in depreciation and amortization expense; to eliminate interest from operating expenses; to eliminate income tax expense, as PSA incurred no actual income tax liability in the fiscal year; to eliminate "Income from Engine Shop Operations"; to remove from operating expenses the provision for pending airframe overhauls; to remove unamortized net gain on sale of aircraft from rate base; and to remove equipment deposits with manufacturers and deferred interest on said deposits from rate base. The historical results of operation reflecting the staff adjustments are set forth below:

TABLE 3

PACIFIC SOUTHWEST AIRLINES
Results of Operation for Fiscal Year
Ending June 30, 1971
(Exhibit 8 - Commission Staff)

Operating Revenues	
Passenger Revenue	$ 77,414,936
Beverage Profit	755,272
Freight Revenue	824,013
Mail, Baggage & Miscellaneous	363,010
Total Operating Revenues	$ 79,357,231
Operating Expenses	
Flying Operations	$ 20,948,882
Direct and Indirect Maint. Expenses	11,136,450
Passenger Service	5,813,661
Airport Terminal Operations	8,468,459
Reservations & Ticket Sales	4,131,056
Sales and Advertising	2,315,164
General and Administrative	5,774,199
Depreciation & Amortization	11,387,070
Total Operating Expenses	$ 69,974,941
Net Income from Operations (After FIT)	$ 9,382,290
Operating Ratio (After FIT)	88.2%
Depreciated Rate Base	$ 117,322,140
Rate of Return on Depreciated Rate Base	8.00%

(FIT = Federal Income Taxes)

The reasons for the staff adjustments described above and reflected in Table 3 will be discussed in connection with test-year operating results.

Issues

The principal issues presented in this proceeding are the following:

1. The reasonable revenues, expenses, net operating revenues and rate base for PSA's airline operations in a future test year.

2. As part of the foregoing, the appropriate method of determining federal income taxes for the test year; that is, whether taxes should be determined on an "as paid" basis, which entails the use of accelerated depreciation and investment tax credit with full "flow-through" of said benefits; or on the basis of normalization of the tax benefits resulting from the use of accelerated depreciation and investment tax credit.

3. The reasonable earnings for PSA's airline operations, based on rate of return on depreciated rate base and on operating ratio after taxes.

4. The effect of Federal Price Commission regulations on applicant's request for rate relief.

Selection of an Appropriate Test Year

PSA and the staff differ as to the period to use as a representative test year. PSA developed its test year operating results using the 12 months ending June 30, 1972; actual operating results were used for the first six months and estimated results were used for the second six-month period. The Commission staff used a test year which is entirely in the future; said test year is for the twelve-month period ending June 30, 1973.

The briefs of PSA and the staff contain argument as to the reasons that the test-year periods advocated by each should be adopted. PSA's view is that a test year extending beyond the current year would not be reasonable because of rapid changes in equipment, routes and services offered by it could not be adequately reflected therein. PSA cites the fact that it may acquire new "air-bus" type of aircraft to replace some of its existing 727-200 aircraft by spring of 1973 or shortly thereafter.

The staff's view is that a period entirely in the future, such as the period selected by it, gives more adequate recognition to gains in revenue from the continually expanding operations of PSA. The staff recognizes that if sales increases are taken into effect, the reasonably definite specific changes in expenses and plant necessary to accomplish the sales forecasted should also be taken into effect.

PSA urged that if the test year estimates of the staff are adopted herein, the operating expenses in such forecast should be adjusted to reflect known increases in certain categories of expenses which PSA argued are not fully reflected in the staff's estimate. PSA also argued that staff estimates of the number of aircraft and the number of flying hours required for test-year operations should be adjusted upward to reflect the level of service historically maintained by PSA.

We have carefully considered the facts and arguments presented as to the test year which should be adopted herein as a basis for evaluating applicant's request and conclude that a test year entirely in the future will be reasonable, provided that all known increases in revenues and expenses are reflected therein. We find that the test year used by the staff, adjusted as hereinafter indicated, should serve as the basis for our analysis of PSA's request.

Sacramento Operations

PSA argued that the staff's test year operating results do not give reasonable effect to the additional service to and from Sacramento inaugurated pursuant to a recent grant of operating authority. The staff's Exhibit 8 contains system test year operating results, and its Exhibit 9 contains estimates of the revenues and expenses to be generated in the test year by the added Sacramento operations granted by Decision No. 79085 in Application No. 51058.

