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Decision No. 85339

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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| Application of PACIFIC SOUTHWEST AIRLINES for authority to increase its passenger air fares. | Application No. 55160 (Filed September 11, 1974; amended March 7 and 20, and July 8, 1975) |

(Appearances are shown in Decision No. 84544.)

Additional Appearances

Frederick R. Davis, for Air California, interested party.
Edward C. Cole, for the Commission staff.

FINAL OPINION

Pacific Southwest Airlines (PSA) seeks authority to increase its passenger air fares by $19,956,000 or 16.45 percent.

Interim Decision No. 84544 dated June 17, 1975 authorized PSA to increase its fares by $7,747,000 or 6.5 percent. Second Interim Decision No. 84767 dated August 5, 1975 authorized PSA to further increase its fares by $2,441,000 or 1.92 percent to offset increased fuel prices.

Further hearing was held before Commissioner Batinovich and/or Examiner Mallory on October 27 and October 29, 1975. The application was submitted on November 12, 1975 upon receipt of late-filed exhibits of PSA and the Commission staff.

Evidence in support of the relief sought in the application, as amended, was presented by PSA's president, senior vice president-finance, assistant comptroller, and a consultant.

A transportation engineer testified with respect to the results of operations study made by the staff. The engineer recommended that the full amount of the fare increase sought be granted.

Background

Decision No. 84544 resulted from hearings which considered the following matters:

1. Whether non-airline expenses and investment are completely excluded from the test year operating results offered in support of the sought fare increase.

2. Whether the deterioration of PSA's cash flow in recent months resulted from use of PSA, Inc.'s funds to offset losses from operations of non-airline subsidiaries of PSA, Inc.

3. Whether increased test year operating expenses for higher wages overstate known contractual wage increases.

4. Acquisition and operation of L-1011 aircraft:

   (a) Whether it is possible to eliminate two existing L-1011 aircraft from PSA's fleet.

   (b) Whether PSA was successful in canceling acquisition of additional L-1011 aircraft.

   (c) The amount of excessive operating expenses, if any, resulting from the use of L-1011 aircraft.

   (d) Whether acquisition of L-1011 aircraft was prudent and, if not, whether excessive operating costs and investment should be borne by PSA stockholders rather than ratepayers.

Decision No. 84544 determined that non-airline operating expenses and investment were excluded from test year operating results, and that wages included in test year operating expenses were not overstated.

Concerning acquisition and operation of L-1011 aircraft, Decision No. 84544 contains the following statements:

> "The PSA fleet currently consists of 26 aircraft in common carrier service within the State of California. The fleet is comprised of one 727-114 which is leased from Lockheed Aircraft Corporation, twenty 727-214's which include one aircraft leased from Armco Boothe Corporation and two aircraft leased from National Aircraft Leasing Company, three 737-214's, and two Lockheed L-1011's which are leased from Security Pacific Leasing Corporation. The lease of two 727-214's from National Aircraft Leasing Company will expire in June 1975. Two 727-214's currently leased to All Nippon Airways through Jetair Leasing will enter the PSA fleet to replace the two leased aircraft upon termination of the lease with National.
>
> "PSA has contracts with Lockheed Aircraft Corporation to take delivery of three additional L-1011's, one each in June, August, and November 1975. PSA is negotiating with Lockheed to delay the November delivery until early 1976 and to cancel the purchase of the two other L-1011 aircraft.
>
> "For economy reasons, PSA grounded one L-1011 on March 15, 1975 and the other on April 1, 1975. L-1011 flights were replaced by 727 aircraft. . . . PSA stated that L-1011 flights will resume and the additional seats on 727-214's will be replaced and full flight attendant staffing will be made at the beginning of the summer peak demand period. The record shows that the L-1011 aircraft will again be placed in service on June 13, 1975." (Mimeo. pages 3 and 4.)

"PSA's financial witness testified that it is not possible to eliminate the existing two L-1011 aircraft from its fleet. The witness stated that PSA has leased the two L-1011 aircraft for approximately 15-1/2 years with the leases expiring December 31, 1989. These leases are noncancellable except under the circumstances of the destruction of the aircraft. The leases are leveraged leases with the full benefit of investment credit flowing to the owner-investor. The effective interest rate under the lease is less than 4.6 percent which assertedly is a very favorable long-term financing rate. The witness testified that airline industry sources and PSA's own investigation indicate that currently there is not a market for L-1011 aircraft on a long-term lease or purchase agreement basis. . . .

"The witness also testified that PSA has not been successful in canceling acquisition of additional L-1011's. The witness indicated that negotiations are continuing with Lockheed for delay in delivery of aircraft No. 3 to the spring of 1976 and the cancellation of the order for aircraft Nos. 4 and 5. An early conclusion of these negotiations is not likely. Lockheed has proposed that PSA attempt to lease two of the aircraft to a foreign airline for a short term (such as two years) and then take the aircraft into PSA's fleet at that time. The witness stated that this proposal is now being studied and contacts are now being made with potential customers." (Mimeo. page 11.)

"We carefully reviewed the evidence adduced by PSA and the staff with respect to operations of L-1011 aircraft. We believe that the test year operating results which will be used as a basis for analyzing PSA's revenue requirements should be further adjusted at this time to exclude the operating costs associated with the use of L-1011 aircraft and that costs associated with the operation of 727-214 aircraft should be substituted therefor.

"Our determination to exclude L-1011 operating costs at this time results from our desire to further evaluate the management performance in regard to all aspects concerning the L-1011 operation. We do not wish to prejudge the matter in this interim decision." (Mimeo. page 25.)