The staff's Exhibit 9 shows that the estimated revenues from the additional Sacramento service will be exactly offset by the added expenses of providing the service. The staff witness therefore concluded that its estimated rate-year operating results in Exhibit 8 would be unaffected by the new service. However, the witness also testified that 50 percent of the estimated passengers for the new service would be diverted from existing Sacramento service of PSA, and no effect to said diversion was given in his revenue estimates in Exhibit 9. Therefore, we find that Exhibit 8 test-year operating revenues should be adjusted to give effect to 50 percent of the added revenues reflected in Exhibit 9. We further find that expenses in Exhibit 8 should be adjusted to reflect added expenses for the newly inaugurated Sacramento operations based on 860 annual flight hours, the hours actually being operated by PSA.

Number of Flight Hours

The principal change recommended by PSA to the staff test-year operating results involves the number of flight hours estimated by the staff. The staff estimated that the number of passengers in the test year would exceed the number transported in the historical year by 15 percent. The staff estimated that PSA would provide 57,500 flight hours of service in the test year. The staff assumed that increased flight hours should bear a relationship of 25 percent of the increase in number of passengers in the test year. PSA contended that such ratio is too low; it showed that in the two most recent years, the actual average ratio of increased flight hours to increased passengers is approximately 61 percent. PSA urged that if its passenger volume is to continue to grow at the pace estimated by the staff, the number of available seats would have to advance in the same ratio as in the recent past. PSA's witness testified that in order to grow, seats must be made available when patrons want to fly; that its peak-hour and peak-day flights are nearly full; and that without an increased number of peak-period flights the growth pattern estimated by the staff cannot be achieved. PSA's witness testified that the staff exhibit should be adjusted to reflect 61,072 flight hours in the test year.

We find that 60,800 annual flight hours for PSA's 1973 service (which includes annual flight hours for the Sacramento service recently inaugurated by PSA) will provide a reasonable relationship to the number of passengers estimated by the staff to be transported in its rate year, and will give adequate recognition to the additional service needed to generate such additional number of passengers.

Number of Aircraft

The staff study states that there are currently 27 aircraft in the PSA fleet that are used primarily in common carrier service consisting of seventeen 727-214's, nine 737-214's and one 727-114.[2/] The study further states that in the rate year the current PSA fleet of 27 aircraft is deemed adequate to perform the projected aircraft hours for all scheduled common carrier air services, as well as the current level of incidental other aircraft services assigned to these aircraft.

PSA also operates a 727-100 aircraft, which is leased from Lockheed Aircraft Corporation, and assertedly was acquired to replace a 737 aircraft sold to Frontier Airlines in March, 1972. PSA has included the lease costs of this aircraft in its adjustments to the test-year operating results developed in the staff study. The staff urged that the lease costs for this aircraft should not be included in test-year operating results inasmuch as said aircraft was used for only 1366 flight hours in the first eleven months of 1971, including contract flight training. The staff contended that there is low utilization of PSA's entire fleet under current conditions; and that the added flight hours resulting from increased passengers estimated for the rate year can be absorbed by PSA's present fleet without the addition of any additional aircraft; therefore, the leased 727-100 is not needed for common carrier service and should be excluded from test-year operating results. The staff pointed out that said aircraft was operated only 63 hours in November, 1971.

2/ This excludes one 737-214 aircraft, which PSA has recently sold. Of the 27 aircraft, one of the 727-214 aircraft is leased from a non-affiliate.

PSA contends that all of the 727 and 737 aircraft operated by it are necessary to provide adequate service to the public; therefore, the operating results estimated by the staff should be adjusted to reflect the additional expenses for lease of said aircraft amounting to $540,000 annually.

We find that the test-year flight hours adopted as reasonable herein can be operated by the 27 aircraft referred to in the staff study and that the lease expenses for the 727-100 leased from Lockheed are not appropriate for inclusion in test-year operating expenses. The record shows that PSA has no specific plans for operation of "Airbus" type aircraft in the test year and no consideration should be given herein to that type aircraft.

<u>Test Year Operating Expenses</u>

Staff estimates of expenses in its Exhibit 8 were developed on the following bases:

> An analysis was made of each of PSA's expenses allocated to scheduled flight operations, and adjustments were made for known increases that can be expected to affect the rate year.
>
> (1) The estimated <u>flying operations</u> expense is the product of the projected flight hours times a unit cost of $338 per flight hour. This unit cost reflects a 4 percent increase in crew salaries that occurred on January 1, 1972. The rental expense of the one leased plane has been separately computed.
>
> (2) <u>Direct maintenance</u> expense is the product of projected flight hours times a unit cost of $187 per flight hour which reflects an 8 percent salary increase in the rate year. The unit cost is based upon maintenance expenditures expected to occur during the rate year in using engine equipment that is now in service.
>
> (3) <u>Indirect maintenance</u> expense is the product of projected flight hours times a unit cost of $28 per flight hour which reflects an 8 percent salary increase for the rate year over the historic period.

(4) Passenger service expense is the product of projected passengers in the rate year times a unit cost of $1.13 which reflects a 6.9 percent salary increase which was offered by the company to its stewardesses. The contract is still being negotiated.

(5) Airport terminal expense is the product of projected passengers times a unit cost of $1.93 per passenger which reflects a 6-1/2 percent salary increase, effective July 1, 1972.

(6) Commission expense for the reservation and ticket expense accounts is computed at 2.03 percent of projected passenger revenue (derived from analysis of historic period). Other passenger traffic expenses in this category were computed as the product of projected passengers times a unit cost of $0.474 per passenger.

(7) Sales and advertising expense is the product of projected passengers in the rate year, times a unit cost of $0.43 per passenger which reflects a 6-1/2 percent salary increase effective July 1, 1972.

(8) General and administrative expense is estimated at $528,000 per month and reflects recently increased property taxes. It also includes increased Social Security taxes for the General and Administrative Account and all the other operating accounts.

PSA's Exhibit 11 contains adjustments to the data in the staff's Exhibit 8 to reflect the changes PSA believes are necessary to properly show conditions which will exist in the test year. For example, PSA endeavored to show that costs per hour for flight operations and for pending and scheduled maintenance, and the costs per passenger for terminal operations and for reservation and ticket sales will be greater in the test year than the costs used in the staff exhibit.

PSA showed that if current expenses are considered, flying operations hourly costs are $403, whereas the staff used $388. Furthermore, if wage rates which became effective in the second six months of 1972 are annualized, the flying operations costs per hour are $408. It is clear that expenses for flying operations are underestimated in the staff's Exhibit 8 and should be adjusted upward.

Included in PSA's test-year operating expenses are provisions for so-called "longevity" salary increases for flight and other personnel. PSA's witness stated that such longevity increases are of greater importance in this proceeding than on past proceedings because PSA has had substantially less turn-over in personnel in recent periods. The staff opposes inclusion of provision for such expenses in test-year operating results. The "longevity" salary provisions stem, for the most part, from collective bargaining agreements and are costs actually incurred by PSA. Therefore, such costs are properly includable in test-operating results.

PSA and the staff disagree as to the reasonable expenses for maintenance. The staff urges that such expense item is overstated in the sum of $2,202,570 in PSA's test-year projection (consisting of $1,122,570 for airframe overhauls, and $1,080,000 for engine overhauls) inasmuch as the overhauls represented by these sums are not actually scheduled to be performed in that year. The staff brief states that it is opposed to the addition of such provision for overhauls, which PSA will not actually perform, principally because applicant does not provide for normalizing overhaul expenses in its accounting. PSA makes charges to expenses for major airframe and engine overhauls as they actually occur. The staff study reflects major airframe and engine overall expenses for the number of such overhauls it believes actually will be performed by PSA in its test year.

In its Exhibit 11, PSA adjusted the unit cost for maintenance expense from $215 per hour used in the staff study, to $258 per hour. The record shows that the unit cost figure recommended by PSA includes maintenance reserves covering work not actually scheduled in the test year. We find that test-year maintenance expenses should reflect expenses actually expected to be incurred, thus the unit cost used in the staff study is appropriate for this proceeding.

PSA showed that its unit cost for first six months of 1972 for terminal operations was $1.85 per passenger. When the increases in labor costs included in that figure are annualized, the cost per passenger is $1.95. We find that $1.95 per passenger for terminal operations will be reasonable for the test year.

PSA also showed that its unit cost for the first six months of 1972 for reservation and ticket sales was 82 cents per passenger. This figure is also reasonable to determine test-year operating results.

PSA contended that general and administrative expense should be increased from 6.98 percent of passenger revenues to 7.20 percent of passenger revenues in the test year. PSA pointed out that the staff witness failed to include increases in property taxes on additions to its aircraft fleet in determining his expenses for the test year. We find that the staff test year operating expenses should be adjusted by approximately $240,000 per year to reflect property taxes on aircraft initially placed on the tax rolls in the second half of 1972.