"The acquisition of the L-1011 aircraft has been discussed at length above. The financial effect of those transactions has been enormous. In addition to the operating consequences of the planes previously delivered, we note the $16 million in deposits on undelivered aircraft which may be lost entirely, depending on the outcome of PSA's ongoing negotiations with Lockheed.

"We are alarmed by the long term implications of the apparent change in management philosophy underlying both the acquisition of the L-1011's and the corporate reorganization. We are told that one of the reasons for PSA's success has been its willingness to do things differently from other airlines, to innovate. The expansion into hotels and car rentals was apparently done because the interstate carriers were engaging in such businesses with the encouragement of the Civil Aeronautics Board. We are concerned that these decisions are evidence that PSA may become 'just another airline', and, if so, it then must expect to endure the financial fortunes and misfortunes associated with the airline business generally." (Mimeo. page 29.)

Concerning the operations of PSA, Inc. (PSA's parent corporation) and its affiliates, Decision No. 84544 comments as follows:

> "...PSA, Inc. has incurred substantial operating losses from its hotel and broadcasting operations which has caused the parent company to be in a very poor financial position. The purpose of this proceeding is to focus on PSA's common carrier airline operations to the exclusion of other operations conducted by PSA's parent corporation. No attempt is made herein to determine the financial status of PSA, Inc. in the test year used herein nor to make PSA, Inc. whole. Our sole consideration is to ensure that we fairly and reasonably measure the test year operating revenues, expenses, rate base, and earning requirements of PSA's common carrier airline services, and to provide reasonable and nondiscriminatory airline fares for that service in the future." (Mimeo. page 28.)

> "We cannot escape the conclusion that the greater part of the airline's immediate financial problem is the product of the parent's management. We question the prudency of the decision, discussed above, to buy $8,000,000 of treasury stock. We believe that such decisions are the reason that, in each of the last two years, PSA has paid to its parent more in dividends than it has earned. We conclude that such transactions have had a detrimental effect on airline cash flow requirements." (Mimeo. page 29.)

Decision No. 84544 was interim in nature and granted only partially the relief sought in order that the Commission could review PSA's experience during its peak travel months of June, July, and August, and to enable the Commission to be advised concerning further steps taken by PSA, Inc. to divest its uneconomical hotel and broadcast subsidiaries, and to determine the current plans of PSA concerning its L-1011 aircraft.

Operation of L-1011 Aircraft

PSA's fleet of aircraft includes Boeing 727 and 737 equipment and Lockheed L-1011 and L-188 (Electra) equipment. Decision No. 84544 concluded that the test year operating results which were used as a basis for analyzing PSA's revenue requirements should be adjusted to exclude the operating costs associated with the use of L-1011 aircraft, and the costs of 727-214 aircraft should be substituted in order that the Commission could further evaluate all aspects of L-1011 operation in our final decision. The background concerning the acquisition and operation of L-1011 aircraft is set out in Decision No. 84544 at mimeo. pages 11 through 15.

PSA's president testified that since the hearings conducted in the initial phase of these proceedings, PSA has grounded the two L-1011 aircraft now in its fleet and has deferred the acquisition of three additional L-1011 aircraft for which deposits of $16,000,000 have been made with Lockheed Aircraft Corporation. Exhibit 14 shows that PSA has offered its L-1011 aircraft to all commercial airlines using jet aircraft known to be operating anywhere in the world. The witness stated that there is an excess of wide-bodied jet aircraft for sale in the world market and that no firm offer has been received. The witness stated that in the event that it is not possible to dispose of the two L-1011's now in its possession, those aircraft would be needed in PSA's operations and would be again placed in service in June 1976.

Evidence Re Subsidiaries

PSA's senior vice president-finance testified with respect to PSA, Inc.'s plans for its hotel and broadcasting subsidiaries. The witness stated that PSA, Inc. has decided that it would dispose of the broadcasting stations and hotels by February 28, 1976. Therefore, it has set up a reserve to cover the expected losses involved in the disposition of such properties by that date. A loss of $6,189,000 is expected, which will involve a projected net cash outlay of $2,067,000 on the target date of February 28, 1976.

Traffic Estimates

A consultant employed by PSA and the Commission staff witness presented estimates of passenger traffic for the year 1976.

The consultant, in Exhibit 17, developed projections of passenger traffic between airport pairs on PSA's routes based on historical data, economic conditions, and other factors affecting air passenger transportation. Exhibit 17 shows that PSA carried 6,386,000 passengers in 1974. The witness estimated that PSA would carry 6,376,000 passengers in 1975. His forecast for 1976 is 6,565,000 passengers, which includes Lake Tahoe and Long Beach-San Jose/Oakland service on a full-year basis.

The corresponding estimate of the Commission staff witness, as set forth in Exhibit 23, is that PSA will carry 6,552,100 passengers in 1976.

The forecasts of both witnesses indicate that the continuous growth of traffic in California has ended, at least for the time being, and that 1976 passenger traffic will be at a level only about three percent greater than that for 1975.

Operating Efficiencies

The consultant also presented data in Exhibit 17 to show the following:

1. Interstate carriers operating route segments in California which are competitive with PSA all show that their intra-California operations are conducted at a loss.[1/] Those carriers all meet the jet commuter fares maintained by PSA. The interstate carriers, as a group, assertedly would require an average 40 percent increase in fares to reach the break-even point for their intra-California operations.