Pacific Southwest Airmotive

Pacific Southwest Airmotive is a wholly owned subsidiary of PSA. Airmotive performs all engine overhauls for its parent company and also performs such service for other airlines. Overhauls for PSA account for approximately half of Airmotive's volume. PSA's exhibits include charges from Airmotive to PSA for work performed by Airmotive assertedly at said company's cost without overhead or profit. PSA's exhibits also include Airmotive's total assets in PSA's rate base, and includes as "other income", the projected net income for Airmotive's total operations. Supplementary exhibits submitted by PSA exclude from rate base that portion of Airmotive's assets which are not used for services performed for its parent and exclude the net income from Airmotive from the airline operating statements.

The staff opposed the inclusion of any Airmotive's investment or operating profits in the determination of fares for PSA. The staff recommends that the Commission accept, for the purposes of this proceeding, the billed costs of Airmotive to PSA as expenses, but urges that Airmotive's investment be excluded from rate base.

In proceedings of this type the Commission's direct interest in the operating results of subsidiaries of a public utility is to determine that excessive earnings do not result from the services performed by the subsidiary for the utility. In this proceeding the charges from Airmotive to its parent are assertedly at cost; thus no profit would result therefrom. The staff indicated that further investigation is needed for it to verify that such charges are at cost; therefore, until all relevant facts can be considered, it opposes inclusion of any Airmotive investment or operating results in the fare determining process for PSA.

We find reasonable for the purposes of this proceeding to include in airline operating expenses the billed costs of Airmotive to PSA for engine overhaul work performed for PSA by Airmotive, and to exclude Airmotive's net revenues from PSA airline operating revenues and Airmotive's assets from airline rate base.

Gains and Losses from Sale of Aircraft

In the transition from Electra prop-jet aircraft to full-jet aircraft, PSA sold several Electras for amounts in excess of net book value. The Commission staff considers such gains on sales of aircraft as applicable to carrier operations and amortized such gains to operations over the depreciable lives of the new aircraft replacing those retired.

In the historical and test-year operating results developed by the staff, depreciation and amortization expense is reduced to reflect amortization of the 1968 and 1969 gains on sale of aircraft, and the rate base is reduced by the unamortized balance of such gains. The staff study states that this rate-making approach is on the basis that the gains and losses on disposition of carrier equipment result in large measure from errors in depreciation accruals under a rigid schedule of service lives and salvage values; consideration of both gains and losses through amortization against a reasonable future period will protect both the carrier and its customers against excessive or deficient depreciation, but will also minimize the distorting effect upon income caused by large, usually sporadic transactions giving rise to such gains and losses.

PSA opposed such adjustments. PSA pointed out that the sale of the involved aircraft preceded the hearings in Application No. 50847; that the staff did not recommend adjustments for gain on sale of aircraft in that proceeding; and that Decision No. 75899 in that proceeding did not contain any adjustment such as recommended herein by the staff. PSA urged, therefore, that the unreasonableness of amortizing gains on aircraft sales is apparent, since during the ensuing period PSA's fares and earnings were not unreasonably high as a result of excess depreciation on aircraft.

The staff position is that the Commission for over a decade has used for both accounting and rate regulation the above-the-line treatment of gains and losses from disposal of utility and carrier property; this treatment was implemented by straight-line-remaining life depreciation, and prescribed use of the depreciation adjustment account.

We find that amortization over the life of the replacement aircraft of gains on sales of aircraft is consistent with the treatment accorded similar transactions in rate-making proceedings involving other classes of utilities and, therefore, is appropriate for the purposes of this proceeding.

Exclusions of Prepayments on Equipment

The staff study excluded from rate base equipment deposits in the amount of $1,813,870 in the historical year, and made a similar adjustment in the test-year rate base. The staff study states that the deductions related to deposits were made because when the related equipment is acquired, the deposits and deferred interest as a component of the purchase price will be capitalized and be considered in determining rate base at that time, as well as depreciation and amortization. The staff study further states that a comparable treatment is accorded by the Commission to other carriers and utilities in rate making in ignoring as rate base construction work in progress which is accumulating rate base value by the capitalizing of interest during construction.

PSA also opposed this staff adjustment on the basis that such type of adjustment was not recommended in prior PSA fare proceedings.

The reasons advanced by the staff appear to result in treatment consistent with that accorded "construction work in progress" in other utility proceedings, and we find that the method used by the staff will be reasonable for the purposes of this proceeding.

Federal Income Taxes

PSA and the Commission staff differ as to the proper method of determining federal income taxes.

PSA's federal tax returns reflect the tax benefits stemming from the use of accelerated depreciation and investment tax credits. No actual federal income liability was incurred in the fiscal year ended June 30, 1971. However, PSA's annual report to its stockholders for the year 1971 contains a provision for federal income taxes based on normalization of the benefits of the use of accelerated depreciation and investment tax credit.

PSA's historical year and test year operating results are based on normalization of federal income taxes. PSA argued that in considering the appropriate treatment of federal income taxes for rate-making purposes, air carriers must be distinguished from other regulated utilities, inasmuch as the useful life of air carrier assets is, at most, 12 to 14 years; while other utilities' assets have depreciable lives of 30 to 40 years. It is PSA's position that the tax benefits to air carriers from the use of accelerated depreciation become tax liabilities in a few years. PSA states that even a short-term slowdown in the expansion of an air carrier could cause substantial risks to its investors, and also could cause fluctuating fare proposals depending on the year-to-year tax position of the air carrier. PSA also argued that its competitors normalize their taxes for rate-making purposes under federal Civil Aeronautics Board rules; thus, PSA may not be able to raise fares from a competitive standpoint.

The Commission staff included no provision for federal income taxes in its historical year or test year operating results under existing fares.[3/] It is the position of the staff that PSA has failed to present evidence which would justify its abandonment of the use of accelerated depreciation with full "flow through" of said benefits to the ratepayer. The staff cited the fact that PSA has shown a record of uninterrupted expansion and growth since its inception. The staff argued that when a utility's future indicates uninterrupted growth and expansion, "flow-through" treatment of accumulated deferred tax reserves are, in effect, a permanent tax savings. (City of San Francisco v. Public Utilities Commission (6 C. 3d 119).)

The staff also pointed out under the Tax Reform Act of 1969 (Section 441) Congress provided that the only appropriate allowance for rate-making purposes for a public utility which has been using liberalized depreciation with "flow-through" with respect to its pre-1970 and post-1969 non-expansion property, is the income taxes actually paid. The staff cites in support thereof the recent decision of the United States Court of Appeals (D. C. Circuit) in Memphis Light and Gas Co. v. Federal Power Commission, et al. (Decisions Nos. 24602 and 24632, issued February 18, 1972.)

3/ Using the "flow-through" method, PSA will incur a small income tax liability in the test year for operations under proposed fares.

Said Decision states as follows:

"There is nothing in the Tax Reform Act of 1969, then, which modifies the Commission's duty under the Natural Gas Act to require regulated utility companies such as Texas Gas, which had been using liberalized depreciation with flow-through with respect to their pre-1970 and post 1969 non-expansion property, to set rates which reflect actual expenditures alone with respect to such property. According to Congress, the only appropriate tax allowance for rate-making purposes for a company such as Texas Gas, which has been using liberalized depreciation with flow-through with respect to its pre-1970 and post-1969 non-expansion property, is income taxes actually paid." (Emphasis supplied.)

Although the Tax Reform Act of 1969 is not specifically directed to airlines, the principle enunciated in the foregoing United States Court of Appeals decision is appropriate to this proceeding and consistent with prior decisions of this Commission with respect to airlines.

This Commission should continue to compute income taxes for rate-making purposes in this proceeding based on income taxes actually paid by applicant. In this application, it has been shown that for several years PSA has determined its actual income tax liability by the use of accelerated depreciation with full "flow-through".

The full "flow-through" of the benefits of accelerated depreciation is consistent with our holdings in Decisions Nos. 59926 (57 Cal. P.U.C. 598), 61711 (58 Cal. P.U.C. 564) and 62585 (59 Cal. P.U.C. 119) in Case No. 6148, an investigation into the rate making treatment to be accorded so-called "liberalized depreciation". Decision No. 62585 reiterated this Commission's prior holding that the "alleged deferred tax liability resulting from liberalized depreciation will not as a practical matter materialize, and ... rates should be determined on the basis of the tax which a utility actually pays."