2. The present San Francisco-Los Angeles (SFO-LAX) jet commuter fare of $22.50 (including tax) is substantially below corresponding fares maintained by other airlines for the same flight segment lengths. The yield of the SFO-LAX jet commuter fare is 6.67 cents per mile; the corresponding yield of other air fares range from 11.52 to 13.17 cents per mile. Assertedly the reason that the fare with the lowest yield can be maintained in the SFO-LAX market is that PSA is the most efficient air carrier of those compared, and that PSA is the fare setting carrier in that market.

3. PSA is an efficient carrier compared with carriers regulated by the Civil Aeronautics Board (CAB). Statistics compiled by CAB show that PSA is the most efficient airline with respect to (a) number of passengers per employee, (b) revenue passenger miles and revenue per employee, and (c) system average annual labor cost per employee. PSA also reduced its number of employees in 1974 versus 1973 more rapidly than did any other airline, when faced with declining traffic and higher energy and other operating costs.[2/]

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1/ The air carriers in question are: Hughes Airwest, Trans World Airlines, United Air Lines, Western Air Lines, American Airlines, and National Airlines.

2/ Air California and other carriers operating intra-California route segments are included in these comparisons.

The foregoing data was presented in response to the following statements in Decision No. 84544, supra:

> "The record in this proceeding contains substantial data which show that PSA is not operating as efficiently as it has done so in the past. In the further proceedings to be held in this matter we intend to pursue our investigation as to whether PSA continues to be the 'most efficient' operator in the California corridor." (Mimeo. page 28.)

> "All of these circumstances taken together raise some fundamental questions with regard to the appropriate regulatory scheme for intrastate airlines. We are concerned that the inefficiency of PSA results simply in higher fares. We intend to explore means by which one carrier's inefficiency can be offset by another, more efficient carrier. We believe that this and future fare increases should be granted with the understanding that the affected routes will be available to other carriers who are willing to fly at the previously effective fares. We believe that we must consider changes in the nature and extent of our regulation of routes and fares, and we intend to institute our own investigation into the subject of airline regulation." (Mimeo. page 30.)

Estimated Results of Operations - PSA

PSA's assistant controller set forth his projected operating results for the year ending December 31, 1976 in Exhibit 18. The following table summarizes PSA's test year estimates of operating results under interim fares and under the full amount of increase sought in the application, as amended:

# TABLE 1

## PACIFIC SOUTHWEST AIRLINES

Projected Operating Results
Year Ended December 31, 1976
(000's Omitted – Except for Percentage and Yield)
(Exhibit 18)

| | Results Without Additional Proposed Fare Increase | Results With Proposed Additional Fare Increases |
|---|---|---|
| Flight hours | 59.9 | 59.9 |
| Passengers | 6,565 | 6,565 |
| Revenue passenger miles | 2,066,334 | 2,066,334 |
| Available seat miles | 3,483,246 | 3,483,246 |
| Load factor | 59.3% | 59.3% |
| Yield | 6.454¢ | 7.039¢ |
| **Revenues** | | |
| Passenger | $133,552 | $145,650 |
| Beverage (net) | 821 | 821 |
| Freight | 2,095 | 2,095 |
| Baggage, mail, and misc. | 1,016 | 1,016 |
| Flight training (outside) | 1,681 | 1,681 |
| | $139,165 | $151,263 |
| **Expenses** | | |
| Aircraft leases | $ 5,154 | $ 5,154 |
| Flying operations | 50,301 | 50,301 |
| Direct and indirect maintenance | 19,698 | 19,698 |
| Passenger service | 8,772 | 8,772 |
| Aircraft servicing | 9,273 | 9,273 |
| Traffic servicing | 14,232 | 14,232 |
| Servicing administration | 852 | 852 |
| Reservations and sales | 10,074 | 10,405 |
| Advertising and publicity | 2,626 | 2,626 |
| General and administrative | 9,448 | 9,448 |
| Depreciation | 12,165 | 12,165 |
| Interest (net) | 2,373 | 2,373 |
| | $144,968 | $145,299 |
| Income (loss) before taxes | $ (5,803) | $ 5,964 |
| Taxes paid | 0 | 3,923 |
| Net income (loss) | $ (5,803) | $ 2,041 |
| Return element | $ (3,430) | $ 4,414 |
| Rate base: Fixed assets | $ 85,795 | $ 85,795 |
| Inventory | 998 | 998 |
| Working cash | 4,923 | 4,923 |
| | $ 91,716 | $ 91,716 |
| Rate of return | (3.74%) | 4.81% |
| Operating ratio | 102.46% | 97.08% |
| Return on stockholders' equity | negative | 2.65% |

The above table includes interest as an operating expense. This Commission considers interest as a below the line expense and, therefore, interest expense should be excluded from operating expense and net income upon which rate of return is calculated.

Table 1 includes the operating expenses of two L-1011 aircraft for the month of June 1976 and succeeding months.

Operating expenses also include the most recent increase in jet aviation fuel prices of Shell Oil Company, PSA's major supplier, effective October 18, 1975 (Exhibit 21). Exhibit 22 is a letter from Exxon Company, USA, which states, in part, that upon expiration of PSA's contract with Exxon on March 31, 1976, the price of fuel at Oakland will be "anybody's guess" and that to "predict future prices is a hopeless task".