Adjusted Test-Year Operating Results

The test-year operating results set forth in Table C-1 of Exhibit 8, introduced by the Commission staff, should be adjusted as set forth below to give effect to the preceding discussion, findings and conclusions:

TABLE 4

Year Ending June 30, 1973

	Present Fares (+ 000)	Proposed Fares (÷ 000)
Statistics		
Passengers	+39.0	+39.0
Flight Hours	÷3.3	÷3.3
Revenue		
Passenger	$÷765	$÷804
Beverage (Net)	÷5	÷5
Freight	No change	No change
Baggage & Misc.	No change	No change
Expenses		
Flying Operations	$÷2,456	$÷2,456
Direct Maintenance	No change	No change
Indirect Maintenance	No change	No change
Passenger Service	No change	No change
Airport Term. Opers.	÷200	÷200
Reservations & Ticket Sales	÷237	÷237
Sales and Advertising	No change	No change
General & Admin.	÷240	÷240
Depreciation	No change	No change
Rate Base	No change	No change

The following table depicts the data set forth in the staff exhibit, adjusted as indicated in Table 4.

TABLE 5

PACIFIC SOUTHWEST AIRLINES
Adopted Results of Operations
Year Ending June 30, 1973

	Present Fares and Freight Rates (÷ 000)	Proposed Fares and Freight Rates (÷ 000)
Statistics		
Passengers	6,226	6,226
Flight Hours	60.8	60.3
Revenue		
Passenger	$ 91,491	$ 96,148
Beverage (Net)	871	871
Freight	1,144	1,602
Baggage & Misc.	375	375
Total Revenue	$ 93,881	$ 98,996
Expenses		
Flying Operations	$ 24,806	$ 24,806
Direct Maintenance	10,753	10,753
Indirect Maintenance	1,610	1,610
Passenger Service	6,991	6,991
Airport Terminal Opers.	12,141	12,141
Reservations & Ticket Sales	5,012	5,105
Sales & Advertising	2,660	2,660
General & Admin.	6,576	6,576
Depreciation	11,174	11,174
Total Expenses	$ 81,723	$ 81,816
Income before Taxes	$ 12,158	$ 17,180
Income Taxes	-	$ 725
Net Income	$ 12,158	$ 16,455
Rate Base	$ 106,093	$ 106,093
Operating Ratio	87.0%	83.4%
Rate of Return	11.4%	15.5%

The above operating results are adopted for the purposes of evaluating PSA's request for additional revenues.

Discussion

In prior rate-making proceedings the rate of return and operating ratio authorized in connection with increased fares (Table 1) was less favorable than will result under operations under present fares in Table 5, above.

Decision No. 75899, supra, authorized a rate of return of 9.35 percent, but the Commission staff in that proceeding recommended that a rate of return of 10.3 percent be found reasonable for PSA's operations at that time. In this proceeding, the Commission staff's financial witness recommended that no increase in fares and rates should be authorized which would cause the rate of return for the common carrier operations of PSA to exceed 11.87 percent, before interest and actual income taxes.

The adopted results of operation for the year ending June 30, 1973 (Table 5) show that operations under present fares and freight rates would result in a rate of return of 11.45 percent before interest and actual income taxes.

The rate of return of 11.89 percent resulting from the granting of that portion of PSA's application seeking increased air freight rates would approximate that recommended as the maximum reasonable rate of return for the test year by the Commission staff and would not produce excessive earnings. However, the granting of the application in full would produce a rate of return of 15.5 percent, which we find would produce excessive earnings in the test year and would also appear to provide revenue increases in excess of Federal Price Commission criteria.

If the requested freight rate increase, alone, is granted, the net income before and after income taxes would be $12,616,000 for the test year, and the resulting rate of return and operating ratio would be 11.89 percent and 86.6 percent, respectively. PSA's testimony herein indicates that its freight rates have not been increased for some time and are on a level substantially below the freight rates maintained by competing airlines in the same markets. The granting of the freight rate increase would permit PSA to maintain air freight rates on bases comparable to its principal competitors and would not materially affect its estimated common carrier profitability nor its rate of return in the test year.

It appears that PSA has been able to absorb much of the increases in its overall costs because of increased efficiency. For example, the record shows the productivity of its operating personnel has increased in each of the last three years, and that such productivity increases partially offset wage increases granted to said employees. While Section 456 of the Public Utilities Code provides that public utilities are not prohibited from profiting from efficiencies, these economies should not be ignored when to do so would require the public to supply additional revenues in the form of increased passenger air fares. (City of Los Angeles et al. v. Public Utilities Commission, 7 Cal. 3d 331, 102 Cal. Rptr. 313.)

Findings and Conclusions

We find:

1. PSA is a passenger air carrier operating wholly within the State of California. By the application herein it seeks to increase its passenger fares and air freight rates as set forth in Appendix A.