Test year estimates of wages include all contractual wage increases occurring in the test year, and PSA's current offer for those crafts whose contracts are now being negotiated. In addition, test year wages and salaries for officers and nonunion employees are increased 7 percent over 1975 wages, to cover wage increases to be granted to such employees to match the median percentage increases in wage contracts for union personnel.

Federal income taxes in Table 1 do not reflect the full amount of the available investment credit carried forward from the 1974 federal income tax return. It is PSA's contention that the carried forward credit should be reduced by the amount of credit which would have been used in prior years if the full amount of revenue increases had been granted to PSA as sought in prior fare applications, and if no regulatory lag had resulted in the granting of such fare increases. A computation of taxable income that was lost to PSA because of regulatory lag and reductions from sought fare levels is shown in Exhibit 19. In that exhibit, PSA's assistant controller developed that there would have been $32,351,000 additional taxable income, the tax on which could be offset, in part, by available investment tax credit. If that income had been earned, $7,764,000 of investment tax credit would have been used on prior income tax returns, leaving only $906,000 for use as an offset against PSA's 1976 income tax liability. This argument is nonsense.

PSA's estimates in Table 1 understate net income from airline operations to the extent that interest is included as an operating expense, and to the extent that test year income taxes do not give effect to the full amount of investment tax credit from prior years which is available as an offset against its test year tax liability.

Test Year Operating Results - Staff

The study of the Commission's Transportation Division is set forth in Exhibit 23. The study contains the estimated results of operations for PSA for the rate year 1976 under conditions of (a) including Lockheed L-1011 aircraft and (b) excluding such aircraft. The study is based on the company's operations for the months of June, July, and August 1975 using present routes and the Lake Tahoe service.

The staff exhibit contains estimated results of operations under fares originally proposed in the first amendment to the application and under the higher fares proposed in the third amendment to the application. The staff exhibit states that present fares produce insufficient earnings. The fares requested in the third amendment to the application (proposed fares) produce an estimated rate of return of 11.53 percent excluding L-1011 aircraft operating expenses and rate base factors, and 7.50 percent including L-1011 operating expenses and rate base factors. The corresponding operating ratios (after taxes) are 94.38 percent and 95.89 percent, respectively.

The witness concluded that the fares proposed in the third amendment will be reasonable considering the rate of return and operating ratio authorized in PSA's last general fare increase proceeding.[3] The staff witness recommended that such fares be granted.

The following table depicts the staff's estimate of operating results for a 1976 test year under fares recommended for adoption by the staff witness.

3/ The last general passenger fare increase granted to PSA was in Decision No. 81793 dated August 21, 1973 in Application No. 53525. The fares authorized in that decision were designed to produce for PSA's scheduled airline operations a rate of return of 12.10 percent and an operating ratio (after taxes) of 88.47 percent for the test year used therein.

TABLE 2

COMMISSION STAFF

Estimated Results of Operation
Pacific Southwest Airlines
(Exhibit 23 - Table 2)

| | Estimated Year 1976 Requested Fares * Without L-1011 Aircraft | With L-1011 Aircraft |
|---|---|---|
| **Statistics** | | |
| Passengers | 6,552,100 | 6,552,100 |
| Flight hours | 62,700 | 62,400 |
| **Revenue** | | |
| Passenger | $140,411,500 | $140,411,500 |
| Beverage (net) | 805,200 | 805,200 |
| Freight | 1,748,000 | 1,748,000 |
| Baggage, mail, and Misc. | 312,000 | 312,000 |
| Flight training | 4,544,000 | 4,544,000 |
| Total | $147,820,700 | $147,820,700 |
| **Expenses** | | |
| Leased aircraft | $ 2,902,000 | $ 5,156,000 |
| Flying operations | 51,221,200 | 51,520,600 |
| Direct maintenance | 12,900,000 | 13,250,000 |
| Maintenance burden | 4,982,800 | 4,982,800 |
| Passenger service | 7,660,600 | 7,676,600 |
| Aircraft servicing | 8,999,300 | 8,999,300 |
| Traffic servicing | 13,781,900 | 13,781,900 |
| Servicing administration | 800,000 | 800,000 |
| Reservations and sales | 9,828,800 | 9,828,800 |
| Advertising and publicity | 2,808,200 | 2,808,200 |
| General and administrative | 9,262,300 | 9,262,300 |
| Depreciation | 10,570,000 | 11,326,000 |
| Total | $135,717,100 | $139,392,500 |
| Income before taxes | $ 12,103,600 | $ 8,428,200 |
| Income taxes | $ 3,801,000 | $ 2,354,000 |
| Income | $ 8,302,600 | $ 6,074,200 |
| Operating ratio | 94.38% | 95.89% |
| Rate of return | 11.53% | 7.50% |
| Rate base | $ 71,984,000 | $ 80,937,000 |

*Fares as shown on Exhibit A of Third Amendment.

Rebuttal Exhibit 25 contains adjustments to the data in staff Exhibit 23 which PSA believes should be made to correctly reflect operating results in the 1976 test year. That exhibit proposes adjustments to staff estimates as follows:

TABLE 3

PACIFIC SOUTHWEST AIRLINES

Adjustments of Transportation Division Projection
Year Ended December 31, 1976

| Description of Change to Projection Without L-1011 (Exhibit 23, Table 2) | Reduction in Revenue Or Increase in Expense |
|---|---|
| Overestimate of flight training hours and revenues | $2,863,000 |
| Aircraft lease expense for equipment to take place of two L-1011's eliminated | 1,356,000 |
| Net change in flying operations expense due to reduction in flight hours and October 1975 increases in fuel cost | (359,000) |
| Net change in direct maintenance expense due to reduction in flight hours and reflection of current maintenance cost | 784,000 |
| Reduction in maintenance burden expense due to reduction in flight hours | (113,000) |
| Net change in passenger service expense due to reduction in flight hours and reflection of more representative cost data | 1,069,000 |
| Reduction in aircraft servicing expense due to reduction in flight hours | (204,000) |
| Increase in depreciation expense for purchase of additional L-188 and other misc. additions | 153,000 |
| Total reduction in income before taxes | $5,549,000 |

(Negative Amount)

The staff's late-filed Exhibit 29 comments on PSA's Rebuttal Exhibit 25.