2. PSA's operations have been profitable in past years, as represented by net operating revenues from airline operations of \$6,462,598 in 1969, \$9,836,621 in 1970 and \$9,905,929 in 1971 (Exhibit 8, Table B-1).

3. The estimates of the numbers of flying hours and aircraft, and the estimates of revenues and expenses based thereon, as set forth in the preceding opinion and summarized in Tables 4 and 5, give adequate effect to the type of service and load factors of equipment necessary to continue the levels of services required to attract additional passengers and to maintain adequate and efficient service in the year ending June 30, 1973.

4. The estimates of revenues, expenses, rate base, rate of return and operating ratio set forth in Table 5 in the preceding opinion reasonably represent PSA's results of operations under present and proposed fares for the year ending June 30, 1973, and are adopted for the purposes of this proceeding.

5. PSA's operations at present fares and air freight rates in the year ending June 30, 1973 will be profitable, as represented by an estimated rate of return of 11.4 percent and an operating ratio of 87.0 percent. (Table 5.)

6. The fares and freight rates proposed in the application will provide an estimated rate of return of 15.5 percent, and an operating ratio (after taxes) of 83.4 percent. Said rate of return on depreciated rate base exceeds that heretofore granted to PSA in recent fare proceedings (Decision No. 75899, 69 Cal. P.U.C. 739, Decision No. 76447, 70 Cal. P.U.C. 419, and Decision No. 77991, unreported). Said rate of return is in excess of the rates of return of 12.0 percent and 12.5 percent found reasonable for trunkline and regional air carriers by the Federal Civil Aeronautics Board in its Docket 21866. Said rate of return also exceeds the maximum recommended herein as reasonable by the staff witness. The estimated rate of return of 15.5 percent resulting from PSA's fare and freight rate proposal in the application herein produces excessive earnings and, therefore, is unreasonable.

7. PSA's air freight rates are depressed in that they are less than those maintained by competing air carriers and have not been increased for several years.

8. The granting of the requested increases in air freight rates sought herein and the denial of the sought passenger fares would produce the following operating results for the year ending June 30, 1973, based on the data set forth in Table 5:

Operating Revenues	$ 94,339,000
Operating Expenses	$ 81,723,000
Income Before Taxes	$ 12,616,000

Income Taxes	$ -
Net Income	$ 12,616,000
Rate Base	$106,093,000
Operating Ratio	86.6%
Rate of Return	11.89%

9. The rate of return of 11.89 percent resulting from the granting of that portion of the application herein seeking increased air freight rates will not exceed those found reasonable for air carriers by the CAB, and will not exceed that recommended herein by the Commission staff. Said rate of return is reasonable, and will not produce excessive earnings.

10. The increases in air freight rates sought herein are justified, and the proposed air freight rates are reasonable. The increases in passenger air fares sought herein have not been shown to be justified.

The Commission concludes that the air freight rates proposed in the application should be granted and that the passenger air fares sought in the application should be denied. The increased air freight rates should be permitted to be established on five days' notice.

O R D E R

IT IS ORDERED that:

1. Pacific Southwest Airlines, a corporation, is authorized to establish the increased air freight rates proposed in the application herein and set forth in Appendix A. Tariff publications authorized to be made as a result of the order herein shall be filed not earlier than the effective date of this order and may be made effective not earlier than five days after the effective date hereof on not less than five days' notice to the Commission and to the public.

2. The authority herein granted shall expire unless exercised within ninety days after the effective date of this order.

A. 52970 ek/JM

3. Except to the extent granted in ordering paragraph 1 hereof, Application No. 52970 is denied.

4. The certificate required by federal price stabilization regulations is attached as Appendix B.

The effective date of this order shall be twenty days after the date hereof.

Dated at San Francisco, California, this 1st day of AUGUST 1, 1972.