One of the changes proposed in Exhibit 25 is the addition of one Lockheed Electra (L-188). The staff exhibit states that it was not informed of the acquisition of that aircraft prior to the hearing. The staff believes that if such aircraft is necessary it should be included in the test year operating results. The added aircraft will be required in the test year to provide adequate Lake Tahoe service, and operating results for the test year should be adjusted accordingly. Depreciation expense in Table 2 should be increased by $153,000 and rate base should be increased by $1,045,500.

The principal change recommended by PSA is a reduction in the number of flight hours and revenues resulting from an alleged overestimate of flight training hours and flight training revenues. PSA presented evidence to show that about 50 percent of its past flight training was conducted with B-737 equipment, which type of aircraft will be eliminated from PSA's fleet in the test year. Assertedly reduction of flight training service will reduce test year revenues by $2,863,000 and test year flight hours by 1,421. Test year expenses for flying operations, maintenance, maintenance burden, passenger service, and aircraft servicing would be reduced because of the decrease in flight hours. Those adjustments are reasonable and should be made.

PSA also proposed that the data in Table 2 be revised to reflect the October 1975 fuel cost increase of Shell Oil Company. That increase amounts to $788,000 annually. That adjustment should also be made.

Exhibit 29 contains an adjustment to the data in Column 2 of Table 2 to show the staff's estimate of test year operating results if flight training revenues are reduced by $2,863,000, flight hours reduced by 1,421, and related changes are reflected in operating expenses. The tabulation set forth below contains the adjustment to Table 2 to reduce flight training flight hours, revenues, expenses, the addition of a second L-188, and to increase fuel costs to October 1975 levels:

TABLE 4

PACIFIC SOUTHWEST AIRLINES

Results of Operations for 1976 Test Year at Proposed Fares
Revision of Table 2 to Reflect Reduced Flight Training and
To Add Second Electra Aircraft and October 1975 Fuel Costs
(Exhibit 29)

| | 1976 Test Year Without L-1011 Aircraft |
|---|---|
| **Statistics** | |
| Passengers | 6,552,100 |
| Flight hours | 61,279 |
| **Revenues** | |
| Passenger | $140,411,500 |
| Beverage (net) | 805,200 |
| Freight | 1,748,000 |
| Baggage, mail, and misc. | 312,000 |
| Flight training | 1,681,000 |
| | $144,957,700 |
| **Expenses** | |
| Leased aircraft | $ 2,902,000 |
| Flying operations | 50,850,100 |
| Direct maintenance | 12,607,600 |
| Maintenance burden | 4,869,800 |
| Passenger service | 7,538,400 |
| Aircraft servicing | 8,999,300 |
| Traffic servicing | 13,781,900 |
| Servicing administration | 800,000 |
| Reservations and sales | 9,828,800 |
| Advertising and publicity | 2,808,200 |
| General and administrative | 9,262,300 |
| Depreciation | 10,723,000 |
| | $134,971,400 |
| Income before taxes | $ 9,986,300 |
| Income taxes | $ 3,136,000 |
| Income | $ 6,850,300 |
| Operating ratio | 95.27% |
| Rate of return | 9.39% |
| Rate base | $ 72,929,500 |

The adjustment of the staff test year estimates as shown in Table 4 is reasonable and should be adopted.

The staff strongly disputes PSA's proposed adjustment to cover lease expense for two additional 727-200's to replace the two L-1011's excluded from the test year compilation shown in Table 2 (Column 2) and in Table 4. The staff showed in Exhibit 29 that the flight hours per aircraft per day using PSA's existing fleet under the annual flight hours in the staff estimate would approximate the same usage as PSA experienced in 1969. The staff contends that its estimate can be achieved by PSA and that any lesser usage would indicate that PSA's efficiency is diminishing. The staff's estimate reflects reasonably efficient operations, and PSA's adjustments to those data should not be adopted.

PSA proposed that the maintenance costs shown in Table 2 be amended to reflect a higher unit cost than the cost used by the staff. PSA contends that the staff estimates are based on 1974 data, and that if more recent experience is used, the unit costs would be greater. The record does not clearly show the manner in which the PSA adjustment was calculated; therefore, that adjustment will not be adopted.

Adopted Results of Operation

The operating results set forth in Table 4 reasonably measure PSA's operating revenues, expenses, income taxes, net operating revenues, rate base, and rate of return for a 1976 test year under fares proposed herein, and are adopted for the purpose of this proceeding. The resulting rate of return of 9.39 percent is well below that found reasonable for PSA in prior fare increase proceedings. In addition, the evidence adduced concerning operating efficiency indicates that PSA is the most efficient carrier in the California corridor, although Air California is approaching PSA. As the most efficient carrier in that corridor PSA's fare structure sets the pattern for all competing air carriers. Historically we have permitted competing air carriers to concurrently raise their fares to the levels authorized to PSA in order not to dilute the revenue requirements of the fare setting (low cost) carrier in its principal markets. Western and United will be granted similar authority to that granted PSA herein for jet commuter service, by separate orders.

The adopted test year operating results in Table 4 are based on elimination of L-1011 aircraft from test year operations. The current service offered by PSA does not involve use of such aircraft, and the number of passengers estimated for the test year does not indicate L-1011 aircraft will be required. Test year operating results should be based on the most efficient aircraft in PSA's fleet which can accommodate the passenger traffic estimated for that period. The most efficient aircraft in PSA's principal markets in the California corridor is the B-727 aircraft.

Alternate Fare Structures

In response to the request of the presiding Commissioner, PSA presented an alternate fare structure in Exhibit 24. PSA's request in the amended application is to increase all fares by the same percentage. According to PSA, that type of fare increase distorts the relationship of fares between short-haul segments and long-haul segments and is not cost-oriented. The alternative fare structure proposed in Exhibit 24 assertedly gives effect to PSA's operating costs in that initially the fares are constructed by combining terminal costs at each airport with cost per mile for flying operations. The fares so developed were modified to provide the same fares between LAX-BUR/SFO-OAK-SJO-SCK, and between LGB-ONT/SFO-OAK-SJO. Also, all short-haul segments were placed on a parity (SAN/LAX-BUR-ONT-LGB; SCK/FAT-SFO; SMF/SFO-OAK). The fare between BUR/SMF was established on a parity with LAX/SMF. The latter alternate fares are lower than originally proposed in order to stimulate traffic to and from Sacramento. The following table sets forth a comparison of PSA's fares proposed in the third amendment to the application and the alternate fares in Exhibit 24. The last two columns develop the fact that each proposal will yield substantially the same total revenues, based on 1976 traffic estimates.

TABLE 5

PACIFIC SOUTHWEST AIRLINES

Revised Proposed Fares
(Exhibit 24)

| Routes Short Segment | Fares With Tax | | Fares Without Tax | | System Weighted Yield | |
|---|---|---|---|---|---|---|
| | Per Third Amendment | Revised Proposal | Per Third Amendment | Revised Proposal | Per Third Amendment | Revised Proposal |
| SAN/LAX, BUR, ONT, LGB; SCK/FAT, SFO; SMF/SFO, OAK | $12.75 | $12.25 | $11.81 | $11.34 | $ 1.6953 | $ 1.6289 |
| LAX/FAT | 20.80 | 20.00 | 19.26 | 18.52 | .1897 | .1824 |
| FAT/SFO | 16.30 | 16.00 | 15.09 | 14.82 | .0881 | .0865 |
| LAX-BUR/SFO, SJC, OAK, SCK | 24.60 | 25.50 | 22.78 | 23.61 | 12.3102 | 12.7603 |
| LGB-ONT/SFO, SJC, OAK | 27.00 | 26.50 | 25.00 | 24.54 | 1.8305 | 1.7966 |
| LAX-SMF | 27.00 | 26.50 | 25.00 | 24.54 | 1.4847 | 1.4573 |
| BUR-SMF | 30.50 | 26.50 | 28.24 | 24.54 | .3361 | .2920 |
| LGB, ONT/SMF | 30.50 | 27.50 | 28.24 | 25.46 | .1945 | .1754 |
| SAN/SFO, SJC, OAK, SCK | 34.35 | 32.00 | 31.81 | 29.63 | 3.7480 | 3.4916 |
| SAN/SMF | 35.00 | 35.00 | 32.41 | 32.41 | .4103 | .4103 |
| SAN/FAT | 30.50 | 30.50 | 28.24 | 28.24 | .0779 | .0779 |
| SJC/OAK | 8.00 | 6.60 | 7.41 | 6.11 | .0003 | .0003 |
| TVL/LAX, BUR (No Change) | 30.00 | 30.00 | 27.78 | 27.78 | .4322 | .4322 |
| | Total system weighted yield: (before dilution) | | | | $22.7979 | $22.7917 |

Calculation based on information from Exhibit 18, Page 12 of 12.

(Midnight flyer fares are not changed from the amended application.)

In a memorandum furnished to the parties, the staff opposed the establishment of PSA's alternate fare structure, and proposed its own.

The reasons for staff opposition are set forth in its memorandum as follows: The fare structure in Exhibit 24 will lower most of the fares except for the fares between the Bay Area and Los Angeles International and Hollywood-Burbank airports. It adjusts the Los Angeles satellite airport market fares so they are one dollar higher than the Los Angeles International fares and lowers all the Sacramento fares except for the San Diego-Sacramento fare. PSA states that these fares better reflect the costs relating to each city pair. The staff has reviewed the costs for the San Francisco-Los Angeles International airports market and believes the 1976 total cost per passenger in this market will be $20.02. The third amendment fare without taxes for this market is $22.78. This appears to be quite adequate to cover costs. The proposed fare of $23.61 seems excessive.

The staff memorandum states that it has studied the fare structure of PSA and believes some changes should be made as follows:

1. Some of the Sacramento fares should be reduced.
2. The Los Angeles satellite airport fares should approximate the dollar differential proposed by PSA.
3. The Los Angeles International to Bay Area fare as requested in the third amendment is exceeding the cost of transportation.