William Symons Jr.
President

Commissioners

I abstain
Vernon L. Sturgeon Commissioner

PACIFIC SOUTHWEST AIRLINES
PRESENT AND PROPOSED AIR FARES AND AIR FREIGHT RATES

	REGULAR PASSENGER FARE				SPECIAL FARE - MIDNIGHT FLYER			
	PRESENT FARE		PROPOSED FARE		PRESENT FARE		PROPOSED FARE	
ROUTE/BETWEEN POINTS	Excluding Transp. Tax	Including Transp. Tax	Excluding Transp. Tax	Including Transp. Tax	Excluding Transp. Tax	Including Transp. Tax	Excluding Transp. Tax	Including Transp. Tax
San Diego/ Los Angeles Burbank Ontario Long Beach	$ 7.41	$ 8.00	$ 7.41	$ 8.00	$ 5.00	$ 5.40	$ 6.48	$ 7.00
Los Angeles/Burbank San Francisco Oakland San Jose	15.28	16.50	16.20	17.50	10.00	10.80	11.11	12.00
Burbank/Ontario/Long Beach Sacramento via San Francisco	19.44	21.00	20.37	22.00	-	-	-	-
San Diego/ Sacramento	23.14	25.00	24.07	26.00	15.00	16.20	15.74	17.00
Ontario/Long Beach San Francisco	16.67	18.00	17.59	19.00	-	-	-	-
Los Angeles/ Sacramento	16.67	18.00	17.59	19.00	12.00	12.96	13.89	15.00
San Diego/ San Francisco Oakland San Jose	22.68	24.50	23.61	25.50	15.00	16.20	15.74	17.00
San Francisco/ Sacramento	7.41	8.00	7.41	8.00	5.00	5.40	6.48	7.00

APPENDIX A

FREIGHT CHARGES

	PRESENT RATES						PROPOSED RATES					
	Minimum Charge		Cents per Pound for Less Than 100 Pounds		Dollars per Hundred Pounds		Minimum Charge		Cents per Pound for Less Than 100 Pounds		Dollars per Hundred Pounds	
ROUTE/BETWEEN POINTS	Excluding Transp. Tax	Including Transp. Tax	Excluding Transp. Tax	Including Transp. Tax	Excluding Transp. Tax	Including Transp. Tax	Excluding Transp. Tax	Including Transp. Tax	Excluding Transp. Tax	Including Transp. Tax	Excluding Transp. Tax	Including Transp. Tax
San Diego/ Los Angeles Burbank Ontario Long Beach	$4.00	$4.20	$.08	$.084	$4.00	$4.20	$6.00	$6.30	$.09	$.094	$6.00	$6.30
Los Angeles/Burbank San Francisco Oakland San Jose	4.00	4.20	.08	.084	4.78	5.02	6.00	6.30	.09	.094	6.00	6.30
Burbank/Ontario/Long Beach Sacramento via San Francisco	4.00	4.20	.08	.084	4.78	5.02	6.00	6.30	.09	.094	6.00	6.30
San Diego/ Sacramento	4.00	4.20	.10	.105	6.42	6.74	6.00	6.30	.11	.115	7.00	7.35
Ontario/Long Beach San Francisco	4.00	4.20	.08	.084	4.78	5.02	6.00	6.30	.09	.094	6.00	6.30
Los Angeles/ Sacramento	4.00	4.20	.08	.084	4.78	5.02	6.00	6.30	.09	.094	6.00	6.30
San Diego/ San Francisco Oakland San Jose	4.00	4.20	.10	.105	6.42	6.74	6.00	6.30	.11	.115	7.00	7.35
San Francisco/ Sacramento	6.00	6.30	.09	.094	6.00	6.30	6.00	6.30	.09	.094	6.00	6.30

APPENDIX B

This appendix constitutes the certification of the California Public Utilities Commission to the Federal Price Commission, as required by Section 300.16 of the Code of Regulations.

1. The order to which this appendix is attached grants an increase in air freight rates of 40 percent, and denies a sought increase in air fares averaging 5.5 percent.

2. The annual increase in revenues to PSA from the increase in air freight rates authorized in the decision to which this is attached is $458,000, which amounts to approximately 0.5 percent of PSA's total common carrier revenues in the test year used in said decision.

3. It is estimated that PSA's rate of return in the test year will be 11.45 percent under existing fares and rates, and 11.89 percent under the increased air freight rates authorized.

4. The projected return on common stock book value (return on equity) averaged 22.44 percent in the best three of the last five fiscal years ending before January 1, 1970 (Exhibit 12). The return on equity in the test year under the increased rates authorized in the decision to which this is attached is 15.98 percent. Thus, the test-year return on equity does not exceed the average return referred to above.

5. The increased air freight rates are not cost based; existing rates are below a reasonable level in comparison with air freight rates maintained by PSA's major competitors in the same California markets.

6. Sufficient evidence was taken in the course of the Commission proceeding to determine whether or not the price increase meets the criteria of the rules of the Price Commission, and reasonable opportunity for participation by all interested parties was afforded.