The staff's proposed fares are shown in Table 6. Those fares are compared to requested fares in the third amendment to the application and PSA's revised fares. The staff's proposal retains the Los Angeles to Sacramento fare of $25.00, lowers the Hollywood-Burbank to Sacramento fare to $25.00, and adjusts the satellite airports of Long Beach and Ontario fares to be approximately one dollar higher than the Los Angeles International fares. The Bay Area to Los Angeles International fare was increased to compensate for the revenue loss due to the fare reductions. This fare was increased to $23.01, only 23 cents above the third amendment fare of $22.78 and 60 cents lower than PSA's proposed fare of $23.61.

TABLE 6

COMMISSION STAFF AND PACIFIC SOUTHWEST AIRLINES

Comparison of Alternate Fare Structures

| Routes | | Fares Without Tax | | |
|---|---|---|---|---|
| Between | And | Per Third Amendment | PSA's Revised Proposal | Staff's Revised Proposal |
| SAN | LAX, BUR, ONT, LGB | $11.81 | $11.34 | $11.81 |
| SCK | FAT, SFO | 11.81 | 11.34 | 11.81 |
| SMF | SFO, OAK | 11.81 | 11.34 | 11.81 |
| LAX | FAT | 19.26 | 18.52 | 19.26 |
| FAT | SFO | 15.09 | 14.82 | 15.09 |
| LAX | SFO, SJC, OAK, SCK | 22.78 | 23.61 | 23.01 |
| BUR | SFO, SJC, OAK | 22.78 | 23.61 | 23.01 |
| LGB, ONT | SFO, SJC, OAK | 25.00 | 24.54 | 24.03 |
| LAX | SMF | 25.00 | 24.54 | 25.00 |
| BUR | SMF | 28.24 | 24.54 | 25.00 |
| LGB, ONT | SMF | 28.24 | 25.46 | 26.02 |
| SAN | SFO, SJC, OAK, SCK | 31.81 | 29.63 | 31.81 |
| SAN | SMF | 32.41 | 32.41 | 32.41 |
| SAN | FAT | 28.24 | 28.24 | 28.24 |
| SJC | OAK | 7.41 | 6.11 | 7.41 |
| TVL | LAX, BUR | 27.78 | 27.78 | 27.78 |

The estimated system weighted yield is similar for all three fare structures shown in Table 6; thus the total revenue from each will be approximately the same.

At the request of the presiding Commissioner, PSA submitted late-filed Exhibit 26. That exhibit reads, in part, as follows:

> "During the course of public hearings, the presiding Commissioner specifically suggested that PSA give consideration to the institution of air service in major California markets at a discounted fare. The purpose of such a program would be to make air service available to many of those Californians hardest hit by the inflationary spiral. PSA hereby responds with a plan it believes meets and even exceeds the goals set by the Commissioner's request. Initially, it is appropriate to make brief comment on the evolution of PSA's discount marketing strategies." (Emphasis added.)
>
> "Since the beginning of its scheduled passenger operations, PSA's management philosophy has been to offer the lowest possible fares to each potential air traveler. This policy has had the ultimate result of providing to the California public travelling between points in this State the lowest cost air transportation available in the country. In 1974 and 1975, for reasons outlined in PSA's exhibits and testimony in this proceeding, the airline experienced economic setbacks. The impact of the recession coupled with the fuel crisis was unprecedented and unforeseeable. PSA's traffic growth declined alarmingly. For the first time in its history, PSA adopted severe financial austerity measures. In addition, PSA for the first time filed tariffs that were intended to generate new traffic by instituting a comprehensive discount fare program including a family fare, group fare, Saturday excursion fare and a tour fare...
>
> "Certain of these fares proved successful for PSA, not resulting in significant diversion of full fare passengers or dilution of traffic. After further application to the Commission, the successful programs remain in effect.

"...PSA has continued to review new marketing techniques. With the recent acquisition by PSA of L-188 Electra aircraft, flexibility in offering new programs has been enhanced both from a legal standpoint and operationally. Based on the suggestions of the Commissioner, the following represents a marketing approach that PSA believes most nearly achieves the purpose of providing low priced air service to those members of the public who in the past may not have been able to afford such transportation, while at the same time reasonably protecting PSA against self-diversion and revenue dilution.

"PSA is prepared to initiate non-stop service between San Francisco and Hollywood/Burbank using Lockheed L-188 Electra aircraft, expanding as traffic warrants to the Los Angeles-San Francisco market. Such service would not be restricted to so-called off-peak times, it being contemplated that two round trips per day would be offered at scheduled times convenient to the morning and afternoon traveler. The fares offered for such service would be $20 (including tax) for passengers requiring reservations and a $17.00 (including tax) space available fare which would be limited to particular segments of the California population; in particular, those on fixed incomes such as senior citizens. The $20 reserved fare represents a discount of 25%, or three trips for the price of two. The $17.00 fare is equal to the fare prevailing in the California corridor three years ago (before the impact of recession).

"PSA proposes that the foregoing program be commenced in December, 1975, but no later than January 5, 1976, on an experimental basis for a period of six months. During the test period, PSA through passenger surveys and other monitoring techniques will evaluate the financial impact and market acceptability of the program. Specifically, PSA would analyze the extent of the possible effects of diversion, dilution or unanticipated cost increases.

"PSA believes this concept will be successful financially and will benefit the public which it is intended to serve. If the program does achieve these goals, PSA will initiate expansion in the program to serve other points such as Sacramento, even if such expansion required the acquisition of a third Electra aircraft. With special reference to Sacramento, PSA is now studying a plan whereby students through high school age who visit the capital would be entitled to one-half fare privileges, whether or not the student is accompanied by an adult. Other student discount plans are under consideration as well.

"Under the expanded programs, discount fares will also be offered between Los Angeles and Hollywood/Burbank on the one hand, and the Bay Area points of San Francisco, San Jose and Oakland, on the other hand, as part of PSA's increasing service to South Lake Tahoe. Similar discount service would be provided non-stop between San Diego and San Jose in connection with PSA's Lake Tahoe authority. Of course, the Bay Area and Sacramento-Tahoe segments would be operated on a closed door basis until Commission action on PSA's pending application for permanent Lake Tahoe route authority.

"In conclusion, PSA believes that the above strategy has the ingredients that make a truly attractive package to the average consumer: non-stop flights; prime time; at discount fares with the assurance, if necessary, of reserved seats. Of course, the program is not contemplated to be an immediate financial success to PSA. However, with affirmative action by the Commission with respect to granting the full relief requested in PSA's present pending fare application, PSA believes it would have the resources to make the proposal a success."

The Commission is convinced of the need for special reduced fares limited to L-188 aircraft and directed to that portion of the public which travels on a discretionary basis and which has limited income for travel.

The order which follows will require PSA to establish discount fares of $18.52 ($20 including tax) on a reservation basis and $15.74 ($17 including tax) on a space available basis between Los Angeles or Hollywood/Burbank, on the one hand, and the Bay Area points of San Francisco or San Jose or Oakland, on the other hand. After a six-month period PSA will be directed to advise the Commission whether the experimental fares have caused dilution or diversion of traffic from the fares and service otherwise applicable, whether the experimental fares cover the avoidable costs of the additional service, and whether unanticipated costs have been encountered in the six-month period. Based on that information and the availability of L-188 aircraft, the discount fares will be reviewed.

The fare structure in the third amendment and the alternate fare structure set forth in Table 6 were not developed in contemplation of the initiation of discount fares. The revised proposed fare structure provided in Exhibit 24 should be approved.

Findings

1. In the third amendment to Application No. 55160 PSA seeks to establish air fares higher than those granted on an interim basis in Decisions Nos. 84544 and 84767 in these proceedings.

2. Evidence concerning results of operation and proposed fare levels was adduced by PSA and the Commission staff.

3. The estimated operating revenues under proposed fares, operating expenses, income taxes, net operating revenues, rate base, rate of return, and operating ratio set forth in Table 4 are reasonable for PSA's airline operations for a 1976 test year, and are adopted for the purpose of this proceeding.

4. The adopted test year operating results indicate that PSA would experience a rate of return of 9.39 percent and an operating ratio (after taxes) of 95.27 percent under the fares proposed. That operating ratio and rate of return is less favorable than corresponding operating ratios and rates of return applicable to fare increases of PSA previously found reasonable by this Commission.

5. The revised proposed fares in Exhibit 24 (Table 5) will not result in excessive earnings for PSA's operations in the test year used herein, such fares are reasonable, and the increases resulting from the establishment of such fares are justified.

6. PSA should establish experimental discount fares using L-188 (Electra) aircraft in conjunction with the increased fares authorized.

Conclusions

1. PSA should be authorized to establish increased air fares found reasonable above.

2. PSA should be ordered to establish experimental reduced air fares using L-188 (Electra) aircraft between LAX/BUR and SFO/SJC/OAK, to monitor the use of such fares, and to report the results thereof, as set forth in the order which follows.

3. PSA should be directed to periodically report to the Commission the results of its efforts to divest its affiliated broadcast and hotel properties, and when such divestiture is completed, PSA should report the financial effect of those transactions on PSA, Inc.

## FINAL ORDER

IT IS ORDERED that:

1. Pacific Southwest Airlines is authorized to establish increased air fares as set forth under the columns entitled "Revised Proposal" in Table 5, except that special fares for midnight flyer service shall be the fares shown in Exhibit A to the third amendment to Application No. 55160.

2. The temporary promotional tour fares maintained by Pacific Southwest Airlines shall be based on the increased fares authorized in the preceding paragraph.

3. Within thirty days of the establishment of the increased fares authorized, Pacific Southwest Airlines is ordered, in connection with its exhibit representation, to provide a minimum of two round trips per day between LAX or BUR and SFO or SJC or OAK at experimental fares of $18.52 ($20 including tax) reserved space and $15.74 ($17 including tax) space available using L-188 aircraft.

4. Pacific Southwest Airlines shall file with the Commission, after the initial six-month period, a report showing: (a) the economic impact of the experimental fares on PSA's net revenues, (b) whether such fares cause dilution or diversion from the full fares maintained by PSA, and (c) the avoidable costs and fully distributed costs of providing the added service with L-188 aircraft.

5. Tariff publications authorized to be made as a result of this order may be made effective not earlier than five days after the effective date of this order on not less than five days' notice to the Commission and to the public.

6. The authority granted herein shall expire unless exercised within ninety days after the date hereof.

7. Pacific Southwest Airlines shall report to the Commission on or before March 31, 1976 whether the sale of affiliated broadcast and hotel operations has been completed and the financial effect thereof on its parent, PSA, Inc. In the event the properties in question have not been disposed of by March 31, 1976, monthly progress reports shall be made.

The effective date of this order is the date hereof.

Dated at San Francisco, California, this 13th day of JANUARY, 1976.

President

William Symons Jr.

Vernon L. Sturgeon

Robert Batinovich

Commissioners

I abstain for reasons stated in my dissent to Dec. 84544
Leonard Ross